

Legal Alert: Intended Operation of New 403(b) Transfer Rules Requires Immediate Attention

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Further study of the new Section 403(b) regulations, and informal contacts with IRS and Treasury personnel involved in their development, suggests that the regulations may functionally require (i) changes in procedures for certain transfers or exchanges of existing contracts as early as September 25, 2007, and (ii) potentially, conversion of many “orphan” Section 403(b) products to IRAs prior to January 1, 2009. (For our earlier alert on these regulations, [click here.](#))

In many cases, Section 403(b) contracts and custodial accounts (hereafter, “products”) do not have any current nexus to an employer program – for example, the employment relationship may have ended years ago, or the participant may have moved his or her account pursuant to Revenue Ruling 90-24 to a product outside the scope of the employer’s program (perhaps multiple times), or the employer may no longer be in existence. As we understand it, IRS and Treasury, based on a perception that such “orphan” products are particularly prone to noncompliance with Section 403(b), intend for the final regulations to drive such products out of Section 403(b) status as of January 1, 2009. The regulations effectuate that intent through two provisions:

- Section 1.403(b)-3(b)(3) requires that products be “maintained pursuant to a plan” of an eligible employer in order to qualify under Section 403(b), and
- The regulations are intended functionally to revoke Revenue Ruling 90-24 as of September 24, 2007, the last day of the transition period allowed under §1.403(b)-11(g). (Because regulations are a superior form of authority, they will automatically supersede Revenue Ruling 90-24 no later than their effective date. As reflected in the preamble, IRS and Treasury may issue a revocation notice or other guidance on this issue prior to 2009.)

Absent relief, it is apparently intended that orphan products would fail to qualify under Section 403(b) on January 1, 2009.

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The regulations are intended to grandfather only one category of orphan products: those received in a valid prior-law transfer on or before September 24, 2007. (It may be sufficient to have completed all the legal steps necessary to establish enforceable rights under the new product to qualify for this grandfathering, which may not necessarily require issuance of final documentation or transfer of funds into the new product, and the grandfather rule by its terms appears to encompass products received in a transfer predating the issuance of the regulations.) In such cases, not only may the participant rely on Revenue Ruling 90-24 to avoid taxation at the time of the transfer, but apparently the grandfathered product received in the transfer will not become subject on January 1, 2009, to either the “maintained pursuant to a plan” requirement or, retroactively, the exchange requirements of §1.403(b)-10(b)(2). (Compliance with all the other requirements of the statute and final regulations will be necessary to continue to qualify under Section 403(b), and Section 72(p) must be satisfied with respect to any participant loans.) Products that are exchanged on or before September 24, and then are exchanged again after that date, apparently lose grandfathering.

The IRS and Treasury were not prepared, however, to let the tax compliance problems attributed to Revenue Ruling 90-24 transfers compound through 2008. The regulations allow the 60-day window through September 24 to allow the completion of transfers in process, but apparently intend that *products received in an exchange on or after September 25, 2007, will need to be part of a program that on January 1, 2009, meets, the “maintained pursuant to a plan,” information exchange agreement, and other requirements of the new regulations in order to continue qualifying under Section 403(b)*. It is not intended that those elements must be in place on the exchange date after September 24, 2007, and before January 1, 2009; it apparently will suffice if those elements are in place on January 1, 2009, bringing the product received in the exchange, along with all other products held pursuant to that “written plan,” within the tax compliance program arranged by the employer including an information exchange agreement with the provider of the new product. (This will be a drafting point to keep in mind in the development of “written plan” documentation.)

Under the intended operation of these rules, there may be at least three categories of products that require attention in advance of January 1, 2009:

- **Orphan products exchanged after September 24.** Under the new regulations, products exchanged after September 24, 2007, that are currently orphaned and do not become attached to an employer “plan” prior to January 1, 2009, will fail to qualify under Section 403(b) no later than January 1, 2009. (It is unclear whether a taxable event would have occurred, retroactively, on the date of the exchange.)

This issue requires immediate attention with respect to exchanges effective as of September 25. If there is no reasonable prospect that an orphan product will become incorporated in a Section 403(b) employer “plan,” the better tax planning option for such a participant desiring to change products after September 24 may be a rollover to an IRA (or a Section 401(a) or other retirement plan, if available), provided that the participant is over age 59-1/2, has severed employment with the employer under whose auspices the Section 403(b) contributions were made, or otherwise qualifies for a distribution from the Section 403(b) product. (If the participant is not currently eligible for a distribution, he or she may not have a portability option after September 24 that preserves tax deferral until such time as distributions become permissible.) Transferring from a Section 403(b) product to an IRA at a minimum entails the loss of the ability to take participant loans, if available under the Section 403(b) product, and would require dealing with any such loans outstanding at the time of the exchange.

- **Products that are not orphans at the time of a post-September 24 exchange but become orphans before January 1, 2009.** There will be products that are not orphans at the time of a post-September 24 exchange, but subsequently become so prior to January 1, 2009 -- e.g., if the employer ceases to exist after the date of the exchange but before putting into place arrangements that satisfy the new regulations, or if the employer and the product provider ultimately are unable for technology, economic or other business reasons to come to an agreement that includes the provider in either the employer’s “plan” or an information sharing agreement as of January 1, 2009. In such a case, the exchange would have been completed in a good faith belief that the new product would continue to qualify under Section 403(b) on and after January 1, 2009. Possible solutions might include exchanging the product again, prior to January 1, 2009, to either a product included in an employer’s Section 403(b) “plan” (if such an opportunity exists) or in a rollover to an IRA or other eligible retirement plan (if distribution from the Section 403(b) product is permissible).
- **Orphan products never involved in an exchange.** The only relief from the “maintained pursuant to a plan” requirement provided in the final regulations appears to be for products received in a grandfathered exchange. As a consequence, the final regulations may not permit, after 2008, Section 403(b) treatment of orphan products that were never the subject of an exchange. If such a product is exchanged on or before September 24, it would appear to qualify for the grandfathering discussed above. Otherwise, unless the participant happens to be working currently for an eligible employer with a Section 403(b) plan (or other retirement plan) to which the

product can be transferred or rolled over, this may functionally compel product providers either (i) to transition orphan products that were never the subject of a pre-September 25 exchange to IRAs prior to 2009, which would impose a significant, unanticipated burden and expense on providers and may not in the end provide a complete solution; or (ii) to administer and tax report such orphan products as disqualified under Section 403(b) starting with the 2009 tax year.

Our sense is that IRS and Treasury are amenable to discussion of additional solutions for these issues.



If you have any questions regarding this alert, or the services we provide, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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