



BDO Seidman, LLP
Accountants and Consultants

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Subject:

New Section 403(b) Regulations

ERISA and Employee Benefits Alert

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Material discussed in this tax alert is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

Background

The Internal Revenue Service announced on August 29, 2006 that the general effective date for the regulations regarding Section 403(b) arrangements that were proposed in 2004 will be extended. These regulations are important because they represent the first comprehensive 403(b) guidance in more than 40 years. They also provide insight into the shifting views that the IRS and Treasury Department are taking with respect to such programs.

In order to provide employers, employees, insurance carriers, and mutual funds involved in section 403(b) arrangements a reasonable advance period before the regulations go into effect, the final regulations generally will not be effective earlier than January 1, 2008.

Section 403(b) plans will look and feel different thanks to the new 403(b) rules which have been confusing plan sponsors. Conducted studies have indicated that most plan sponsors have misconceptions about the new law. Below is a summary of the proposed new regulations, which will generally be effective on or after January 1, 2008.

Summary of Proposed New Regulations

The proposed regulations make it very clear that they may not be relied upon prior to their effective date as set forth in the final regulations, when issued. Thus, any employer that follows these regulations prior to their finalization will not be maintaining their 403(b) program in accordance with current law. While it is good to be aware of the proposed changes and make plans for probable changes to 403(b) programs, it is also important to remember that these proposed regulations are not final, have no legal authority and should not be confused with rules and regulations that currently guide 403(b) plans.

Section 403(b) plans can only be maintained by eligible employers that include non-profit organizations described in § 501(c)(3) and public education organizations. Once these new regulations are implemented, § 403(b) and § 401(k) plans will look like fraternal twins. The main provisions of the proposed regulations are summarized below:

- Written Documentation Requirement. Section 403(b) plans will have a new look because for the first time there will be a formal, written plan document requirement. Under the new regulations, § 403(b) plans must be formalized in a writing that includes, but is not limited to, all substantive provisions relating to eligibility, benefits, applicable contribution limits, a description of available contract provided under the plans, loan procedures, and hardship withdrawals and distributions. The regulations will allow plan sponsors to choose between having a plan document for each vendor or combining all vendor contractual provisions under one plan.
- Return of Excess Employee Deferrals. Excess employee deferrals may be returned to the employee prior to April 15th of the calendar year following the year that the excess contribution deferral was made. However, other contributions that exceed § 415(c) limitations cannot be returned by the employer. Instead, they must be deposited in a separate account and treated like a § 403(c) taxable contribution that is immediately included in the employee's gross income. Should the employer fail to establish such an account, the entire contract would and all amounts held in it will be disqualified and immediately taxable.
- New Required Employer Communication and Transfer Rules. Section 403(b)'s new backdrop mandates that employers provide their employees with "meaningful notice" about their rights to participate in the plan and provide participants with time to change or make elective deferrals. Transfers within the same § 403(b) plan are permitted as are transfers to another plan of the same employer or a different employer if it is offering the same vendor investment. In-service transfers to investment options not specifically named in the plan document, however, will not be permitted. Regardless of the transfer, the amount must equal the account balance contained in the original § 403(b) account before the balance.
- Deposit Requirements. Employers will have to transmit an employee's salary reduction contributions no later than the 15th business day of the month following the date on which the amounts would have been paid to the employee.
- Employer Contributions Permitted for Former Employees. Post severance contributions by employers into employee § 403(b) accounts are permitted for up to five years after severance from the employer. Contributions can be the lesser of the employee's last 12 months of compensation prior to termination or the annual dollar limit in effect for each year.
- Coordination of Catch-Up Limits. Contributions to § 403(b) plans may qualify for two salary deferral catch-up contributions - (1) traditional catch-up requiring 15 years of service and allowing an additional \$3,000 per year and (2) the age 50 catch-up allowing an additional \$4,000 per year.

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- Roth Contributions. ROTH contributions will be permitted if certain requirements are met.
 - Restrictions on Life Insurance. Stand alone incidental life insurance benefits will no longer be an allowed plan component. Providers, however, can develop products containing death benefit features within an annuity contract configuration.
 - Employers May Terminate 403(b) Plans. Plan terminations will now be permitted and assets distributed to employees upon termination.

These requirements can be arduous. To streamline the compliance process, you should begin preparation for the new rules now by:

1. Creating a plan document;
2. Listing all of your current § 403(b) vendors and narrowing that list;
3. Creating an advisory board for your § 403(b) plan consisting of key employees; and
4. Setting up procedures to allow you to continually monitor your vendors.

The above is only a summary of key elements of the proposed 403(b) regulations. Should you have questions regarding the new § 403(b) requirements or need compliance assistance, please do not hesitate to contact us.