403(b) Perspectives

Insights into the Administration of §403(b) Tax-Sheltered Arrangements

FALL 2015

Supreme Court Ruling on Same-Sex Marriage

On June 26, 2015, the U.S. Supreme Court issued its decision in *Obergefell v. Hodges*,* ruling that the 14th Amendment requires all states (and the District of Columbia and U.S. territories) to recognize same-sex marriage. The ruling also requires states to recognize same-sex marriages lawfully performed in another state.

Background

Previously, in 2013, the Supreme Court had ruled in *United States v. Windsor*** that Section 3 of the Defense of Marriage Act (DOMA) was an illegal denial of equal protection rights guaranteed by the Constitution. DOMA is an all-encompassing statute that applies to more than 1,100 federal laws and regulations administered by federal departments and agencies, including the Internal Revenue Service (IRS) and the Department of Labor (DOL).

Section 3 of DOMA had defined the term "marriage" as "a legal union between one man and one woman as husband and wife" and the term "spouse" as "a person of the opposite sex who is a husband or a wife," thereby precluding same-sex couples from being considered married under federal law. After the Supreme Court held Section 3 of DOMA to be unconstitutional, same-sex married individuals in states allowing same-sex marriage became entitled to the same general rights as opposite-sex married partners.

Qualified Plan and ERISA 403(b) Spousal Rights

Prior to *Windsor*, spousal qualified plan rights, which includes ERISA 403(b) plans, were not available to same-sex partners, but they became available nationwide, with the following retirement plan rights and requirements applying to both same-sex and opposite-sex married couples:

- The need for spousal consent to name someone other than the spouse as beneficiary
- Qualified joint and survivor annuity (QJSA) protections
- For plans subject to the QJSA rules, the need for spousal consent for such things as distributions, loans, or hardship withdrawals
- Availability of hardship distributions for a spouse's hardship
- For purposes of calculating required minimum distributions, use of the joint life tables that apply where the spouse is more than ten years younger than the account owner

Continued on Page 2

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Continued from Page 1

- Ability of a spouse to roll over plan assets into his or her own IRA or his or her own qualified plan account, if the plan permits such rollovers
- Ability of the spouse to roll over the IRA of the deceased spouse into the surviving spouse's own IRA or into an inherited IRA
- Availability of qualified domestic relations orders (QDROs)
- Family attribution rules must reflect the spousal relationship for purposes of determining highly compensated employees, key employees, and controlled groups

14th Amendment

State and local governments are subject to the 14th Amendment guarantee of equal protection. The Supreme Court held that same-sex couples may not be deprived of that right and liberty. The *Obergefell* decision holds that the 14th Amendment now requires a state to license a marriage between two people of the same sex and to recognize a same-sex marriage lawfully licensed and performed out of state.

Retirement Plan Impact

Private sector employer sponsored retirement plan benefits and spousal benefit rules are regulated by federal law. As a result, after the *Windsor* decision and IRS guidance on income tax and qualified plan matters, private sector qualified retirement plans and ERISA 403(b) plans recognized same-sex spouses as spouses for all qualified plan purposes. However, certain types of retirement plans sponsored by public sector employers and churches are not subject to ERISA, which is a federal law, and therefore were not impacted by the *Windsor* decision. The *Obergefell* decision will have a greater impact on public sector and church plans as all states must now recognize same-sex marriages performed in any state and permit same-sex marriages. Thus, plan administration of non-ERISA 403(b) plans just became simpler. Note that non-ERISA plans are still not qualified plans, and thus, certain qualified plan rules will still not apply. For example, requiring spousal consent to the naming of a beneficiary other than the spouse is a qualified plan rule that does not have to apply to a non-ERISA 403(b), unless the 403(b) is in one of the community property states. There are nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Civil Unions or Domestic Partnerships Going Forward

The purpose of civil unions and domestic partnerships was to afford individuals some of the benefits of marriage (such as medical power of attorney) because the state did not have same-sex marriage laws. If a couple that entered into a domestic partnership or civil union does not wish to get married, perhaps due to the expense of restructuring all the documents they created under the domestic partnership or civil union rules, then the members of the domestic partnership or civil union will not be recognized as marital spouses, and thus will not be entitled to the qualified plan spouse rules.

Retroactivity Issue

An additional rule concerns retroactive application of the *Obergefell* decision. Generally, when the Supreme Court holds a law to be unconstitutional, it is as if the law never existed. After the *Windsor* decision, the IRS issued guidance which, for the most part, eliminated any requirement for retroactively changing decisions made in the past under qualified plans. This issue is particularly critical for defined benefit plans and plans subject to spousal consent under which distributions had previously been made. For example, if a participant's beneficiary received a distribution prior to the *Windsor* decision and there was no spousal consent deemed necessary for the designation of that beneficiary — because same-sex spouses were not recognized — the IRS's position was that *Windsor* would not apply retroactively. Whether the IRS will see a need to issue any additional guidance after the *Obergefell* decision remains to be seen.

Best Practice Tip

As a best practice, plan sponsors should remind all plan participants to review — on a recurring basis — their current beneficiary designations to ensure they are accurate and up to date. Many commentators suggest that reviews be made every five years and whenever there is a life event, such as a birth, death, marriage, or divorce. ■

* 576 U.S. ___ (2015)
** 570 U.S. ___ (2013)

Hardship Distribution and Loan Documentation

A recent edition of the IRS newsletter for plan sponsors (*Retirement News for Employers*) contained an important reminder: 403(b) plan sponsors that permit hardship distributions or participant loans should confirm that current approval procedures are operating in compliance with IRS requirements.

Hardship distributions. The IRS makes it clear that the following paperwork must be retained in conjunction with the approval of a hardship distribution:

1. Documentation of the hardship request, review, and approval;
2. Financial information and documentation that substantiates the employee's immediate and heavy financial need;
3. Documentation to support that the hardship distribution was properly made in accordance with the applicable plan provisions and the Internal Revenue Code; and
4. Proof of the actual distribution made and related Forms 1099-R.

Failure to have these records available is a plan qualification failure. It is not sufficient for the participant to retain his or her own hardship distribution records; the plan sponsor, or the party who is responsible for approving hardship distributions, must retain documentation that demonstrates the nature of a hardship. The IRS noted that while participants are permitted to "self-certify" that they have no other way to alleviate a financial hardship, self-certification — filed electronically or on paper — is not enough to prove the nature of a hardship request.

Example: John requests a hardship distribution to pay a hospital for unreimbursed medical expenses. He certifies that he has no other means of satisfying the hardship besides taking a distribution from his 403(b) account. However, John does not submit any hospital bills with his hardship distribution application and simply signs a form indicating he is using the funds to pay unreimbursed medical expenses. If John's hardship request is approved without obtaining and retaining supporting documentation that reflects the amount John owes to the hospital, the plan is not operating in compliance with the IRS's documentation and retention requirements.

Participant loans. The IRS requires plan sponsors or the party who is authorizing the hardship, such as the 403(b) vendor, to retain similar documentation with respect to participant loans, including the following:

1. Evidence of the loan application, review, and approval process;
2. An executed plan loan note;
3. If applicable, documentation verifying that the loan proceeds were used to purchase or construct a primary residence;
4. Evidence of loan repayments; and
5. Evidence of collection activities associated with loans in default and the related Forms 1099-R, if applicable.

During audits, the IRS has found that some plans have operated in a manner which permitted a participant to self-certify their own loan eligibility. When a participant requests a loan in excess of five years for the purchase or construction of a primary residence, he or she should be required to provide documentation of the purchase prior to the approval of the loan.

In reviewing the responses to a 401(k) questionnaire sent to employers in 2010, the IRS discovered that instead of an administrator overseeing the actual operation of the plan, the hardship distribution approval process, in many cases, has been relegated to a computerized investment platform with no procedure in place to actually ensure that a hardship distribution is for an allowable reason or for a proper amount. The IRS also discovered that there is often minimal oversight regarding plan loan repayments being made according to the amortization schedule.

Keep in mind that one of the reasons the IRS brought in a written plan document requirement in the final 403(b) regulations was the widespread noncompliance of 403(b) plans with the hardship and participant loan requirements. So, although the recent issue involves self-certification, largely in 401(k) plans, the lack of hardship/loan documentation has been an issue for 403(b) plans that the IRS has been working on for a number of years. ■

http://www.irs.gov/Retirement-Plans/Its-Up-to-Plan-Sponsors-to-Track-Loans-Hardship-Distributions

Determination Letter Program Changes

Based on its need to direct its limited resources more efficiently, the IRS stated in Announcement 2015-19 that effective January 1, 2017, the staggered five-year determination letter remedial amendment cycles for individually designed plans will be eliminated for all qualified plans. The IRS will be limiting the issuance of determination letters for individually designed plans to the initial qualification of new plans and plan termination qualification, as well as to certain other limited situations to be determined by the Treasury and the IRS.

We and other document drafters submitted our first-ever draft of a 403(b) preapproved plan (prototype or volume submitter) by April 30, 2015. We are in the two-year IRS review phase of the six-year cycle. As the IRS has stated in the past, for 403(b) plans, the preapproved program is the sole vehicle for providing 403(b) plan sponsors with an IRS-reviewed document to provide the plan sponsor with reliance as to the form of their 403(b) plan (having met all legal requirements and being bulletproof to an IRA audit). The IRS has stated that they do not intend to have a determination letter program for 403(b) plans.

Now that IRS Announcement 2015-19 has curtailed the five-year determination letter program for qualified plans, existing individually designed plans could risk facing an increase in plan document failures arising during plan audits because the IRS will rely on auditing to keep plans in compliance.

As a result of this change, and the fact that the IRS does not intend, for the foreseeable future, to offer an individually designed 403(b) plan document program, we are likely to see a trend where sponsors of most 403(b) plans move their model plan to preapproved documents. ■

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