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403(b) & 457 Plans Face New Compliance Challenges

Robert J. Toth, Jr. and Conni M. Toth

The evolution of 403(b) tax-deferred defined contribution plans — first designed as individual pension plans — spans more than 50 years, with some versions of these plans dating back to the original Tax Code; 457 plans were introduced 30 years ago.

Regulations and guidance for 403(b) plans have been sparse and remained virtually unchanged during the first 35 years of the plans' formal existence. These familiar old rules are fully woven into the plan's structural tapestry and ingrained into the administrative processes for all those involved in establishing and maintaining such plans.

The Tax Reform Act of 1986 began changing 403(b) plans to make them more like traditional 401(a) plans. More than 10 years later, in July 2007, new 403(b) regulations were issued by the Internal Revenue Service (IRS) that fundamentally changed the way 403(b) plans operate. These regulations are generally effective for plan years beginning after January 2009.

The new regulations are highly technical and complex. The complexity is compounded by recent regulatory activity by the U.S. Department of Labor (DOL) under ERISA regarding reporting and disclosure, and the unusual manner in which IRS and DOL guidance interacts with rules promulgated by the Securities and Exchange Commission.

Historically, employers and plan sponsors have relied on plan service providers and investment professionals for guidance and direction. However, the new rules have forced service providers and investment professionals to redefine their traditional roles. They are faced with significant market-driven changes to their products, services and processes during this critical transition period.

Resistance to change is not uncommon during major shifts in business processes. Therefore, not surprisingly, the market has experienced resistance and a large amount of confusion as involved parties attempt to implement the required changes and meet new expectations. Much of the resistance and confusion is due to the need for clear and concise directions on accomplishing the smoothest transition possible while, at the same time, managing risk.

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These market challenges can be overcome by the provision of consistent and thoughtful guidance for those affected by the change in the following areas:

- Plan design
- Employer and provider processes, material controls and risk assessment
- Effective corrections and correction programs
- Effective communications and disclosures

All parties involved in such plans — plan service and investment professionals, employers, plan sponsors, employees/participants and beneficiaries — need to collaborate as the new regulations are implemented. A collaborative effort will achieve successful plan designs, promote product harmonization and reduce the risk of negative tax consequences and significant penalties.

Service providers and investment professionals are faced with significant market-driven changes to their products, services and processes during this critical transition period.

Background

Formal 403(b) plans first became law in 1958. They allowed employees of certain tax-exempt employers to defer receipt of currently earned salary up to something called the “maximum exclusion allowance,” or MEA. Predating 401(k) plans by nearly 20 years, this was a new concept for the tax code. Taxes were not levied against the earned salary at the time of deferral, and earnings accumulated tax-free. Employers agreed to place the deferred salary into an annuity contract for the benefit of each specific employee. Taxation was deferred until these savings were withdrawn as supplemental retirement funds.

403(b) plans, by design, posed very little burden on the employer and offered insurance companies the opportunity to accumulate a significant sum of assets under management. (See “Historical Expectations” sidebar.) They were, in effect, personal supplemental pension plans.

403(b) plans hold significant assets. It is estimated that well over \$600 billion are held for investment in such plans.

Transformation Begins

403(b) plans began to transform over the years through a series of legislative changes. In 1974, with the passage of the Employee Retirement Income Security Act (ERISA), Code Section 403(b) was amended to include a provision that allowed 403(b) plans to expand their investment options to include both mutual funds and annuities. In 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) was enacted, permitting employees to borrow against retirement savings held in a 403(b) plan for the first time while introducing retirement income accounts, a type of 403(b) plan specifically designed for religious organizations.

In 1978, Code Section 457 was passed, providing nonqualified, nonfunded tax deferred compensation plans for employees of state or local governments and certain tax-exempt organizations. Employers agreed to defer salary on a tax-free basis, allowing earnings to accumulate tax-free in a type of program used to provide executive deferred compensation plans for private employers.

In 1986, the Tax Reform Act introduced new nondiscrimination rules for employer contributions to 403(b) plans similar to those found in 401(k) plans, and imposed new minimum distribution rules. In 1996, Congress amended the 403(b) rules governing the making of elective deferrals, modifying them to make them very similar to the 401(k) rules. At the same time, Congress imposed new tax-qualification rules on 403(b) contracts.

The IRS issued a series of rulings related to the administration of 403(b) plans between 1961 and 2007, which affirmed their fundamental nature as personal pension plans. These included the rules governing:

- 1) the availability to move 403(b) retirement savings between 403(b) and non-403(b) retirement plans;
- 2) limitations on annual amounts of elected salary deferrals;
- 3) withdrawal restrictions; and
- 4) early penalties and introduction of required minimum distributions.

One of these rules permitted service providers to rely upon the representations of employees with regard to the tax compliance rules — including exchanges, loans, hardships, contributions and distributions.

Historical Expectations Run Counter to New Obligations

The transitional difficulties in moving to the new 403(b) regulations are directly related to the historical expectations of 403(b) plan sponsors, which are fundamentally different than in the typical 401(k) arrangements the new regulations are attempting to mirror. In the past:

- Employers and plan sponsors allowed representatives from insurance and mutual fund companies to periodically visit on site and sell their annuities and fund families to employees for supplemental retirement savings.
- Employers and plan sponsors maintained an awareness of approved vendors, but rarely provided more than allowing the human resources department to distribute forms and contact information for the approved vendor representatives.
- Employee education of plan design and investment was managed by the representatives with little to no involvement of the employer and plan sponsor.
- Plan design was driven by what the tax code allowed and the unique characteristics of each investment contract or fund.
- The investment contract or fund defined the 403(b) plan. With multiple vendors and various annuity and mutual funds offered, a cohesive 403(b) plan rarely existed.
- Government reporting and disclosure requirements were limited.
- There had been long-standing employer ambiguity toward plan and operational failures, which has been changing through increasing IRS and DOL audit programs. This resulted in negative tax consequences and penalties that had not historically occurred.

The IRS began a coordinated examination program of tax-exempt employers in the early 1990s, under which it discovered what it termed massive noncompliance in 403(b) plans. This led to the implementation of a rigorous IRS examination program, which then led to the issuance of new regulations in 2007 that address what the IRS views as abuses within the 403(b) market.

New Rules Represent Significant Change

The new 403(b) regulations provided a comprehensive update to the historic, and familiar, 403(b) regulations. The required changes will significantly affect employers that sponsor 403(b) plans, administrators, insurance companies that offer annuities, mutual funds, employees and beneficiaries (see sidebar).

These multifaceted modifications to the familiar backdrop of 403(b) plans introduce new risks for employers and service providers. This, in turn, has caused all involved parties to attempt to develop and negotiate clear and concise documentation of their respective roles and to otherwise establish formal procedures to assist during the transition and management of 403(b) plans now and in the future.

In addition, the new rules, when considered in the context of the current investment market volatility, are making 403(b) plan sponsors increasingly aware of their heightened fiduciary exposure.

403(b) Risks and Challenges

Several key compliance risks regarding the new rules must be addressed both during and after the transition period. Some risks become immediately apparent because of the specific transition dates under the regulations. Others will only surface as steps are taken to bring the plans' operations and procedures into compliance over time.

Plan Documentation and Design

The new rules require, for the first time, that a written plan document be adopted by an employer as a condition of qualifying as a 403(b) plan. Employers were first required to adopt these plan documents by Jan. 1, 2009, but the IRS extended that deadline. Plan sponsors must now execute a written plan document no later than by Dec. 31, 2009, but must meet certain conditions to take advantage of that extension, to include:

Changes to 403(b) Plans as a Result of New Regulations

- Written plan documentation is required for all plans .
- Reliance upon employee representation for compliance is eliminated.
- Employer control and fiduciary responsibility increases.
- Employers are responsible for “meaningful notice.”
- Universal eligibility is modified.
- Recordkeeping and compliance coordination benefit from centralization.

- documenting plan operations retroactive to Jan. 1, 2009, in the new plan document;
- reviewing plan compliance with the new rules for 2009; and
- engaging in “best efforts” to correct any operational errors that were discovered for the 2009 plan year.

The IRS did issue model plan language for school districts and other non-ERISA plans, but even that language is insufficient for most plan sponsors.

Compliance Challenges

403(b) plan sponsors face several significant challenges in complying with the new rules, including:

- 1) *Even with the IRS model document language, many of the document vendors and service providers in the marketplace have fallen short in capturing the various features required to adequately document the plan.* In some cases, 401(k) plan documents have been adopted for 403(b) plans, resulting in issues with eligibility, loans and hardships, to name a few. The IRS requires that the plan document must reflect the actual plan terms in both “form and operation.” Failing to do so would cause the plan to not meet the written plan document requirement.
- 2) *The rules under which 403(b) plans have often operated in the past have been “product based.”* Unlike the typical 401(k) plan, the actual plan terms have not been historically centralized. Instead, they have been found in the various investment contracts purchased by participants, “hold harmless” and other side agreements between vendors and employers, and in an employer’s communications to its employees. Written plan documentation may have included several (and often contradictory) policies related to investments, loans, domestic relations orders and any special processes or procedures that apply to a particular product.

Further, the administration of a plan’s terms has often been spread between the investment vendors, the employer and, in the past, the plan participant. This is a particular problem in a multivendor environment.

Product harmonization is required for plan sponsors to properly capture all the material plan terms required by the regulations. This includes terms related to: (a) the ability of the product to capture contribution sources; (b) benefit structures under the various products; (c) available distribution methods; and (d) limitations under the products. This will also ensure clarity in communication to employees and participants, and reduce the employer’s risks related to plan operation.

- 3) *Employers will need to review their plan design and determine whether what’s offered under the plan can be supported by their administrative process or by the*

Compliance Challenge Snapshot: Plan Documentation and Design

- Even with IRS model document language, many document vendors and service providers have not captured the various features required to adequately document the plan.
- Past 403(b) rules have often been “product based” rather than plan based.
- Employers will need to review their plan design and determine whether plan offerings can be supported by their administrative process or the products offered.

products offered. For example, the regulations permit the plans to offer “safe harbor” hardships, but this should not be done unless the employer has the ability to suspend and restart elective deferrals in accordance with the regulations.

ERISA Status

Historically, most nongovernmental and nonchurch 403(b) plans have considered themselves as “non-ERISA” plans, meaning that they were designed in such a manner to avoid being subject to the fiduciary, reporting and disclosure rules under Title 1 of ERISA.

In 1979, the DOL issued “safe harbor” regulations outlining the conditions that need to be met for a 403(b) plan to claim exemption from these rules. The DOL safe harbor is premised on the notion of 403(b) plans being personal pensions with limited employer involvement in the plan. Once the employer began exercising control and influence over the plan, it would fall out of the safe harbor and become an “ERISA 403(b) plan.”

Oddly enough, it is the new IRS regulations that now challenge this well-settled ERISA notion of employers’ limited involvement by forcing employers to become more accountable for compliance of 403(b) plans with the tax rules. In doing so, the IRS has also forced

employers to review whether they can continue to fit within ERISA’s safe harbor. Although the DOL has issued guidance stating that merely complying with the new IRS regulations will not, in itself, trigger ERISA status, DOL staff has made public statements that serve to further limit the applicability of the safe harbor under some very common circumstances.

The risks of making an improper determination are significant. One of the greatest (but by no means the only) risks lies in the filing of the annual report, Form 5500. An ERISA 403(b)

plan must file a Form 5500, with failure to file resulting in IRS penalties of \$25 per day (up to \$15,000) for each plan year it has not been filed, and DOL penalties of up to \$300 per day, without a cap.

Compliance Challenges

Here are the challenges faced by 403(b) plan sponsors related to ERISA status:

- 1) *Private employers that are claiming non-ERISA status for their 403(b) plans must review their activities and determine whether it is possible to continue in such a manner.* One of the most significant issues is how service providers are dealing with plan sponsors, even those of non-ERISA plans. Service providers are now regularly asking all employers to sign off on common events such as loans and hardships — approval by an employer that will cause a plan to lose safe harbor status. As a

Compliance Challenges Snapshot: ERISA Status

- Private employers that are claiming non-ERISA status for their 403(b) plans must review their activities and determine whether it is possible to continue in such a manner.
- Recent DOL comments have caused sponsors of non-ERISA plans to review their historical claim of safe harbor status.
- Transitioning from non-ERISA status to ERISA status is not a simple task.

practical matter, employers will need the full cooperation of their service providers in order to continue non-ERISA status.

- 2) *The recent comments by the DOL have caused sponsors of non-ERISA plans to review their historical claim of safe harbor status to determine whether they had actually qualified under the safe harbor, or whether they should take advantage of the DOL’s remedial programs for plans that failed to properly file the Form 5500 in the past.*
- 3) *Transitioning from non-ERISA status to ERISA status is not a simple task.* Employers that now need to treat their plans as ERISA plans will have several difficult transition rules to work through.

Data Collection

The new regulations require, for the first time, that employers be responsible for the proper collection of data used for compliance purposes — such as checking for proper loan amounts, limits on contributions, hardship withdrawals and other matters. Prior to this new requirement, employers and service providers could rely upon the representations of plan participants without any independent verification.

This new obligation has created new data collection and coordination requirements that have not existed in the past.

The DOL has also issued new regulations requiring ERISA 403(b) plans to compile and report financial data at the plan level for the first time, beginning with the 2009 plan year. Unlike 401(k) plans, 403(b) plans typically do not have a centralized repository for such data. This is particularly true for contracts related to deselected vendors or for former employees.

Compliance Challenges

Following are the compliance challenges that 403(b) plan sponsors face regarding data collection:

- 1) *Employers will now need to gain access to and manage information necessary for tax compliance, testing and documenting internal processes with adequate controls to promote consistent and compliant administration.* This is a new task for most 403(b) plan sponsors, and currently there is inadequate logistical support in the marketplace to assist them.
- 2) *The DOL’s new Form 5500 rules force employers to collect and compile data for the annual report in ways that were never required*

Compliance Challenges Snapshot: Data Collection

- Employers need to access and manage information for tax compliance, testing and documenting internal processes with adequate controls to promote consistent and compliant administration.
- The DOL’s new Form 5500 rules force employers to collect and compile data in ways that were never required in the past.
- Some of the new data required by the new Form 5500 relates to “direct and indirect compensation” that is paid to service providers and salespersons related to the 403(b) contracts.

in the past. Services providers are also challenged, as the necessary data is often inaccessible, but failure to properly report such information triggers a requirement that plan sponsors report such failures to the DOL.

- 3) *Some of the new data required by the new Form 5500 relates to “direct and indirect compensation” that is paid to service providers and salespersons related to the 403(b) contracts.* Plans will be receiving this information for the first time in the history of their plans. The receipt of this data will trigger a fiduciary duty to review the data to ensure the compensation paid is reasonable and to make changes in the plan’s investment products if necessary.

Contracts Purchased and Exchanged Before Jan. 1, 2009

In 2007, the IRS published a revenue procedure that attempted to provide guidance for contracts purchased and exchanged before Jan. 1, 2009. However, the guidance is ambiguous and has created confusion for all parties involved in such plans — plan service and investment professionals, employers, plan sponsors, employees/participants and beneficiaries. At the end of this special report are transition charts describing applicable guidelines for purchased and exchanged contracts.

Compliance Challenges

One of the most significant challenges for these affected parties is to determine which party is responsible for the compliance activities for these pre-2009 contracts and under what conditions, and which party should be responsible for approving distributions from these contracts.

Internal Control, Self Audit and Correction

The regulatory agencies now expect 403(b) plans adopt adequate controls and processes to: (1) ensure compliance; (2) conduct periodic reviews to uncover problems; and (3) correct any problems that are found by using the established correction programs made available by both the IRS and DOL.

Compliance Challenges

The two key challenges regarding internal control, self audit and correction are:

- 1) *Employers will now need to identify, document, and prioritize cost-effective processes to help meet the regulators’ new expectations* — including the use of both internal and external control points.
- 2) *The IRS and DOL have extensive corrections programs that they expect plan sponsors to use in coordination with a regular review of their retirement programs.* These corrections programs apply to 403(b) plans as well, and plan sponsors and their service providers will need to become familiar with their use.

Non-Tax/Non-ERISA Exposure

403(b) plans are unique in how other laws may apply to them, particularly federal securities laws and state insurance laws. Plans that are not subject to ERISA (particularly school districts) may also find themselves exposed to several state-law issues.

Compliance Challenges

The following is a sampling of potential concerns:

- 1) *Non-ERISA employers may need to deal with state fiduciary laws and state common-law agency rules.* For example, a school sponsoring a 403(b) plan could be considered its employees' agent in establishing and administering the plan — raising the risk that the school administrator owes the duties of prudence and loyalty to its employees in its administration of that plan. In addition, non-ERISA employers may need to ensure that: (a) plan's fees are reasonable and disclosed; (b) appropriate investment alternatives are made available; and (c) plan service providers and vendors appropriately manage the plan in compliance with applicable laws, regulations and contractual duties.
- 2) *The 403(b) regulations appear to ignore, in several respects, that state insurance law governs the annuity contracts issued to 403(b) plan participants.* Plan sponsors will need to know how to deal with such conflicts.
- 3) *Federal securities law applies to all 403(b) plans that are funded with variable investments, and claims under such laws may be available to 403(b) participants.* 403(b) contracts do not enjoy the exemptions from federal securities laws that are afforded to trusts holding 401(a) plans. Particularly, the anti-fraud provisions of these laws have a broad sweep.
- 4) *The state trust law issue is an issue, in the context of handling contributions from non-ERISA plans — particularly regarding the mishandling of employee contributions.* State fiduciary laws identify standards of prudence and loyalty that apply to those in positions of trust in handling other people's money. A trust or constructive trust law analogy may apply to the limited period when the plan sponsor

Compliance Challenges Snapshot: Other Issues

- Determining compliance and distribution issues regarding pre-2009 contracts.
- Identifying, documenting and prioritizing cost-effective processes to help meet new expectations regarding internal control, self audit and correction.
- Becoming familiar with IRS and DOL corrections programs.
- For non-ERISA employers, possibly dealing with state fiduciary laws and state common-law agency rules.
- Dealing with conflicts like the fact that the 403(b) regulations appear to ignore that state insurance law governs the annuity contracts issued to 403(b) plan participants.
- Understanding that federal securities law applies to all 403(b) plans funded with variable investments, and claims under such laws may be available to 403(b) participants.
- Knowing that state trust law is an issue, in the context of handling contributions from non-ERISA plans — particularly with regard to the mishandling of employee contributions.
- Realizing that non-ERISA plan sponsors are exposed to state-law claims such as breach of contract, misrepresentation and consumer protection claims.

still controls employee contributions, when a constructive trust might be imposed on the school district.

- 5) *The potential bases for exposures do not end with the above short list.* Because non-ERISA plans are also exempt from ERISA's preemptive protections, plan sponsors are exposed to state-law claims such as breach of contract claims, third-party beneficiary claims, negligence, misrepresentation and various state consumer protection claims, among others.

Conclusion

403(b) plans have avoided the focus of regulators since their inception in 1958, enjoying a sort of benign neglect because of their status as individual pension plans. Both the IRS and the DOL have taken steps to address this "neglect" by imposing a series of rules that previously only applied to "employer based" plans, like 401(k) plans. The transition to this new regime is proving to be challenging to all parties involved: plan sponsors, employees and service providers. Not only do we not have all the answers, but we don't know all the questions that will result from this transition. We do know that these fundamental changes will require a new diligence for all involved.

New Resource on 403(b) Plan Transition Coming Soon

To help 403(b) and 457 plan sponsors and their service providers deal with the challenges ahead, Thompson Publishing Group will be introducing a new publication to guide you through this transition — starting with the historical expectations in offering a 403(b) plan to the new expectations of sponsoring such plans and the related fiduciary responsibilities under the final 403(b) regulations and 457 rules. The publication will include insight and successful practices for designing, setting up and administering 403(b) and 457 plans, based upon the experience, expert analysis and advice of practitioners who have successfully navigated the transition. Also included will be valuable guidance on selecting plan services and investment professionals and on identifying a plan fiduciary. The publication will provide a complete collection of relevant tax code and ERISA provisions, Treasury and DOL regulations and federal agency rulings and announcements.

For more information, contact Thompson Publishing Group's Customer Service Department at 800-677-3789.

**Transitional Guidance for Contracts Issued as a Result of
A 90-24 Exchange Transaction***

Jan. 1, 2005	Sept. 24, 2007	Dec. 31, 2008	July 1, 2009
Contracts issued as a result of 90-24 for ACTIVE EMPLOYEES & FORMER EMPLOYEES OR BENEFICIARIES that are issued before 9-24-2007 are not subject to a written plan or information sharing and WILL NOT fail 403(b) status.			
	Contracts issued after 9-24-2007 as a result of the expired 90-24 exchange rules for ACTIVE EMPLOYEES & FORMER EMPLOYEES OR BENEFICIARIES that are issued by an unapproved issuer and NOT subject to an information sharing agreement before 1-1-2009 CAN BE "re-exchanged" back to a contract issued by an approved issuer, or issuer with an information sharing agreement, before 7-1-2009 to be recognized by the written plan or administered by information sharing.		
	Contracts issued after 9-24-2007 as a result of 1.403(b)-10(b) and 11(g) exchange rules for ACTIVE EMPLOYEES & FORMER EMPLOYEES OR BENEFICIARIES issued before 1-1-2009 without receipt of contributions for one year following issue because contract was issued by an unapproved issuer WILL NOT fail 403(b) status if either: (1) employer identifies unapproved issuer and provides contact information of plan compliance coordinator; or (2) unapproved issuer communicates with employer to coordinate compliance type information prior to a distribution or loan.		

*All purchased contracts receiving contributions and exchanged contracts after 1-1-2009 are subject to a written plan.

**Transitional Guidance for Contracts Purchased Due to Enrollment,
But Not Exchanged***

Prior to Jan. 1, 2005	Jan. 1, 2005	Sept. 24, 2007	Dec. 31, 2008
<p>Contracts for ACTIVE EMPLOYEES & FORMER EMPLOYEES OR BENEFICIARIES issued before 1-1-2005 are not subject to a written plan and WILL NOT fail 403(b) status.</p>			
	<p>Contracts issued after 12-31-2004 and before 1-1-2009 without contributions in a year after the contracts were issued (e.g., a discontinued issuer) WILL NOT fail 403(b) status if a reasonable good faith effort to include those contracts as part of the employer plan by either: (1) employer identifying discontinued issuers and providing contact information for plan compliance coordinator; or (2) unapproved issuer communicating with employer to coordinate compliance-type information prior to a distribution or loan. Pursuant to IRS Revenue Procedure 2007-71 and failure of the reasonable good faith effort, a 403(b) plan will not fail to satisfy 403(b) requirements if the plan does not include terms relating to these contracts.</p>		
	<p>Contracts for FORMER EMPLOYEES OR BENEFICIARIES issued after 12-31-2004 and before 1-1-2009 by an issuer that ceases to receive contributions before 1-1-2009 (e.g., a discontinued issuer or an employer that subsequently ceased to exist) WILL NOT fail 403(b) status if discontinued issuer communicates with employer (assuming employer still exists) to coordinate compliance-type information prior to a loan (assuming employer subsequently ceased to exist, discontinued issuer can rely on FORMER EMPLOYEES OR BENEFICIARIES representations). Pursuant to IRS Revenue Procedure 2007-71, a 403(b) plan will not fail to satisfy 403(b) requirements if the plan does not include terms relating to these contracts.</p>		

Note: Issuers that issue *annuities* and *mutual funds held in a custodial account* are considered "Contracts" for the purposes of this chart.

*All purchased contracts receiving contributions and exchanged contracts after 1-1-2009 are subject to a written plan.