Proposed Section 403(b) Regulations

The Internal Revenue Service has proposed the "first comprehensive guidance on section 403(b) arrangements in over 40 years" in regulations that were proposed on November 16, 2004.

The general effective date of the proposed regulations, which cannot be relied upon until they are issued in final form, has been postponed until taxable years beginning after December 31, 2006 (union plans and church plans may have different effective dates).

The proposed regulations generally impose requirements that will make employer-sponsored Section 403(b) plans more like qualified retirement plans. The specific requirements include:

1) Employer-sponsored Section 403(b) plans have to be maintained pursuant to a written defined contribution plan document. The plan document must contain all material terms, including eligibility, benefits, benefit limits, contracts available under the plan and the time and form of benefit distributions. The plan may contain permitted optional provisions dealing with hardship distributions, plan loans, plan-to-plan transfers and acceptance of rollovers.

2) Participant notice requirements will be imposed in order to implement the required "universal availability" of any salary reduction contributions provided by the plan. Participants must be given an "effective opportunity" to make or change such contributions by providing notice of the right to do so as well as the specific election mechanics.

3) The following categories of excludable employees listed in IRS Notice 89-23 will no longer be subject to exclusion from a Section 403(b) plan:

    - employees who make a one-time election to waive 403(b) participation in order to participate in a governmental plan;

    - employees covered by a collective bargaining agreement;

    - visiting professors (currently limited to exclusion for a one-year period under certain conditions); and

    - employees affiliated with a religious order who have taken a vow of poverty.

    Section 403(b) plans can continue to exclude employees eligible to make elective deferrals under a Section 401(k) maintained by the employer, non-resident aliens, students performing services and employees who normally work fewer than 20 hours per week (see item 4 below).

4) Section 403(b) plans have always been permitted to exclude employees who normally work fewer than 20 hours per week. The proposed regulations permit

this exclusion of part-time employees, but also provide that an employee will be considered to work fewer than 20 hours per week *only* if:

- the employer reasonably expects the employee to complete fewer than 1,000 hours of service during the first 12 months of employment; and

- for each plan year ending thereafter, the employee completed fewer than 1,000 hours of service in the preceding 12 month period.

5) There are currently no restrictions on when a participant may take a distribution of non-elective employer contributions plus earnings from a 403(b) annuity contract. The proposed regulations would permit such distributions only upon termination of employment or another sanctioned trigger event (a fixed number of years, upon attainment of a stated age or upon the occurrence of a disability).

6) Qualified plan antidiscrimination tests of Code Sections 401(a)(4) and 410(b) are to be applied to employer 403(b) plan contributions in lieu of the good faith standard of IRS Notice 89-23, which is targeted for revocation. Also, the annual limit on annual compensation that may be taken into account pursuant to Code Section 401(a)(17), which is $220,000 for 2006, will apply to Section 403(b) plans under the proposed regulations.

7) Participant hardship distributions will be permitted in accordance with the Section 401(k) rules on hardship distributions.

8) Elective deferral contributions to a Section 403(b) plan, just like 401(k) contributions, must be transferred by the employer to the plan within 15 business days following the month in which such deferrals are deducted from the participant's pay.

9) Life insurance policies (except for grandfathered policies) may not be used to fund a Section 403(b) plan.

10) Section 403(b) plans can be terminated by an employer-sponsor with plan assets distributed to participants with full rollover options even if participants have not separated from service or otherwise incurred a sanctioned trigger event referred to in item 5 above.

11) In-service plan-to-plan 403(b) asset transfers by participants will be limited, as in qualified retirement plans, to transfers to a receiving plan in which the employee is a participant. Annuity contract exchanges among annuity contract providers must occur within the same 403(b) plan and the exchanged assets must not be diminished in the transaction. The annuity transfer rights provided by Rev. Rul. 90-24 will be restricted accordingly.

12) As we have already discussed in some detail, tax-exempt employers will be aggregated based on an 80 percent director control test to determine the identity of all entities to be treated as a single employer for Section 403(b) purposes.

The above rules, subject to modification by the anticipated final regulations, will require a conforming amendment of existing plan documents. The optional plan features identified in item 1 above may warrant consideration by employers. Any additional monitoring of antidiscrimination compliance (item 6 above) should be arranged with the relevant service provider. There also may be a need to modify the language of existing contracts with service providers to specify new duties and responsibilities in light of the above regulations.

In addition to the above, tax-exempt employers should consider the "Roth 403(b)" option. This option would allow participants to make elective Section 403(b) contributions that would not currently be excluded from income for tax purposes but would be distributable free of income tax after age 59½, if certain conditions are met. Unlike a Roth IRA, there is no income restriction on those eligible to make Roth 403(b) contributions. Consequently, this option would permit highly compensated employees to make such contributions for the first time. The new Roth 403(b) rules are currently effective and can be implemented at any time.

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