



Washington Update

Proposed changes that could affect your Retirement Program

IRS Publishes Proposed Rules for 403(b) Programs

For the past 40 years, 403(b) programs have been regulated by a patchwork quilt of regulations, exam guidelines, revenue rulings and notices. In late 2004, the IRS finally issued updated proposed 403(b) regulations, as well as a temporary regulation regarding the definition of salary reduction arrangement for purposes of including amounts in FICA wages.

While the proposed rules are helpful in understanding the IRS's current perception of 403(b) arrangements, it is important to remember that these regulations cannot be relied upon by taxpayers. That is, sponsors of 403(b) programs *should not* make any changes to their programs to comply with these rules. It is quite possible for the IRS position to change dramatically between now and the publication of final regulations. On the other hand, employers *must* comply with the temporary rule regarding FICA wages.

Major changes under the proposed rules would:

- Impose written plan document and operational compliance requirements;
- Repeal the existing nondiscrimination safe harbor for employer contributions and impose a set of "controlled group" rules;
- Prohibit the use of life insurance (and certain other incidental benefits) in 403(b) programs;
- Impose conditions on transfers between providers while still in service; and
- Allow plan terminations (and concurrent distributions) under rules similar to those for 401(k) plans.

Written Plan Document

For the first time, 403(b) arrangements would be required to have written plan documents that contain all material terms and conditions for eligibility, benefits, limitations, and time and form of distributions. However, a "plan" would not necessarily have to consist of a single plan document. It could consist of an annuity contract or contracts and a supplemental document containing provisions that are not included in the annuity contract(s).

The major concern about this requirement is the possibility that the existence of a plan document could mean that certain 403(b) programs that are not currently covered by ERISA (e.g. a salary reduction-only arrangement), would now be subject to ERISA. The IRS has asked for comments on this issue, which it promises to share with the DOL. We expect that IRS will receive a significant number of negative comments regarding this proposal.

Defined Benefit 403(b) Plans Not Permitted

The proposed regulations would require that a 403(b) plan be a defined contribution plan, except in the case of a church 403(b)(9) plan in existence on September 3, 1982. Certain other grandfather rules are available for plans in existence on the effective date, but only for pre-effective date accruals.

403(b) Contract Requirements

The proposed regulations would require that certain 403(b) contracts contain the following provisions:

- Nonforfeitability;
- Nontransferability;
- Limit on elective deferrals;
- Minimum required distribution rules (including the incidental death benefit rule); and
- Direct rollover rules.

Plan Requirements

Plan document provisions would have to include nondiscrimination rules and limits on annual additions.

Incidental Benefits Restricted

In general, 403(b) programs could no longer be funded with term and permanent life insurance and endowment contracts. A grandfather rule would apply for contracts issued before February 14, 2005.

Eligible Employers

An organization that is both a governmental entity and a 501(c)(3) tax-exempt organization would be allowed to maintain a 403(b) program, but would not be allowed to sponsor a 401(k) plan. This rule would typically affect governmental hospitals that have obtained 501(c)(3) approval by the IRS.

Timing of Contributions

Employers would be required to transfer contributions to the 403(b) provider within a period that is no longer than reasonable for the proper administration of the plan. An example of a reasonable time period is within 15 business days following the month in which the amounts would have otherwise been paid to the participant.

Church Retirement Income Account Plans

The proposed regulations incorporate a number of provisions to recognize church retirement income account plans under Code section 403(b)(9). These proposed rules were previously contained only in some legislative history.

Contribution Limits

Elective deferrals would not include contributions under a one-time irrevocable election made on or before an employee's first becoming eligible to participate, or a contribution made as a condition of employment.

However, under the temporary rule, FICA taxes apply to all salary reduction contributions, whether they are voluntary or required contributions.

If an employee is eligible for both the age 50 catch-up contribution and the 15-year catch-up, any catch-up contribution would first be counted as a 15-year catch-up. Once that limit is exceeded, catch-ups would be treated as age 50 catch-up contributions.

Definition of "Includible Compensation"

The proposed rules follow existing rules regarding the definition of includible compensation from which deferral contributions may be made. However, the IRS requests comments on whether plan sponsors should be allowed to use a simpler taxable-year based definition, such as W-2 compensation, for administrative ease.

Nondiscrimination Rules

The qualified plan nondiscrimination rules would generally be imposed on all employer contributions (other than elective deferrals) made to 403(b) programs. The current "universal availability" rule would continue to apply to elective deferrals made to all 403(b) programs, including those offered by governmental employers but excluding some church plans.

Anti-Conditioning Rule

Similar to existing 401(k) plan rules, the proposed 403(b) rules would prohibit employers from conditioning rights or benefits under other plans directly or indirectly on an employee's participation (or non-participation) in the 403(b) program.

Controlled Group Rules

New controlled group rules would apply to tax-exempt entities, such as 501(c)(3) organizations, for purposes of nondiscrimination testing, annual additions limits, the 15 years of service catch-up election, and the minimum distribution rules.

Grandfather for Pre-'87 Contributions

Pre-'87 contributions may continue to be grandfathered from the minimum distribution rules, but only if those amounts are separately accounted for.

Qualified Plan Distribution Restrictions Imposed on 403(b) Annuities

Employer contributions would be subject to the qualified profit sharing plan distribution rules. Plans would have to provide a predetermined formula for distributing the funds in the plan after a fixed number of years, the attainment of a stated age, or after the occurrence of an event such as a layoff, illness, disability, retirement, death or severance from employment.

Severance from Employment

In general, the 401(k) rules for determining whether there is severance from employment, would apply to participants in 403(b) programs. In addition, a severance would occur when an employee ceases to be employed by an eligible employer that maintains the 403(b) program.

Plan Termination Permissible

For the first time, it would be possible to terminate a 403(b) program and distribute benefits due to plan termination.

Transfers between Contracts and Plans

Transfers between 403(b) contracts within a program (and between programs) while an individual is still employed, would still be allowed, provided certain conditions are met. In a significant change to prior guidance, transfers by employees and beneficiaries could only be made to 403(b) contracts of the individual's employer. However, 403(b) assets would still not be able to be merged with, or transferred to or from, other types of tax-favored retirement arrangements (e.g., 401(k) plans, 457 plans, etc.).

Effective Dates of Proposed Regulations

The new rules are proposed to be effective for tax years beginning after December 31, 2005 (generally, January 1, 2006). A delayed effective date would apply to programs maintained under a collective bargaining agreement that is ratified and in effect when the final regulations are issued. Final regulations would not apply to church plans until the earlier of (1) January 1, 2007, or (2) 60 days following the earliest church convention that occurs after the date of publication of the final regulations. We anticipate that the IRS will receive substantial comments urging a later effective date, to allow sufficient time to make and implement required changes.

The IRS has set February 14, 2005, as the deadline for comments. A public hearing has been scheduled for the next day. As always, Prudential plans to be actively involved in the formulation of comments and industry efforts to seek changes, refinements and clarifications to these proposals. We are hopeful that these efforts will result in eliminating some of the most onerous requirements and ease compliance burdens. Please contact your Prudential Retirement Relationship Manager or Client Consultant if you have specific questions, comments or concerns.

Washington Update by Prudential Retirement

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