

**COMMENTS OF THE COMMITTEE OF ANNUITY INSURERS  
ON TREASURY/IRS SECTION 403(b) REGULATIONS PROJECT**

May 27, 2003

The Committee of Annuity Insurers (the “Committee”) is a coalition of 31 life insurance companies formed in 1982 to address federal legislative and regulatory issues relevant to the annuity industry and to participate in the development of federal policy regarding annuity taxation. The member companies of the Committee represent more than one-half of the annuity business in the United States, and include some of the largest issuers of section 403(b) annuity contracts.<sup>1</sup> Accordingly, the member companies of the Committee and their customers have a strong interest in promoting increased clarity and simplification under any new regulations promulgated under section 403(b).

The Committee commends the Treasury Department (“Treasury”) and Internal Revenue Service (the “Service”) for recognizing the importance of this project, engaging in an open dialogue on the issues, and giving the Committee the opportunity to provide input early in the process. As a general matter, the Committee believes that any new regulations under section 403(b) should preserve the flexibility that Congress intended to facilitate in connection with section 403(b) arrangements, and consistent with the historical treatment of such arrangements, should limit the burdens placed on the tax-exempt employer-sponsors. More specifically, the Committee has identified several issues that it believes should be addressed by any new regulations under section 403(b) in order to remove many of the uncertainties currently faced by employer-sponsors, issuers, and participants in connection with section 403(b) arrangements. The Committee’s comments on these issues are set forth below.

**1. Regulations Should Clarify Certain Aspects of the “Universal Availability” Nondiscrimination Requirements of Section 403(b)(12)(A)(ii).**

Under section 403(b)(12), a section 403(b) arrangement must be operated in accordance with certain nondiscrimination requirements. The first such requirement provides that, with respect to contributions not made pursuant to a salary reduction agreement, the section 403(b) arrangement must meet the requirements of paragraphs (4), (5), (17), and (26) of section 401(a), section 401(m), and section 410(b) in the same manner as if the arrangement were subject to section 401(a).<sup>2</sup> The second nondiscrimination requirement provides that, with respect to contributions made pursuant to a salary reduction agreement, all employees of the employer-sponsor must be permitted to elect to have the employer make contributions of more than \$200 pursuant to a salary reduction agreement if any employee of the organization may make such salary reduction contributions.<sup>3</sup> This requirement is sometimes referred to as the “universal

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<sup>1</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>2</sup> See section 403(b)(12)(A)(i).

<sup>3</sup> See section 403(b)(12)(A)(ii).

availability” requirement. Under section 403(b)(12)(A), employees “who normally work less than 20 hours per week” may be excluded for purposes of the nondiscrimination requirements under section 403(b)(12).<sup>4</sup> IRS Notice 89-23<sup>5</sup> provides guidance regarding these nondiscrimination requirements, including with respect to the exclusion of employees who normally work less than 20 hours per week. The Notice also provides that a section 403(b) arrangement generally is deemed to satisfy these requirements if the employer operates the arrangement in accordance with a reasonable, good faith interpretation of section 403(b).

The Committee requests that regulations clarify the following issues arising in connection with the nondiscrimination requirements under section 403(b)(12).

**a. *Universal Availability: Excluding Employees Who Normally Work Less Than 20 Hours Per Week.***

Pursuant to section 403(b)(12)(A) and Notice 89-23, employees who “normally work less than 20 hours per week” may be excluded for purposes of the universal availability requirement.<sup>6</sup> However, neither the Code nor Notice 89-23 provides further elaboration on what is meant by the term “normally work.” For example, it is unclear for how many weeks an employee must sustain at least a 20-hour work week in order to be considered to “normally work” more than 20 hours per week.

This uncertainty surrounding the meaning of the term “normally work” is particularly acute in connection with the application of the universal availability requirement. For example, substitute school teachers work sporadic schedules. In this regard, a substitute teacher at a public school may work less than 20 hours per week for six months out of the year and more than 20 hours per week for the remaining six months of the year. Moreover, because school years can be shorter than calendar years, a substitute teacher who works more than 20 hours per week for the majority of the school year may not do so on a calendar year basis. In each case, it is unclear whether the substitute teacher may be excluded by an employer for purposes of the universal availability requirement.

Given the severe consequences that may result if an employer-sponsor incorrectly determines that an employee is an excludable employee, the Committee believes that additional guidance is needed regarding the meaning of “normally works” for purposes of the universal availability requirement of section 403(b)(12)(A)(ii). For example, the regulations could clarify that an employee may be excluded from participation in a salary reduction section 403(b) arrangement as an employee who “normally works less than 20 hours per week” if the employee

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<sup>4</sup> As discussed *infra*, this rule is subject to the conditions applicable under section 410(b) (regarding minimum coverage requirements).

<sup>5</sup> 1989-1 C.B. 854, *extended by* Notice 96-64, 1996-2 C.B. 229.

<sup>6</sup> *See* section V.B.3.a.(iii) of Notice 89-23.

has not worked, nor is reasonably expected to work, at least 20 hours per week for at least a six-month consecutive period. The regulations also might clarify that if the employee is not reasonably expected to, but actually does, work at least 20 hours per week for a six-month consecutive period, then the employer must allow the employee to participate in the arrangement as soon as reasonably practicable. For this purpose, the Committee believes that a safe harbor should apply under which an employer would be treated as satisfying the “reasonably practicable” standard if (1) the employer evaluates an employee’s eligibility to participate in the arrangement at least twice per year, and (2) allows the employee to participate in the arrangement within 30 days after determining that he or she is eligible for such participation. Such clarifications would provide employer-sponsors of section 403(b) arrangements with bright-line rules to help ensure that their section 403(b) arrangements and the participants therein will not be adversely affected by virtue of an inadvertent failure to satisfy the universal availability requirement.

***b. Universal Availability: Employees, Independent Contractors, and Leased Employees.***

As described above, section 403(b)(12)(A)(ii) generally requires that the ability to make salary reduction contributions to a section 403(b) arrangement be made available to all “employees” of the employer-sponsor if any employee of the organization may make such salary reduction contributions. Often, employer-sponsors of section 403(b) arrangements employ independent contractors or “leased employees” to supplement their work forces. The universal availability requirement does not apply to such individuals, and the employer-sponsor is not required to offer participation in its section 403(b) arrangement to such individuals. In fact, such individuals are not permitted to participate, and contributions for them would not be excludable under section 403(b). However, the question of whether an individual is or is not an “employee” is not always clear. In this regard, if an employer-sponsor of a section 403(b) arrangement incorrectly classifies an employee as an independent contractor or leased employee, and based on this incorrect classification excludes the individual from participation in the arrangement, the universal availability requirement would not be satisfied. Consequently, all participants in the employer-sponsor’s section 403(b) arrangement would be adversely affected.

To prevent this result, the Committee requests that regulations provide a safe harbor for purposes of satisfying the universal availability requirement for employer-sponsors who make a reasonable, good faith interpretation of the status of a worker as an employee or non-employee. Such a safe harbor would be consistent with the general provisions of Notice 89-23, which provide that a section 403(b) arrangement will be deemed to be in compliance with the nondiscrimination requirements of section 403(b)(12) if the employer operates the arrangement in accordance with a reasonable, good faith interpretation of section 403(b). It also would preserve the status of the section 403(b) arrangement for the benefit of all participants in the event that an employer-sponsor made a reasonable and good faith, albeit erroneous, determination regarding the employment status of a particular individual.

*c. Separate Testing for Salary Deferral and Non Salary Deferral Contributions.*

The flush language of section 403(b)(12)(A) provides that certain individuals may be excluded for purposes of satisfying the nondiscrimination requirements of that section.<sup>7</sup> These individuals include employees who are students performing services described in section 3121(b)(10) and, as described above, employees who normally work less than 20 hours per week. It is clear under section 403(b)(12)(A) and Notice 89-23 that such employees may be excluded for purposes of the requirements of sections 403(b)(12)(A)(i) (regarding non-salary reduction contributions) and 403(b)(12)(A)(ii) (regarding salary reduction contributions and the universal availability requirement). While sections 403(b)(12)(A)(i) and (ii) clearly address each type of contribution separately, it is not clear whether an employee may be excluded for purposes of one contribution type while being eligible to participate in another. For example, it is unclear whether a section 403(b) arrangement may provide for participation through elective salary reduction contributions by a student performing services described in section 3121(b)(10), but then exclude the student from eligibility and from nondiscrimination testing under section 403(b)(12)(A)(i) with respect to non-elective, non-salary reduction contributions.

To clarify this situation, the Committee requests that regulations clarify that excludable employees, as described in section 403(b)(12)(A) and Notice 89-23, may be treated as excludable employees for purposes of either one or both of the nondiscrimination requirements under section 403(b)(12)(A)(i) or (ii). The Committee believes that such a clarification would benefit those employees who an employer otherwise might completely exclude from participation in a section 403(b) arrangement by providing the employer the flexibility to allow an excludable group of employees to make salary reduction contributions without triggering a requirement to take the employee into account for purposes of nondiscrimination testing for employer non-salary reduction contributions.

**2. Regulations Should Clarify the Meaning of “Health and Welfare Service Agency.”**

The limitations on elective deferrals under section 402(g) include a special rule allowing increased contributions to be made in certain cases involving a qualified employee of a “qualified organization.” Under section 402(g)(7)(B), a “qualified organization” includes a “health and welfare service agency.” However, the Code, the regulations, and other published guidance from the Service do not provide a definition of the term “health and welfare service agency.” Accordingly, the Committee requests that regulations include a definition of that term for purposes of section 402(g)(7)(B). Alternatively, the Committee requests that regulations clarify what organizations are considered to be health and welfare service agencies for this purpose.

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<sup>7</sup> The excludability of such individuals is subject to the conditions applicable under section 410(b)(4). Section 410(b) generally sets forth certain minimum coverage requirements, and paragraph (4) thereof provides for the exclusion from coverage of employees who do not meet certain minimum age and service requirements or, in the alternative, provides that such employees may be tested separately for purposes of the minimum coverage requirements.

**3. Regulations Should Clarify That an Alternate Payee Under a QDRO May Establish a Section 403(b) Annuity Contract or Custodial Account to Accept Rollover Funds.**

Under section 402(e), an alternate payee who is the spouse or former spouse of a participant in a section 403(b) arrangement (a “spousal alternate payee”) is treated as the distributee of any distribution paid to the spousal alternate payee under a qualified domestic relations order (“QDRO”). As a distributee, the spousal alternate payee may elect to roll over the distribution in the same manner as if he or she were the participant.<sup>8</sup> In this regard, if a distribution to a participant under a section 403(b) arrangement is an eligible rollover distribution, the participant may elect to roll over the distribution to another eligible retirement arrangement, which would include a section 403(b) annuity contract or custodial account.

Pursuant to the foregoing, it would appear that if an eligible rollover distribution under a section 403(b) arrangement is made to a spousal alternate payee, he or she should be eligible to elect to roll over the distribution to a section 403(b) annuity contract or custodial account, regardless of his or her independent eligibility. However, a question exists as to whether such a rollover could be made if the spousal alternate payee is not independently eligible to have a section 403(b) annuity contract or custodial account established on his or her behalf (for example, because the spousal alternate payee is not employed by an employer that is eligible to sponsor a section 403(b) arrangement). The Committee requests that regulations clarify whether a section 403(b) contract or custodial account may be issued to a spousal alternate payee under these circumstances.

**4. Regulations Should Provide Rules that are Specific to Hardship Withdrawals Under Section 403(b).**

In general, a distribution or withdrawal from a section 403(b) annuity contract or custodial account that is attributable to salary reduction contributions is prohibited before the participant attains age 59½, subject to certain exceptions.<sup>9</sup> One such exception is set forth in section 403(b)(11)(B), which provides that distributions may be made at any time “in the case of hardship.”<sup>10</sup> Neither the Code nor the regulations under section 403(b) define the term “hardship” for this purpose. Although the statute is silent concerning the standards for “hardship” under section 403(b)(11), and no guidance has been issued in this regard, the legislative history of section 403(b)(11) briefly addressed the issue.<sup>11</sup>

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<sup>8</sup> See section 402(e)(1)(B).

<sup>9</sup> See section 403(b)(11).

<sup>10</sup> In the case of hardship, withdrawals are limited to salary reduction contributions only; earnings on such amounts may not be withdrawn.

<sup>11</sup> See H.R. CONF. REP. NO. 99-841, at 453, 455 (1986); STAFF OF JT. COMM. ON TAX’N, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 715 (Jt. Comm.

In this regard, the legislative history states that the standards for “hardship” for purposes of a qualified cash or deferred arrangement (*i.e.*, a qualified plan) apply in determining what constitutes a hardship under a section 403(b) arrangement.<sup>12</sup> The Committee believes that the rules applicable to qualified plans – including the safe harbors set forth in the regulations under section 401(k) – can provide an appropriate framework for issuing guidance in connection with “hardship” determinations for purposes of section 403(b)(11). However, in order for any guidance to be meaningful in administering section 403(b) arrangements, the regulations also should recognize the unique circumstances in which a section 403(b) arrangement may operate, and provide rules and safe harbors with respect to hardship withdrawals that reflect those unique circumstances.

For example, many section 403(b) arrangements consist primarily of a contractual relationship between a participant and the issuer responsible for administering the section 403(b) annuity contract or custodial account, with the employer-sponsor having little or no involvement in administering the arrangement other than remitting salary reduction contributions to the issuer on behalf of the participant. In fact, section 403(b)(11) requires the section 403(b) annuity contract (rather than the employer-sponsor) to allow distributions of amounts attributable to salary reduction contributions to be paid only in certain circumstances, such as in the case of hardship, although an employer-sponsor may assume such obligations outside of the annuity contract.<sup>13</sup> Nevertheless, a tax-exempt employer may desire to limit its involvement in light of personnel resources, or in order to preserve its exemption from Title I of the Employee Retirement Income Security Act (“ERISA”).<sup>14</sup>

In these circumstances where there is little or no employer involvement, the obligations of administering the section 403(b) withdrawal restrictions in the contract or custodial account fall on the issuer of the annuity contract or custodial account. To address this

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Print 1987) (“legislative history”).

<sup>12</sup> *See id.* Similar to the rules under section 403(b), section 401(k)(2)(B) generally prohibits distributions from a cash or deferred arrangement before the participant attains age 59½. Section 401(k)(2)(B)(i)(IV) sets forth an exception permitting certain distributions “upon hardship of the employee.” Treas. Reg. section 1.401(k)-1(d)(2) sets forth rules applicable to hardship distributions, including specific “safe harbors” for which distributions are deemed to be made upon hardship of the employee.

<sup>13</sup> Similar rules apply to custodial accounts under section 403(b)(7)(A)(ii).

<sup>14</sup> Pub. L. No. 93-406 § 402(a)(1) (1974). In Department of Labor (“DOL”) Advisory Opinion 94-30 A, the DOL concluded that certification by an employer of an employee’s hardship would subject the section 403(b) arrangements involved to the requirements of Title I of ERISA, the requirements of which impose administrative and fiduciary duties on an employer-sponsor that the employer-sponsor may not be equipped to assume.

common circumstance, the Committee believes that regulations under section 403(b) should provide a safe harbor that allows the issuer to “stand in the shoes” of the employer for purposes of administering the hardship withdrawal requirements, including allowing the issuer to rely on a participant’s representation of hardship eligibility. In this regard, the hardship withdrawal rules set forth in the regulations under section 401(k) generally provide that an employer may rely on such representations by participants. Likewise, issuers of section 403(b) contracts and custodial accounts should be entitled to rely on such representations.

**5. Regulations Should Clarify the Status of Certain Distributions of an Annuity Contract (or Employer Relinquishment of Contract Rights in an Existing Contract) for Federal Income Tax Purposes.**

Plan termination is a unique issue for section 403(b) arrangements. Where the arrangement consists solely of individually-owned section 403(b) annuity contracts or custodial accounts coupled with salary reduction agreements, plan termination generally requires only a cessation of salary deferrals, with contract or account restrictions regarding withdrawals being administered by the issuers of the annuity contracts or custodial accounts. If a section 403(b) arrangement funded through individually-owned contracts is exempt from Title I of ERISA, but also includes a formal plan document, then the plan generally may be terminated according to the terms of the plan document, contributions may be stopped, and applicable withdrawal restrictions may be applied under the terms of the annuity contracts or custodial accounts.

However, section 403(b) arrangements that are subject to the requirements of Title I of ERISA present the additional challenge of how to effectively distribute all assets out of the arrangement in order to permit a termination that is effective for purposes of Title I of ERISA, without violating the withdrawal restrictions under the Code. Often, this issue will arise where a section 403(b) arrangement is funded through a group annuity contract, although it also may arise where an arrangement is funded through individual annuity contracts. The Committee believes that a clarification in the regulations under section 403(b) would resolve various issues under the Code, as well as facilitate a resolution to this grey area by the Department of Labor.

Accordingly, the Committee recommends that the regulations confirm that if, in connection with the termination of a section 403(b) arrangement, an employer relinquishes all rights under or control over the operation of the section 403(b) annuity contracts or custodial accounts that are part of its section 403(b) arrangement, and/or distributes individual annuity contracts to participants, then such actions will not be treated as a distribution for federal income tax purposes, including for purposes of the withdrawal restrictions of section 403(b)(11) and section 403(b)(7)(A)(ii).

**6. Regulations Should Recognize That Section 403(b) Arrangements May Provide For Vesting of Employer Contributions.**

Like other types of pension arrangements, a section 403(b) arrangement may provide for a vesting schedule in connection with contributions made by the employer. Until recently, the permissibility of vesting schedules in section 403(b) arrangements was reflected in

the statutory language under section 403(b)(1), which provided for the exclusion from an employee's income of amounts contributed by an employer "on or after such rights become nonforfeitable." Although this provision was removed from section 403(b)(1) as part of certain technical corrections made to the Code in 2002,<sup>15</sup> the prior language, as well as the legislative history to the technical correction, clearly indicates that Congress was fully aware that vesting is permitted under a section 403(b) arrangement.<sup>16</sup> Moreover, Treasury and the Service, through regulations, examination guidelines, and prior rulings, have recognized the permissibility of vesting in connection with section 403(b) arrangements.<sup>17</sup>

Section 403(b) arrangements that provide for vesting schedules generally include a formal, written plan document in addition to a section 403(b) annuity contract or custodial account. The plan document, the annuity contract, the custodial account, or a governing state statute may provide for the schedule under which the employer contributions will vest in the employee and the manner in which forfeitures are to be allocated or applied for the benefit of plan participants. With respect to the manner in which forfeited amounts may be allocated, the Committee believes that regulations under section 403(b) should clarify that the same rules that apply under the Code for other defined contribution plans also apply to section 403(b)

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<sup>15</sup> See section 411(p)(1) of the Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147 ("JCWAA").

<sup>16</sup> The technical correction to section 403(b)(1) was made necessary by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 ("EGTRRA"). Prior to EGTRRA, the annual contribution limit applicable to a section 403(b) annuity generally was the lesser of the "exclusion allowance" or the section 415(c) defined contribution limit. The above-quoted provision of section 403(b)(1) (*i.e.*, prior to its amendment by JCWAA) clarified that non-vested employer contributions did not count against the exclusion allowance. EGTRRA repealed the exclusion allowance, and a year later JCWAA removed this provision from section 403(b)(1) as a technical correction. In making this correction, Congress recognized the use of vesting schedules under section 403(b) arrangements, and intended the correction to clarify that, following the repeal of the exclusion allowance, such vesting schedules are to be disregarded for purposes of applying the contribution limits to section 403(b) arrangements. See STAFF OF THE JT. COMM. ON TAX'N, 107TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS, at 252-53 (Jt. Comm. Print 2003) (stating that the amendment of section 403(b)(1) "clarifies that the [section 415(c)] limits apply to contributions to a tax-sheltered annuity plan in the year the contributions are made without regard to when the contributions become vested.").

<sup>17</sup> See Treas. Reg. section 1.403(b)-1(d)(3); sections 3.1 and 5.2(1)a of Internal Revenue Manual (IRM) 4.72.13 (Sept. 24, 2001) (the "IRS Examination Guidelines"). See also PLR 200020062 (Feb. 24, 2000), PLR 9529006 (April 10, 1995), and PLR 200317031 (Nov. 4, 2002). Of course, private letter rulings do not constitute precedent, and may be relied upon only by the taxpayers to whom they are issued (*see* section 6110(k)(3)), although they are widely accepted as indicating the views of the IRS National Office.

arrangements. Thus, where the nonvested portion of employer contributions (and the earnings thereon) under a section 403(b) arrangement has been forfeited upon an employee's separation from service, such amount may be applied to pay plan expenses, may be offset against future employer contributions, or may be allocated to the accounts of participants and treated as annual additions under section 415(c).

**7. Regulations Should Recognize the Absence of a Formal Plan Document Requirement under Section 403(b) and Treat Arrangements Equally Whether or Not a Plan Document Exists.**

Unlike qualified plans and IRAs, there are few requirements under the Code regarding the form of a section 403(b) annuity contract or custodial account. Moreover, there is no requirement under the Code that a section 403(b) arrangement be created under, or operated in accordance with, a formal "plan document." The absence of such requirements is recognized in the IRS Examination Guidelines.<sup>18</sup> In this regard, the IRS Examination Guidelines recognize that a section 403(b) "plan" may take a wide variety of forms, and may consist exclusively of an annuity contract issued by an insurance company coupled with a salary reduction agreement between an eligible employer and participant.<sup>19</sup> Thus, the Committee believes that the IRS Examination Guidelines accurately reflect the historical development and treatment of section 403(b) arrangements. Thus, as a general matter, the Committee believes that, consistent with the position historically taken by Treasury and the Service, the regulations should reflect the fact that many section 403(b) arrangements are not governed by a formal plan document.

The Committee also recognizes, however, that some section 403(b) arrangements in fact are governed by formal plan documents, whether because the employer-sponsor voluntarily adopts such a document or because such a document is required under ERISA.<sup>20</sup> In this connection, the Committee understands that Treasury and the Service may be considering different alternatives for reviewing and approving relevant documents for section 403(b) arrangements. If such a review and approval process is developed through the regulatory process, the Committee believes that the regulations should ensure that the different documents that may constitute a section 403(b) "plan" are given equal footing under the process. Such parallel treatment could be accomplished, for example, through model language that, if used in the various documents comprising the section 403(b) "plan," will be deemed to satisfy the relevant statutory requirements without the need for separate formal IRS pre-approval.

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<sup>18</sup> See section 1.1.5 of the IRS Examination Guidelines.

<sup>19</sup> See section 1.1.1, Example 1, of the IRS Examination Guidelines.

<sup>20</sup> See Pub. L. No. 93-406, § 402(a)(1) (1974).