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Client Alert

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September 2006

Effective Date of Section 403(b) Regulations Extended

The Internal Revenue Service has announced that the effective date for final regulations under Section 403(b) of the Internal Revenue Code of 1986, as amended (the "Code"), as well as the related controlled group regulations with respect to tax-exempt entities under Code Section 414(c), will be delayed. The regulations were originally proposed in November of 2004. The Internal Revenue Service has stated that in order to provide employers, employees, insurance carriers and mutual funds involved with Code 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.

Final regulations, of course, have not yet been issued. While the Internal Revenue Service is hopeful of releasing final regulations shortly, they will not at this point predict the anticipated release date. The Pension Protection Act of 2006 (the "Act") and the additional burdens it has imposed on the Internal Revenue Service will likely impact the timing of the issuance of the final regulations. We hope that this impact will be limited. The delay in the effective date of the final regulations is practical (and much appreciated) as it is already September and year-end is around the corner.

Current Actions To Consider

Notwithstanding the delay of the effective date of the 403(b) regulations, certain provisions included in the proposed regulations are clearly going to be included in the final regulations. Indeed, the Internal Revenue Service has asserted that some of these provisions already should be applied in practice under current law. Accordingly, employers should not delay in complying with certain aspects of the proposed regulations despite the delay of the release, and the effective date, of the final regulations.

Universal Availability

Internal Revenue Service representative have consistently stated that not only must the ability to make salary reduction deferrals be available to all employees of an employer which offers a 403(b) plan (except those who are specifically excluded in accordance with applicable Internal Revenue Service guidance), but all such employees must be aware that they are eligible to make such deferrals. Accordingly, employers should implement procedures designed to notify employees of their eligibility to make elective deferrals on an ongoing basis.

Excluded Employees

Internal Revenue Service representatives also have firmly asserted that Code Section 403(b)(12), which permits the exclusion (for nondiscrimination testing purposes) of employees who normally work less than 20 hours per week, is overridden for plans that are subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), by the ERISA equivalent of Code Section 410(a) (which the Internal Revenue Service interprets for both tax and ERISA purposes) and that the 20-hour standard is not a reasonable classification for plan eligibility exclusion. Code Section 410(a) prohibits the exclusion from a plan of employees who work 1,000 hours or more during the applicable 12-month period once they satisfy eligibility waiting periods. Accordingly, employers subject to ERISA who maintain plans that include the 20-hour exception for either employee or employer contribution eligibility need to eliminate this exclusion and, if appropriate, implement the 1,000-hour requirement.

Elimination of Safe Harbor

There is little doubt that use of the nondiscrimination safe harbor under Internal Revenue Service Notice 89-23 will be prohibited under the final regulations as of their effective date and, hence, employers should

begin to think about restructuring their 403(b) plans in order to satisfy the nondiscrimination requirements of the Code.

Pension Protection Act of 2006

In addition to the implications of the 403(b) regulations, the Act, which amended dozens of provisions of the Code and ERISA, may have an impact on certain 403(b) plans. The Act amended the minimum vesting rules applicable to employer nonelective contributions under 403(b) plans. Currently, employer contributions (other than matching contributions) to a 403(b) plan and related earnings must vest on a schedule that provides either for graded vesting at a rate of at least 20% a year from 3 to 7 years of service or 100% vesting at no later than 5 years of service. The Act requires that for contributions for plan years beginning after December 31, 2006 such employer contributions and related earnings must vest at a rate of at least 20% a year from 2 to 6 years of service, or must be 100% vested no later than 3 years of service. Employer contributions made on or before December 31, 2006 and related earnings may continue to vest on their prior vesting schedule. This new faster vesting schedule is the same schedule that currently applies to matching contributions. While many 403(b) plans provide for immediate full vesting of employer contributions, those that do not will have to promptly address this requirement.

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Proskauer's Employee Benefits and Executive Compensation Law Practice Group includes over 50 attorneys with significant and diverse tax, executive compensation, and employee benefits law experience.

The Non-Profit/Exempt Organizations Practice Group at Proskauer Rose LLP forms, represents, and counsels entities that are exempt from taxation under the U.S. Internal Revenue Code.

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