Federal Legislative & Regulatory Report

Nationwide® Retirement Solutions
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July 2009

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I. Washington Update

While the Obama Administration and Congress continue to pursue health care reform as a top domestic policy priority, Congress has also continued work on some retirement plan proposals that could potentially affect state and local government retirement plans. It is unclear if any of these initiatives will be enacted this year. However, they provide an indication of congressional priorities in the retirement plan arena, and the direction Congress will take when retirement legislation is enacted.

Fee Transparency and Investment Advice

On June 24, 2009, the House Education and Labor Committee, chaired by Representative George Miller (D-CA), met to consider *The 401(k) Fair Disclosure for Retirement Security Act of 2009* (H.R. 1984) and the *Conflicted Investment Advice Prohibition Act of 2009* (H.R. 1988). At that time, the two bills were combined to form the *401(k) Fair Disclosure and Pension Security Act of 2009* (H.R. 2989). This legislation was passed by committee (as amended) by a vote of 29 to 17 on a mostly party-line vote. If enacted, H.R. 2989 will:

- Require 401(k) plans to disclose, in one-dollar figure, fees that are taken from a participant's account in his or her quarterly statement.

- Require 401(k) service providers and plan administrators to disclose fees charged to 401(k) plans itemized in four categories: administrative fees, investment management fees, transaction fees, and other fees.
- Require plan sponsors to provide participants with certain up-front information regarding plan investment options, including information on risk, return, fees, and investment objectives.
- Require plan administrators to offer at least one low-cost index fund to plan participants in order to receive protection against liability for participants' investment losses [under ERISA Section 404(c)].
- Require service providers to disclose to plan sponsors financial benefits (such as revenue sharing) derived from third parties in connection with services rendered to the plan. Such disclosures must also include the benefits of "cross-selling" of affiliated products or services to the plan sponsor or participants. This cross-selling disclosure could include, for example, benefits derived from the receipt of rollovers from plan participants.
- Repeal the investment advice provisions of the Pension Protection Act of 2006 ("PPA") and also invalidate most existing advice arrangements permitted under the law in effect prior to the PPA.

In addition to the fee disclosure and independent advice provisions, H.R. 2989 includes adjustments to funding rules to help pension plans deal with the current economic crisis. A press release about this committee action can be found at http://edlabor.house.gov/newsroom/2009/06/house-committee-approves-bill.shtml.

Defined Contribution Plan Fee Transparency Act of 2009

Last month, Rep. Richard Neal (D-MA) introduced the *Defined Contribution Plan Fee Transparency Act of 2009* (H.R. 2779) which requires:

- Plan administrators of participant directed 401(k), 403(b) and governmental 457(b) plans to provide employees with detailed information about plan investments and fees on a quarterly basis. Plans with fewer than 100 participants may provide this information annually instead of quarterly.

  Failure to provide participants and beneficiaries with this information will result in a tax of $100/day for each day until the notice is provided or the failure is otherwise corrected. This tax applies for each violation with respect to any single participant or beneficiary. The total amount of the tax for any plan year will not exceed the lesser of 10% of the plan's assets and $500,000.

  The tax will not be imposed on failures that are corrected within in 90 days if certain conditions are met. Except for multi-employer plans, the employer maintaining the plan will be liable for the tax.
- The Treasury to develop model notices and guidance for delivering participant disclosures.
- Service providers to provide plan administrators, prior to entering into a contract for services and annually thereafter with separate detailed written information about investment fees and expenses, plan administration and recordkeeping fees and any compensation arrangement the service provider expects to receive from a source

outside the plan. Unlike H.R. 2989, H.R. 2779 does not contain a conflict of interest provision requiring service providers to disclose any financial or personal relationship with the plan, plan sponsor or another plan service provider,

Service providers who fail to timely provide plan administrators with this information will be subject to a tax up to $1,000,000 for the plan year. The tax will not apply if the failure is corrected within 90 days and will not apply to any service provider, affiliate or subcontractor that receives direct or indirect compensation for the plan year of $5,000 or less.

- Unlike H.R. 2989, the Neal Bill does not require the plan to offer a low-cost index fund.

H.R. 2779 has been referred to the House Ways and Means Committee.

The Retirement Security for Life Act

On June 18, 2009, Senators Kent Conrad (D-ND) and Pat Roberts (R-KS), members of the Senate Finance Committee, introduced the *Retirement Security for Life Act* (S. 1297). This is companion legislation to a bill recently introduced by Representatives Earl Pomeroy (D-ND) and Ginny Brown-Waite (R-FL), *The Retirement Security Needs Lifetime Pay Act* (H.R. 2748). Both of these legislative proposals would provide tax incentives for workers to select an annuity distribution for part of their retirement savings. Last year, a similar bill received broad support in both chambers of Congress, with 79 co-sponsors in the House and 12, in the Senate. Because of its cost and the current federal budget environment, it is unlikely that this issue will go far this year. However, these bills serve as a placeholder for the future and offer an indication of the direction that Congress may take.

IRS Semi-Annual Regulatory Agenda

The IRS recently released its semi-annual agenda for projects it anticipates completing by the end of the fiscal year. Although the majority of the projects deal with health care and general tax issues and programs, a few pertain to retirement related issues such as the following:

- Advance notice of proposed regulations on determining governmental plan status (definition of governmental employer); issues have been raised over the past several years as there is no consistent definition of a governmental employer among the various regulatory sources. This notice is expected to be released by the end of June.
- Proposed regulations on definition of "highly compensated employee" under Internal Revenue Code Section 414(q);
- Proposed regulations on multiple annuity starting date limitations under defined benefit plans;
- Proposed regulations to provide guidance on the definition of a "bona fide severance pay plan" and "substantial risk of forfeiture";
- Action on prior proposed regulations on the calculation of the portion of an employee's accrued benefit derived from the employee's contributions to a defined benefit plan;
- Proposed and final regulations on multiemployer defined benefit plan funding;
- Proposed and final regulations regarding hybrid retirement plans, including vesting, payment of benefits and age discrimination;

- Final regulations regarding the tax treatment of payments by qualified plans for medical or accident insurance;
- Final regulations on required notice for amendments significantly reducing the rate of future benefit accrual;
- Final regulations on benefit restrictions for underfunded pension plans;
- Final regulations on diversification requirements for certain defined contribution plans;
- Final regulations on the determination of benefit liabilities and assets for purposes of the funding requirements that apply to single employer defined benefit plans;
- Final regulations on the application of the accrual rules to defined benefit plans whose benefits are determined on the basis of the greater of two or more separate formulas;
- Final regulations on minimum required contributions for single employer defined benefit plans; and
- Final regulations for failure by plan sponsor to provide information to employees to defer receipt of retirement benefits under Internal Revenue Code Section 411(a).

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II. IRS Retires Obsolete 403(b) Documents

IRS Revenue Procedure 2009-18 lists guidance documents dating back to 1964 that have become outdated because of subsequent law changes as reflected in the final 403(b) regulations.

The two more prominent guidance documents that no longer apply are:

1. *Rev Ruling 90-24,* which allowed participants and beneficiaries to make non taxable transfers of their 403(b) account balances to other 403(b) product providers without an employer's approval or knowledge and
2. *IRS Notice 89-23,* which has been replaced with the final 403(b) regulations and the controlled group rules of the final regulations. Governmental entities (public schools, school districts, and educational organizations) and churches and qualified church controlled organizations (as defined in IRC 3121(w), however, still can rely on the portion of the guidance under Notice 89-23 that defines an employer for purposes of the controlled group rules until further guidance is issued.

Effect of controlled group rules on retirement plans

In general, the controlled group rules treat employers in the same controlled group as a single employer for purposes of determining employee compensation, hours of service, the 415 limitations, and any applicable non discrimination and coverage requirements.

Generally Notice 89-23 states that all public education employers will be treated as a single employer if:

- The employer and all entities receive at least 80% of their funding from the same tax levy; and
- Their budgets are set or reviewed by the same educational organization. An educational organization includes an entity established under state law for educational purposes and includes an educational organization that has the power to levy taxes to support a public school.

Example from Notice 89-23

A two-year college and university each receive 80% of their tax disbursement from state taxes. Their budgets reviewed by the same educational organization, which in a number of states is the State Board of Regents or its equivalent. The Notice concludes that both schools are treated as a single employer.

Although Notice 89-23 treats both employers as a single employer, they would not be treated as a single employer for purposes if:

- They are on separate payrolls, or
- The employer has historically treated one or more of its geographically distinct units as separate for employee benefit purposes and the unit operates independently on a day-to-day basis.

Exception for Universal Availability: For purposes of the 403(b) universal availability rules, the controlled group rules plans apply separately to each common law employer (501(c)(3) within

controlled group and for separately for each public educational organization that is not part of a common payroll.

Reference Material

Revenue Ruling 90-24:
http://www.legalbitstream.com/irs_materials.asp?pl=i2. Enter "90-24" in the Search Box.

Notice 89-23:
www.legalbitstream.com/irs_materials.asp?pl=i5. Enter "89-23" in the Search Box.

Final 403(b) Regulations:

(Federal Register)
http://edocket.access.gpo.gov/2007/pdf/07-3649.pdf

(IRS) http://www.irs.gov/pub/irs-tege/td9340.pdf

Universal Availability

With the exception of several groups of employees that may be excluded from a 403(b) plan, all employees of an eligible employer must be permitted to make 403(b) elective deferrals if any employee of the employer is permitted to make elective deferrals.

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III. Treasury Clarifies Treatment of ARRA Tax Credits for Government Retirees

The American Recovery and Reinvestment Act of 2009 (ARRA) provides that workers employed during 2009 and 2010 may be eligible for the Making Work Pay Credit. This tax credit is capped at $400 for single filers and $800 for joint filers, and phases out for taxpayers with adjusted gross incomes over $75,000 for single filers and $150,000 for workers filing joint returns.

The ARRA also provides a special $250 credit (retiree credit) for government retirees with retirement income who are not covered under Social Security. In a written response to a letter from Senator Susan Collins sent on behalf of a retired public school teacher, the Treasury clarified that a taxpayer with both retirement income and earned income may qualify for both credits, but must reduce the Making Work Pay Credit by the amount of the retiree credit.

The Treasury letter addresses the situation of a retired teacher with retirement income only and his spouse with earned income of $68,000. The teacher would not be eligible for the Making Work Pay Credit if he filed a separate return because he had no earned income. If he and his wife filed jointly they would qualify for the $800 Making Work Pay Credit. This credit would have to be reduced for the $250 retiree credit resulting in a $550 Making Work Pay Credit. Thus, the couple filing jointly would still receive $800 in total tax credits: $550 Making Work Pay Credit plus $250 retiree credit.

Reference Material:

www.irs.gov/pub/irs-wd/09-0105.pdf

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IV. Federal Appeals Court Upholds City's Position in DROP Case

The San Diego Police Officers Association (the Association) filed a lawsuit in the District Court for the Ninth Circuit charging the defendants – the City of San Diego et al – had violated:

- The Association's contractual right to an actuarially sound pension plan when the City reduced its contributions to the pension system; and
- The Association's vested contractual rights when the City reduced salaries for DROP participants and reduced "pick up contributions" for non DROP participants.

The District Court for the Ninth Circuit found that none of the City's actions affected the Association's constitutionally protected rights and awarded litigation costs to the defendants but denied an award of attorney's fees to any party. On appeal, the District Court of Appeals for the Ninth Circuit upheld the decision of the District Court but returned the decision of awarding of attorneys' fees back to the District Court for further consideration.

Background

The San Diego City charter:

- Empowers the City Council to set benefits and establish a retirement plan for its employees; and
- Gives San Diego Retirement System Board the power to determine eligibility for receipt of retirement benefits under the System's defined benefit plan, and to administer the plan and perform various functions related to the plan including the calculation of annual employer and employee contributions.

City employees are required to participate in the Retirement system as a condition of employment. Both the City and employees make contributions to the Retirement System's defined benefit plan. Employee contributions are "picked up" by the employer and contributed to the plan. Prior to 1996, the City's annual contribution to the San Diego Retirement System was determined by the System's actuary who set the contribution rate based on actuarial calculations.

What is the funded ratio for a defined benefit plan?

Determination of the retirement system's funded ratio is based on the current value of the system's assets compared to its future liabilities (promised benefits). Any difference between the two constitutes the "unfunded accrued actuarial liability."

In 1996, the Retirement Board and City Council changed the way the City's employer contributions were calculated. Instead of using an actuarially calculated contribution, the City's contribution rate was determined on an agreed upon rate that was lower than its actuarially determined calculation. But if the retirement System's funded ratio fell below 82.3% (trigger percentage), the City's contribution rate would be increased on July 1 following the actuarial valuation, to restore the funding ratio back to the 82.3% trigger rate.

The Retirement System fund approached the 82.3% trigger in 2001 because of declining financial conditions and investment losses. To avoid having to pay the full amount to restore

the funded ratio to the trigger level by the following year, the City, as part of labor negotiations offered a new proposal that retained the 82.3% trigger but extended the City's fixed contribution rate for another 5 years, during which time the City would increase its contributions by 1% per year. Despite the Association objections, City Council passed an ordinance specifying that the City's contributions were to be made on the rate in the new proposal.

In 2005 amid increasing financial pressures, the City engaged in bargaining sessions with several unions, including the Association, to get financial concessions that would translate into recurring budgetary savings. The City proposed to reduce:

- The salaries of union employees who were participating in the DROP, or
- The City's pick-up contribution for employees who were not participating in the DROP

Bargaining sessions between the City and the Association were deadlocked when the City made its final offer. The City's final offer would, for one year, reduce employer pick-up contributions by 3.2%, reduce DROP employees' salaries by an equivalent amount and change the service eligibility requirements for retiree health benefits. After a formal hearing, the San Diego City Council enacted an ordinance for fiscal year 2005-2006 that included the terms of the City's final offer.

The Lawsuit

The Association filed a lawsuit in federal district court against the City, the Retirement System and a number of individual defendants claiming that the City ordinance reducing the City's contributions to the employees' retirement fund violated the Association's contractual right to an actuarially sound pension system and that the City's imposition of its final offer after the breakdown of 2005 labor negotiations violated the Associations' vested contractual rights under the U.S. Constitution. In 2007, the District Court:

- Found that none of the alleged actions affected the Association's constitutionally protected rights,
- Awarded the defendants, as prevailing parties, all of their recoverable costs incurred during litigation, but
- Declined to award the attorneys fees to any of the parties involved in the lawsuit.

The Association appealed the District Court's decision and both sides appealed the District Court's decision not to award attorney's fees to any party.

The Appeal

The District Court of Appeals for the Ninth Circuit examined the Association's claims that its members had a contractual right to an actuarially sound pension plan and the enactment of the City's final offer resulted in underfunding of the pension fund which was an impermissible impairment of that contractual right under the U. S. Constitution which states that "no State shall…pass any…Law impairing the Obligation of Contracts."

The City together with the other defendants asserted that there was no federal Constitutional right under the Contracts Clause of the U. S. Constitution to an actuarially sound pension plan. Although the federal courts look to state law to determine the existence of a contract, federal law, rather than state law, determines whether state or local statures or ordinances create

contractual rights protected by the Contracts Clause of the U. S. Constitution. The state's statutory language must clearly show that the legislature intends to bind itself contractually before state legislative action may be deemed a contract for purposes of the Contracts Clause of the U. S. Constitution.

The Appeals Court agreed with the District Court after examining whether the state law had operated as substantial impairment of a contractual relationship noting that laws that substantially impair state or local contractual obligations are valid if they are "reasonable and necessary to serve an important public purpose."

The remainder of the Association's appeal claimed that:

1. DROP members' salaries are vested pension rights entitled to protection under the Contracts Clause of the U. S. Constitution. The Association argued that the DROP amounts became vested benefits immediately upon being contributed and credited to a member' DROP account and that by reducing amounts contributed by both the participants and the City reduced the return earned on the DROP account.

   The City pointed to extensive evidence that DROP employees are considered active employees and subject to all the terms of active employment. DROP members are considered retired only for the purposes of calculating pension benefits while they remain subject to all the other terms and conditions of employment including disciplinary actions and termination.

   The Appeals Court, finding the Association's argument unpersuasive, held that DROP salary is not a vested right subject to the protection of the Contracts Clause.

2. The City's imposition of its final offer in the 2005 labor negotiations and corresponding reduction in the City's pickup contributions also impaired vested pension benefits in violation of the Contracts Clause of the U.S. Constitution. The Association did not cite any direct legal support for this assertion, but sought reliance on the City's historical practice of negotiating the amount of "pick-up" only in lieu or in conjunction with salary increases, confirming that the City has treated pickups as compensation and not a retirement benefit.

   The City offered evidence establishing that the City's pick-up is considered equivalent to a negotiated salary item by both the Association and other California cities noting that an employee upon termination has no vested right in the amounts contributed by the City. The Court agreed, concluding the City's pick-up contribution is not a vested contractual benefit entitled to protection under the U. S. Constitution and the reduction in the pick-up amount did not violate any of the Association's constitutional rights.

3. The Association's final contention stemming from the 2005 labor negotiations is that modifications imposed by the City's final offer on employee eligibility requirements for retiree health benefits impaired its vested contractual rights. The Association argued that retiree benefits are a vested right and not longevity based fringe benefit for long term employees. The Court held that retiree health benefits were longevity based benefits that continued only if they were renegotiated as part of a new collective bargaining agreement.

Conclusion

The District Court of Appeals affirmed the rulings of the District Court but sent the award of attorneys fees back to the district court for further consideration.

www.ca9.uscourts.gov/datastore/opinions/2009/06/10/07-56004.pdf

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V. IRS Compliance Help for Public Employers – Part I

The IRS Office of Federal, State and Local Governments (FSLG) is responsible for ensuring federal tax compliance by federal, quasi-governmental and state agencies; city, county and other units of local government. To help public employers understand their compliance obligations, the FSLG has issued the following online guidance materials.

What happens during an examination?

Although there is no statutory or common law definition of the term "examination," an examination, or audit, may be described as the systematic inspection of the books and records of a taxpayer for the purpose of making a determination of the correct tax liability.

Because government entities are generally exempt from federal income tax, IRS compliance efforts are generally focused on employment tax and information return reporting. During examinations, FSLG Specialists search for errors or omissions on employment tax and information returns. Examples of common mistakes employers make include:

- Discontinuance of reporting wages for FICA tax purposes before the annual wage limitation was reached ($106,800 for 2009).
- Taxing compensation for Federal income tax withholding purposes but not for FICA and/or Medicare tax withholding.
- Failing to report the wages of all employees such as wages of janitors, part-time or seasonal workers, etc.
- Incorrectly reporting the amount of wages or income tax withheld
- Not reporting bonuses, vacation pay, or other payments that constitute additional wages for employment tax purposes.
- Not reporting the fair market value of non-cash compensation.

During an audit, the FSLG specialist will also verify that:

- All appropriate returns were filed timely, and
- All deposits were made timely.

Quick Reference Guide for Public Employers

The Guide is intended to provide a brief introduction to basic Federal employment tax and reporting information for governmental employers and the most common issues faced by public employers. The Guide provides a number of links to other publications and guidance. One of the topics covered in this guide is the application of employment taxes to special situation public workers such as:

Elected and Appointed Officials

With the exception of fee-based officials, elected and appointed officials are employees for Federal income tax withholding purposes. For social security and Medicare purposes, all elected and most appointed officials are employees of the public entity they serve. More information is available in IRS Publication 963.

Volunteer Firefighters

Volunteer firefighters are considered employees and their remuneration is generally subject to all withholding taxes. However, if the payment is reimbursement for out-of-pocket expenses actually incurred in the course of work, and the payment is properly accounted for, then the payment is excludable from the rest of the firefighter's Form W-2.

If the employee:

1. Incurs the expenses in the performance of work;
2. Adequately accounts for the expenses within a reasonable period of time, and
3. Returns any amounts in excess of expenses within a reasonable period of time,

Then: No tax reporting is necessary.

If these conditions are not met, the reimbursements or advances are included in wages, and the employee may deduct allowable business expenses on Form 1040.

Election Workers and Officials

Payments to individuals for election work are exempt from income tax withholding but may be subject to social security and Medicare tax either under a Section 218 Agreement, or by law, if the amount of compensation exceeds an annual threshold ($1,500 in 2009). If payments are subject to income tax or social security and Medicare tax withholding, Form W-2 should be furnished to that individual. If the employee has non-election work wages from the same employer, the normal Form W-2 rules apply to those wages.

Road Commissioners

The road commissioner is an elected or appointed official of the governmental entity, and therefore is an employee who can be supervised, directed, and disciplined, and a work plan and job description can be developed for the position by the appointing body. All remuneration that the road commissioner personally receives is wages.

The Guide also covers:

- Compensation
- Social Security and Medicare coverage (includes coverage flowcharts)
- Retirement and 457 plan coverage
- Fee based public officials
- Fringe Benefits (includes a table showing the application of employment taxes for non cash fringe benefits)
- Information Reporting (Forms W-2, 1099, 941, 945 etc.)
- Backup Withholding and
- Key dates for Section 218 of the Social Security Act.

What State and Local Government Employers Should Know about Social Security

The IRS Office of Federal, State and Local Governments (FSLG) works with the Social Security Administration (SSA) to educate government entities about **Section 218 Social Security Agreements** (voluntary agreements that provide social security and/or Medicare coverage for state and local government employees). While IRS is responsible for administering and enforcing the tax laws, SSA processes and interprets Section 218 agreements and related coverage issues.

The IRS has issued a brief summary of the coverage rules for social security and Medicare. State and local government employees may be covered for social security and Medicare either **mandated by law**, or provided under a **Section 218 Agreement** between the state and the Social Security Administration. Under some circumstances employees may be covered by neither social security nor Medicare.

When employers fail to properly apply the terms of coverage to their employees, incorrect reporting, including non-reporting or erroneous coverage, will result and continue until the Social Security Administration or the IRS becomes involved, typically during claims processing or examinations and audits.

Reference Material

IRS Office of Federal, State and Local Governments website
www.irs.gov/govt/fslg/article/0,,id=159772,00.html

Quick Reference Guide for Public Employers
www.irs.gov/pub/irs-tege/public_employers_outreach_guide.pdf

Publication 963, Federal-State Reference Guide
www.irs.gov/pub/irs-pdf/p963.pdf

Publication 15, Employer's Tax Guide
www.irs.gov/pub/irs-pdf/p15.pdf

FSLG Fact Sheets
www.irs.gov/govt/fslg/content/0,,id=110150,00.html

What State and Local Government Employers Should Know about Social Security FSLG website
www.irs.gov/govt/fslg/article/0,,id=182888,00.html

Social Security Administration website for State and Local government employers:
www.ssa.gov/slge/

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VI. IRS Compliance Help for Public Employers – Part II

EPTA Compliance Assistance Tools

The IRS Employee Plans Team Audit (EPTA) program examines large public and private sector employer plans (more than 2,500 participants) by a team of specialists. The EPTA has developed several tools to assist employers in understanding the EPTA Program and issues found during EPTA examinations.

EPTA Tips and Trends

Trends are plan mistakes that area IRS Employee Plans sees recurring in large case audits and voluntary compliance submissions. This topic covers common trends across all plans, 401(k) plans, multi–employer plans and defined benefit plans with numerous links to more extensive information and guidance. Trends of interest specifically to governmental employers include:

457(b) Governmental Plan Trends

- *Failure to follow unforeseeable emergency 457 plan distribution rules*

  Improper administration of distributions made on account of an unforeseeable emergency is a frequent source of errors for sponsors of 457(b) plans. Hardship distributions from a 457(b) plan are only permitted when the participant is faced with an unforeseeable emergency and where the amount of these distributions does not exceed the amount reasonably necessary to satisfy the emergency need. Although determining whether a participant or beneficiary is faced with an unforeseeable emergency is based on the facts and circumstances of each situation, rules and examples defining "unforeseeable emergency" must be applied. Errors made in administering these distributions include mistaken determinations, inadequate documentation, and distributions that exceed the amount needed for the unforeseeable emergency.

- *Failure to comply with IRC Section 457(b) catch-up limitations*

  Generally, 457(b) plans can allow for two types of catch-up provisions. The first is similar to the age 50 catch-up contributions in 403(b) and other defined contribution plans, and amounts to an additional $5,500 (in 2009) that can be contributed by participants who are over age 50 by the end of the calendar year.

  The second [only available to governmental 457(b) plans] is much more complicated and is available to 457(b) plan participants who are within 3 years of normal retirement age. This second catch-up feature can be equal to the annual employee deferral limit for the year ($16,500 for 2009) so it can effectively double this limit in a given year, but the IRC Section 457(b)(3) catch-up increase is limited to unused deferral limits from previous years under a formula that is affected by several factors. This formula essentially means that participants who had previously deferred the maximum amount of money into a 457(b) plan every year they were eligible for that plan would not be able to utilize this extra IRC Section 457(b)(3) catch-up. Participants in eligible governmental 457(b) plans may only use it in the last 3 tax years **prior** to the tax year in which the participant

reaches normal retirement age under the terms of the 457(b) plan. These governmental IRC Section 457(b)(3) catch-up contributions cannot be combined with age 50 catch-up contributions in any year, so eligible participants are limited to contributing the higher of their age 50 catch-up increase or their IRC Section 457(b)(3) catch up increase.

- *Failure to comply with IRC Section 457(b) permissive service credit transfer rules*

  An eligible governmental 457(b) plan may permit participants and beneficiaries to transfer deferred amounts to defined benefit governmental plans for the purpose of purchasing permissive past service credit under the receiving defined benefit governmental plan. Permissive past service credit is credit for a period of past service recognized by a governmental defined benefit plan. Both the transferee and receiving plans must permit the transfers and the receiving plan must also prevent the amount transferred from exceeding the amount necessary to fund the benefit resulting from the past service credit on an actuarial basis. The participant and beneficiary must voluntary contribute the transferred amount to the defined benefit governmental plan in addition to any regular employee contribution required under the plan. These transfers are not treated as distributions for purposes of the IRC Section 457.

403(b) Tax Sheltered Annuity Plans

- *Failure to properly apply universal availability to participants*

  Elective deferrals, under a 403(b) plan are not governed by a mathematical test as there is for a private sector 401(k) plan. Instead they are subject to "Universal Availability" which requires that participants who are not among one of the permissively excludable groups must have the right to make elective deferrals. Universal availability has many, factors, and it applies to each common-law entity separately. A prominent issue in the conduct of exams is confirming that all employees who technically have the right to make elective deferrals are actually offered that right in practice, are given a meaningful notice of that right and the timing requirements for making and changing elections.

  A central issue in examining the universal availability requirement is confirming that all individuals who are common-law employees and not members of a permissively excludable group are eligible to make elective deferrals. Employees eligible under other deferral plans (such as 401(k) plan or 457(b) governmental eligible plans that also provides for salary deferrals), nonresident aliens, and employees who ordinarily work less than 20 hours per week can be excluded without violating the universal availability requirement. Among these permissive exclusions, determining when employees ordinarily work less than 20 hours per week and ensuring that the written plan spells out the details of this exclusion present the most problems. For example, how are hours tracked and monitored? Exams discover 403(b) plans that improperly exclude groups such as collectively bargained employees, visiting professors, employees who have taken vows of poverty, employees who make a one-time election to participate in a governmental non-403(b) plan, and specified categories of employees, such as substitute teachers, janitors, cafeteria workers, and nurses. These groups are not permissive exclusions.

- *Failure to properly track and limit 15-year rule contributions and combine with age 50 Catch-up Feature*

  Employee elective deferrals can have different classifications depending on the circumstances of a particular participant and, in the case of the permissive 15-year rule contributions and the permissive age 50 catch-up contributions, the ordering rules required for classifying these contributions are a potential source of errors. The failure to track and properly limit contributions made under this 15-year rule is a common error and usually occurs either because weak internal controls prevent the plan sponsor from maintaining records of the employee's elective deferrals in all prior years throughout the employment period or the employee is not employed by an eligible employer.

  Catch-up ordering is another aspect that causes errors. A 403(b) plan may permit participants who are age 50 or over by the end of the calendar year to make additional salary deferral contributions that are classified as catch-up contributions. These catch-up contributions receive favorable treatment because they are not subject to the general limits that apply to 403(b) contributions, but properly identifying and classifying these contributions is a frequent compliance issue. Contributions can only be considered age 50 catch-up contributions **after** the employee elective deferral limits and the 15-year rule amounts are met for the tax year. Therefore, properly designating employee elective deferrals as age 50 catch-up contributions requires precision in classifying and limiting the overall employee elective deferral and the 15-year rule contribution limits as well.

- *Failure to have a written plan document (effective 1-1-2010)*

  The regulations require that the written 403(b) plan document include all of the material provisions regarding eligibility, benefits, applicable limitations, the contracts available under the plan, and the time and form under which benefits distributions would be made.

  For the very first time, non ERISA governed 403(b) programs are required to be maintained pursuant to written defined contribution plans for taxable years beginning after December 31, 2009. These written plans must satisfy the 403(b) requirements in form and contain all the terms and conditions for eligibility, limitations, and benefits under the plan, although there is no requirement that all of the materials that make up a plan must be in a single document or form. This essentially means that all provisions concerning the way the plan works have to be spelled out in a plan and the plan has to operate in accordance with these written terms.

  Although this is a new requirement that all 403(b) plan sponsors should take special care to comply with, many organizations may already have the detail of these types of programs spelled out though a number of items that are stapled or paper clipped together. To help organizations meet this written plan requirement, a revenue procedure was released that contains model plan language that may be used by public schools to comply with the written plan requirement. Although the model plan language is provided specifically for use by public schools, it could be used as a starting point for a 403(b) plan sponsor to help adopt or amend a very simple basic 403(b) program to comply with the new written plan requirement.

- *Failure to comply with the IRC Section 403(b) post severance contribution requirements*

  No employee elective deferrals can be made from compensation payable from any payroll period that begins after severance from employment unless the compensation meets the 2½ month rule described below, the total and permanent disability rule, or the qualifying military service rule. The 2½ month rule allows employee elective deferrals to be made from certain compensation paid by the later of 2½ months after severance from employment or the end of the limitation year (usually a calendar year) that includes the date of severance from employment. Regular compensation, overtime, shift differential, commissions, bonuses, and other similar payments are eligible for the 2½ month rule as well as certain leave cash-outs and deferred compensation payments. Employees may also be eligible to make elective deferrals from post severance compensation paid to them when they are permanently and totally disabled or when they end employment to perform qualified military service if specific requirements of the total and permanent disability or qualifying military service rules are satisfied.

- *Failure to limit contributions under IRC Section 415*

  Generally, the sum of elective deferrals and employer contributions made on behalf of any participant cannot exceed the lesser of $49,000 (for 2009) or 100% of includible compensation for the participant's most recent year of service, plus any age 50 catch-up contributions. Employee elective deferrals include the 15 year catch-up discussed above, but if an eligible employer also sponsors a 457 plan for its employees, employee elective deferrals do not include contributions under the 457 plan for these purposes. Also, contributions to multiple 403(b) accounts, or other qualified plans or simplified employee pensions of certain related entities, must be combined in testing this limitation for each participant. Errors made in determining includible compensation, the most recent year of service, whether contributions from other plans are included, or how the IRC Section 415 limit applies to contributions after retirement can cause 403(b) plans to fail to comply with the required limitations under IRC Section 415.

The EPTA has also developed two other tools to help employers understand what will be covered during and EPTA exam and to help employers keep their plans in compliance.

- Internal Controls Questionnaire

  This questionnaire offers examples of questions asked by Employee Plans examiners to gain an understanding of the system procedures and internal controls. This product was developed with outside practitioner input in an effort to make plan sponsors and administrators understand the responsibilities and coordination needed to keep a qualified plan and trust in compliance with the tax laws. The questionnaire consists of four topics: Human Resources, Payroll, Plan failures and plan administration.

- Taxpayer Documentation Guide

  This guide provides a comprehensive listing of documents needed for a proper examination of issues identified for examination and the plan information needed to be kept current and readily available or recoverable when requested for an audit. There are separate guides, valid for plan years 2003-2005, for defined contribution and defined benefit plans covering the life cycle of a plan from establishment through termination.

The guide is currently under review for updates related guidance and law changes. An updated guide will be available in the coming months.

Reference Material

EPTA Compliance Trends & Tips
www.irs.gov/retirement/article/0,,id=206497,00.html

EP Team Audit (EPTA) Program website
www.irs.gov/retirement/article/0,,id=129221,00.html

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VII. Keeping watch

You can find the most recent information on issues affecting governmental defined contribution plans, plan sponsors and plan participants on the Employer page of our plan Web site, NRSforu.com. In addition, we report guidance on legislative and regulatory activity relevant to government sector defined contribution plans through:

- *Federal Legislative and Regulatory Report* — distributed monthly and posted on the Legislative / Regulatory tab on the Employer section of NRSforu.com. It's available online and for download.
- *Plan Sponsor Alerts* — published as needed to announce breaking news, and distributed by e-mail and posted in the Plan Sponsor Corner of NRSforu.com.

About this report

JOANN ALBRECHT, CPC, QPA, Plan Technical Consultant, our resident expert on legislative and regulatory issues, prepares this report. As a leading member of the Nationwide Legislative Task Force, she identifies how federal actions may affect your plan and its participants.

Albrecht is a member of American Society of Pension Professionals and Actuaries (ASPPA), currently serving on its Government Affairs Committee, is immediate past chair of the ASPPA Tax Exempt and Government Plans Subcommittee and is a subject matter expert (SME) for the ASPPA Education and Examinations Committee. She is a current contributor to Aspen Publisher's "457 Answer Book."

BOB BEASLEY, CRC, CIC, Communications Consultant, edits it. Beasley brings 19 years of financial services communications experience to your plan. He helped prepare the *457 Guidebook* and *Fiduciary Fundamentals,* edited countless newsletters and plan sponsor communications, and in 2001 authored "What you should know about the Economic Growth and Tax Relief Reconciliation Act of 2001."

Beasley serves on the Education and Communication Committee for the Profit Sharing / 401k Council of America and is a member of the National Association of Governmental Defined Contribution Administrators.

NRM-7187AO (07/2009)

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Information presented in this newsletter was current and accurate as of the date of publication. This information is of a general and informational nature and is NOT INTENDED TO CONSTITUTE LEGAL OR INVESTMENT ADVICE. Rather, it is provided as a means to inform you of current information about legislative, regulatory changes and other information of interest. Plan Sponsors are urged to consult their own counsel regarding this information.