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2008 ISSUE 1

## THE 403(b) TAX SHELTERED ANNUITIES REGULATIONS

by Jerry L. Zimmerman

Internal Revenue Code ("Code") Section 403(b) annuity contracts are the predominant "private" retirement vehicles used by public school districts. The annuity contracts supplement and are separate from the Oklahoma Teachers' Retirement System. For purposes of the Teachers' Retirement System, payments into the tax sheltered annuities are considered to be the payment of salary. Almost universally, 403(b) enables employees of school districts to provide for retirement through an "income deferred" tax sheltered annuity ("TSA"), although 403(b) also provides for payments to specified custodial accounts. In RFR's representation of public school districts and technology centers, the tax sheltered annuity is far more predominant than tax sheltered custodial accounts. Additionally, the con-



"... 403(b) annuity contracts are the predominant, "private" retirement vehicles used by public school districts."

tributions to tax sheltered annuities are primarily done through elective "pre-income tax" deferrals by employees of the school districts and technology centers. Although permissible, rarely has RFR seen a program of nonelective contributions, other than nonelective contribution plans for the benefit of a retiring class of employees.

For purposes of ERISA, TSA programs maintained by public school districts are "governmental plans" and are not subject to ERISA. However, TSA programs are subject to provisions of the Code, including sections 402, 403 and 415. Because TSAs are subject to the provisions of the Code, the limitations on the amount of annual contributions that can be made by, or on behalf of an employee, to a TSA, are subject to two fundamental annual limitations. For 2008, the two primary limitations are as follows:

i) The Maximum Allowable Contribution ("MAC") Limitation: This limitation is the lesser of (a) 100% of compensation or (b) \$46,000. This is an increase of \$1,000 from 2007. However, in addition to the MAC, it is possible that

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## CALIFORNIA HOME SCHOOLING DECISION UNLIKELY TO AFFECT OKLAHOMA

by Jerry A. Richardson

A recent decision regarding home schooling by a California state court has generated nation-wide attention. In a decision issued on February 28, 2008, the California Court of Appeals, Second Appellate District, ruled that parents do not have a constitutional right to home school their children. The court observed that under the California Education Code, all minor children are required to attend public school unless (1) the child is

enrolled in a private full-time day school and actually attends that private school or (2) the child is tutored by a person holding a valid state teaching credential for the grade being taught. Based on the second of these requirements, the court concluded that a parent could not lawfully home school his or her child unless the parent holds a valid teaching certificate for the grade or grades being taught.

An organization supporting the rights of parents to home school their children has filed a request for a rehearing and has promised to appeal the decision to the California Supreme Court.

Because home schooling has become much more common across the nation in the last ten to fifteen years, some media commentators have speculated that this decision

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## THE 403(b) TAX SHELTERED ANNUITIES REGULATIONS (CONTINUED FROM PAGE 1)

employees who are age 50 or older may be eligible to contribute an additional \$5,000. The MAC is the sum of (i) employer, nonelective contributions, plus (ii) employee elective contributions.

ii) The Maximum Elective Employee Contribution: Exclusive of special "catch up" contributions, this limitation for 2008 is \$15,500. This amount

remains unchanged from 2007. Additionally, under certain circumstances, an employee with at least 15 years of service with the same school district could be eligible to make annual

longevity-based catch up contributions over a period of five years, but in no event may the MAC be exceeded.

### The 403(b) Regulations

The final 403(b) regulations were published on July 26, 2007. The project of drafting, receiving and considering comments and finalizing the regulations took five years. The complexity of the regulations is generally mirrored by the volume of the regulations. The regulations are approximately 130 pages in length. The effective date of the regulations is generally January 1, 2009. However, the effective date for a 403(b) plan maintained pursuant to collective bargaining agreements is the earlier of (a) the date the collective bargaining agreement terminates or (b) July 26, 2010.

### A Sampling of the Critical Requirements in the Regulations

A 403(b) program must be maintained pursuant to a written plan document. Currently, most school districts simply honor payroll deduction requests of employees and contribute the deferral to a TSA designated by the employee. While the TSA contract is a written agreement (generally between the issuer and the employee), the plan itself has rarely been in writing. It is important to distinguish between the TSA (which is always in writing) as the method of funding for retirement and the "plan," which is the program under which contributions to the TSAs are made. The TSA is the "annuity contract" between the vendor (generally an insurance company) and the employee. It is the "vehicle" to which payroll deduction amounts are paid by the school district. The plan is the school district's program under which the individual TSAs may be purchased. Thus far, RFR has had the opportunity to review a prototype 403(b) plan which has been prepared by a significant vendor in Oklahoma, and that plan document was very good.

Additionally, the IRS has issued a prototype 403(b) plan document. The plan document issued by the IRS is not as detailed as the prototype that RFR has reviewed. However, and very importantly, any public school district is deemed to have complied with the requirement that it adopt a written 403(b) plan if the public school district adopts the text of the

prototype plan published by the IRS. The text of the IRS prototype plan is in Revenue Procedure 2007-71. The instructions in Revenue Procedure 2007-71 concerning the adoption of the IRS prototype plan are complicated, and it would be prudent to engage a professional to assure that the adoption of the IRS prototype 403(b) plan has been done correctly.

Additionally, the mere adoption of the 403(b) plan is not sufficient to comply with the regulations. The administration of the plan must be in accordance with the terms of the plan document. This requirement corresponds to the requirement which permeates the entire arena of deferred compensation, namely: the text of the plan **and** the operation of the plan must be in accordance with the law.

Two new rules are provided in the regulations, as follows:

1. The distribution of benefits must have a required beginning date. Generally, the required beginning date is April 1 of the calendar year following the later of (i) the calendar year in which the employee attains age 70½ or (ii) the calendar year in which the employee retires. This rule generally corresponds to the distribution rule of Code Section 401(k) plans and should not impose any undue burden on school district or TSA vendors.

2. If a benefit (such as disability insurance or life insurance) that is incidental to the retirement benefit is provided under the TSA, then the TSA must specify the incidental benefits that are provided.

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*“ . . . 403(b) enables employees of school districts to provide for retirement through an “income deferred” tax sheltered annuity . . . ”*

## THE 403(b) TAX SHELTERED ANNUITIES REGULATIONS (CONTINUED FROM PAGE 2)

Generally, in the course of RFR's review of TSAs, there have only been limited occasions when an incidental benefit was provided under a TSA.

Hardship withdrawals and distributions may be permissibly authorized under a 403(b) plan. The concept of "hardship" has been highly regulated and events of hardship are subject to a requirement that a hardship withdrawal should be the last option available to the employee. The events of hardships are those that are specified for 401(k) plans:

- (a) unreimbursed medical expenses,
- (b) the purchase of a home,
- (c) payment of college expenses for the future 12 months,
- (d) payments to prevent eviction or foreclosure,

(e) funeral expenses.

### Elective Contributions and Universal Availability

With very limited exceptions, employees must be given the opportunity, and meaningful notice of the opportunity, to elect to defer compensation into a TSA. Employees who may be excluded from making elective contributions are:

- (a) students,
- (b) employees in other private deferred compensation plans such as 457(b) plans,
- (c) those employees who normally work less than 20 hours per week. In determining whether an employee may be excluded by virtue of being an employee who works less than 20 hours per week, the IRS uses a liberal test. On the date of hire, if the school district reasonably

expects the employee to work less than 1,000 hours over the ensuing 12-month period, then the employee may be permissibly excluded. The issue of availability to employees is the critical audit question. The IRS has issued questionnaires to EVERY public school district in Washington, New Jersey and Missouri to assist in determining whether 403(b) opportunities are being afforded to all employees.

School administrators are aware that from time to time employees transfer or "roll" their balances from one TSA to another TSA. The regulations specifically authorize transfers from one TSA to another TSA provided four conditions are satisfied.

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## CALIFORNIA HOME SCHOOLING DECISION UNLIKELY TO AFFECT OKLAHOMA (CONTINUED FROM PAGE 1)

may trigger similar court challenges to home schooling in other states. If such a trend were to develop, it is unlikely that Oklahoma courts would be receptive to attempts to impose such a requirement here.

Oklahoma's compulsory attendance law provides that it shall be "unlawful for a parent, guardian, or other person having custody of a child who is over the age of five (5) years and under the age of eighteen (18) years, to neglect or refuse to cause or compel such child to attend and comply with the rules of some public, private, or other school, unless other means of education are provided ...." OKLA. STAT. tit. 70, § 10-105 (Supp. 2007). In 1922, the Oklahoma Court of Criminal Ap-

peals ruled that home schooling could satisfy the statute's "other means of education" requirement and held that parents who were home schooling their children could not be prosecuted for violating the compulsory attendance law. *Wright v. State*, 1922 OK CR 136, 209 P. 179. The court noted that the compulsory attendance statute then in effect did not specify any qualifications required of a "private teacher," and it concluded that a parent desiring to home school his or her children had only to show that the home school education was provided in good faith and "equivalent to those afforded by the state." This remains the law today.

Based on *Wright*, the Oklahoma Attorney General concluded in an opinion issued in 1973 that Okla-

homa law does not require that a "private tutor" teaching in a home school hold a teaching certificate. 1973 OK AG 129.

An Oklahoma court would be unlikely to depart from these precedents merely because a court in another state reached a different conclusion. For that reason, any change in Oklahoma law regarding the rights of parents to home school their children would have to come from the legislature rather than from the courts.



*"... Oklahoma law does not require that a 'private tutor' teaching in a home school hold a teaching certificate."*

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**RF&R SPEAKERS/EVENTS SHOWCASE**

**John G. Moyer, Jr.** will be speaking at the Oklahoma State Department of Education New Board Member Workshop in Oklahoma City on April 12, 2008.

**Mr. Moyer** will also be speaking at the CCOSA regional meeting in Muskogee on April 25, 2008.

**RF&R HIRES NEW ATTORNEY**

**Rosenstein, Fist & Ringold** takes pleasure in announcing that Matthew J. Ballard has joined the firm as an associate attorney. Mr. Ballard received his undergraduate degree in Political Science (B.A. 1999) and his law degree (J.D. 2002) from the University of Oklahoma. Prior to coming to the firm, Matt was an associate attorney with Carle & Higgins in Claremore, Oklahoma (2006-08) and an assistant district attorney with the Oklahoma County District Attorney's office (2001-06).

**THE 403(b) TAX SHELTERED ANNUITIES REGULATIONS (CONTINUED FROM PAGE 3)**

1. Transfers must be permitted by the plan. This requirement is generally easy to satisfy. The plan document must merely authorize contracts to be exchanged. The prototype plan document which has been published by the IRS contains text that satisfies this requirement.

2. The participant has an accumulated benefit after the exchange that is at least equal to the accumulated benefit of the participant prior to the exchange. Comparability results should be provided to the plan administrator prior to its authorization of the exchange of the TSAs. Those results will provide the administrator with a prudent due diligence analysis to be assured that this requirement has been satisfied.

3. The new annuity contract contains restrictions against distribution of benefits which are at least as strict as the restrictions specified in the annuity contract that is being exchanged.

4. The employer and the issuer of the annuity enter into an "information sharing agreement." That agreement requires:

- the employer to provide to the issuer the participant's employment information, participation in other 403(b) contracts and other relevant data (such as information concerning hardship withdrawals), and
- the issuer to provide to the em-

ployer the information to enable the employer to be reasonably satisfied that applicable tax requirements have been satisfied.

RFR has reviewed several information sharing agreements that have been prepared by vendors. Thus far, all of those agreements have contained the relatively minimal text required by the regulations.

**Oklahoma Law**

**O**klahoma law generally allows any full time employee or any teacher to direct the school district to pay a portion of his/her compensation into any annuity contract from any insurance company authorized to do business in Oklahoma. This law is not superseded by the new regulations. If the requirements set forth in the regulations and Code Section 403(b) are satisfied by an insurance company that is authorized to do business in Oklahoma, then that company may issue an annuity to any full time employee or teacher in the district. Under Oklahoma law, a district's refusal to enter into its standard form information sharing agreement with an issuer will not likely be grounds to deny access to the issuer.

**D**ue to the diversity of its attorneys and its historical commitment to educational law in Oklahoma, RFR is in the unique position of analyzing the interplay between Code Section 403(b) and Oklahoma education law. If RFR can assist in evaluating or structuring your district's 403(b) program, we would welcome the opportunity to do so.

**We're on the Web:  
www.rfrlaw.com**

*Chalkboard* is a Rosenstein, Fist & Ringold publication that addresses current education law issues. *Chalkboard* is published four times a year and is sent without charge to all education clients of Rosenstein, Fist & Ringold and all other persons who are interested in education law issues. We invite you to share *Chalkboard* with your friends and colleagues. We think you will find *Chalkboard* to be informative and helpful with the difficult task of operating our educational institutions.

*Chalkboard* is designed to provide current and accurate information regarding current education law issues. *Chalkboard* is not intended to provide legal or other professional advice to its readers. If legal advice or assistance is required, the services of a competent attorney familiar with education law issues should be sought.

We welcome your comments, criticisms and suggestions. Correspondence should be directed to Rosenstein, Fist & Ringold, 525 South Main, Seventh Floor, Tulsa, Oklahoma 74103-4508, or call us at (918) 585-9211 or 1-800-767-5291. Our FAX number is (918) 583-5617. Help us make *Chalkboard* an asset to you.