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Get Familiar with the Facts

403(b) Regulations: Understanding the Proposed Changes

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New 403(b) Regulations ...

The First in 40 Years

There have been many changes to pension and tax law over the last four decades, but much of what the Internal Revenue Service (IRS) has addressed dealt primarily with 401(k) retirement plans. Finally, the IRS is directing its attention to 403(b) programs and how they should be administered.

Employers, employees, insurance carriers and mutual fund companies that are involved in section 403(b) arrangements will have through the end of 2007 to prepare for the proposed regulations. These new rules offer comprehensive, interpretive guidance for the first time since 1964 when regulations under section 403(b) were first published, and update the current regulations by deleting provisions that no longer have legal effect due to subsequent changes in the law. The proposed regulations will make many revenue rulings, notices and other guidance under section 403(b) obsolete.

Change is Good

As an employer, you have been offering your employees a 403(b) retirement plan without much guidance from the IRS for years. Legislation such as the Employee Retirement Income Security Act (ERISA) and the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) changed the rules for many retirement savings programs, but the legislation had little impact on schools and non-profits. Subsequent confusion surfaced among plan employers and, over time, many 403(b) programs fell out of compliance. After conducting numerous audits, the IRS recognized it was time to provide guidance to make sure that 403(b) programs operate in compliance with these laws.

The new regulations may also offer insight into the shifting views of the IRS and Treasury Department. Essentially, these proposed changes aim to align the rules governing 403(b) plans more closely with those governing salary reduction arrangements such as 401(k) or 457(b) plans.

Beginning January 1, 2008, or a later date established by the final regulations, section 403(b) plans will look different. The new rules will affect all 403(b) arrangements in terms of due diligence and compliance expectations, which will directly impact how you manage these benefits for your plan participants. By adhering to the new regulations, you will have strategic opportunities to introduce enhanced services, improve investment performance and reduce fees, which will directly benefit your employees.

We understand that change can be good, but it can also cause concern. That's why at The Standard, our goal is to extend our experience and expertise to you — to help you navigate through these coming months before the regulations go into effect.

This resource will provide you with a review of the proposed regulations, answers to commonly asked questions and concerns, and a game plan for streamlining your compliance process.

Section 403(b) Requirements

The Major Changes

Three major differences between 403(b) and 401(k) elective deferrals:

- 1) Section 403(b) is limited to specific employees (employees of state public schools, employees of section 501(c)(3) organizations, and certain ministers);
- 2) Unlike section 401(k), contributions under section 403(b) can only be made to certain funding arrangements; and
- 3) A universal availability rule applies to section 403(b) elective deferrals, whereas the ADP test and 410(b) coverage rules apply to 401(k) deferrals.

A Plan Document

Under the new rules, you will need to maintain a written defined contribution plan document and operate the 403(b) program according to its terms for eligibility, benefits, limits, contracts and the form of and time for benefit distributions.

The plan document may also include some optional features:

- Loans
- Hardship withdrawals
- Transfers
- Roth contributions
- Employer contributions, including post-employment contributions

If your plan includes any of these optional features, then it must adhere to the new 403(b) requirements in both form and operation.

Elective Deferrals

403(b) elective deferrals must generally be made available to all employees, and other contributions must satisfy the general nondiscrimination requirements applicable to qualified plans. All elective deferrals must satisfy the section 402(g) deferral limits (\$15,500 for 2007), and the overall section 415 annual addition limit.

403(b) plans must also satisfy minimum required distributions rules, incidental benefit requirements and the rollover distribution rules. The new regulations explicitly state that 403(b) elective deferrals are limited to contributions made pursuant to a cash or deferred election.

The 403(b) and 401(k) elective deferral rules are similar in terms of the frequency with which a deferral election can be made, changed or revoked, including automatic enrollment. At minimum, employees must have an opportunity to make, change or revoke a deferral election annually.

Acceptable 403(b) Funding Arrangements

- Annuity contracts issued by an insurance company
- Custodial accounts invested solely in mutual funds
- Retirement income accounts (permitted for church employees only)

Universal Availability Rule

In general, universal availability now applies separately to each entity employing a 403(b) program (in public schools, for example, where there is not a common payroll). If any employee who could be excluded from participating in the 403(b) program is able to participate, then all employees within that excludable category must be allowed to participate.

The nondiscrimination and universal availability requirements do not apply to a section 403(b) contract purchased by a church.

Additionally, the proposed regulations state that the following categories of employees are exempt from the universal availability rule:

- non resident aliens
- students performing services described in section 3121(b)(10)
- employees who normally work less than 20 hours per week
- employees who can participate in an eligible governmental plan under section 457(b) permitting contributions or deferrals, or a plan offering 401(k) deferrals

The nondiscrimination and universal availability rules are “in addition” to other legal requirements. For example, employers who are subject to Title I of ERISA would not be able to exclude employees who work fewer than 20 hours per week.

Employers must also provide employees with an annual notice explaining the “effective opportunity” to make or change their contribution to the plan. For many plan sponsors, this means assuming a more active role in communicating with employees.

Universal Availability Notice

Make Employees Aware:

- A cash or deferral election is available
- The time period during which the election can be made
- Their right to contribute up to the maximum allowed
- Any other conditions on elections

Catch-up Contributions

A 403(b) program may provide additional catch-up contributions for participants who are age 50 by the end of a calendar year (up to \$5,000 for 2007). Additionally, employees of a qualified organization with at least 15 years of service are entitled to a special 403(b) catch-up limit of up to \$3,000. A participant who is eligible for both types of contributions must first satisfy the special 403(b) catch-up limit before using the age 50 catch-up provision.

Timing of Distributions

Employer contributions may not be paid to a participant from a 403(b) custodial account before the participant has a severance from employment, becomes disabled or turns age 59½.

Any contribution amounts attributable to elective deferrals may not be paid to a participant before he or she has a severance from employment, becomes disabled, experiences a hardship or turns age 59½.

The regulations also include a number of exceptions to the timing of distributions. Specifically, the rule for elective deferrals does not apply to those deferrals made before January 1, 1989.

Transfers and Exchanges

The new transfer rule brings the 403(b) plan in line with the way transfers occur in 401(k) plans. Plan employers are allowed to direct or authorize the transfer. Two types of transfers are permitted:

Plan-to-Plan Transfers	Contract-to-Contract Exchanges
<ul style="list-style-type: none">• The participant whose assets are being transferred is an employee of the employer that sponsors the receiving plan.• The plans respectively provide for the transfer and the receipt.• The participant's benefit after the transfer at least equals the benefit before the transfer.	<ul style="list-style-type: none">• The exchange occurs within the same section 403(b) plan.• The plan permits the exchange.• The participant's benefit after the exchange at least equals the benefit before the exchange.

In either case, the amounts transferred must be subject to distribution rules at least as restrictive as those of the transferring contract.

Loans

The new rules include a provision that allows participants to take a loan from their 403(b) accounts.

Plan Termination

The proposed regulations now allow 403(b) plans to be terminated. All accumulated benefits under the plan must be distributed to participants and beneficiaries as soon as administratively possible after termination of the plan.

Taxation

The new regulations state that only amounts actually distributed from a section 403(b) contract are includible in the gross income of a participant for the year in which the distribution is made.

A payment that is considered an eligible rollover distribution is not taxed in the year distributed as long as the payment is directly rolled over or transferred to an eligible retirement plan. However, a 20 percent Federal withholding applies if the distribution is not directly rolled over.

Qualified Domestic Relations Orders

The proposed regulations clarify that section 414(p) QDRO rules apply to 403(b) plans.

Making Your 403(b) Program More Competitive

A thoughtful investment policy and competitive RFP process, together with service provider accountability, are a powerful combination of tools employers can use to select and maintain top performing providers and investment options.

Though these regulatory changes may appear to be challenging to many 403(b) plan employers, the new rules aim to strengthen 403(b) plans by initiating:

- Improved performance of investment options
- New, enhanced participant services
- Reduced fees

These new rules present a strategic opportunity for employers to reposition and enhance their 403(b) programs, transforming it into a powerful recruitment and retention tool. How? First, you must bring your plan in line with those offered by the most successful or “model” employers.

Fewer Service Providers and Investment Options: Less Means More

Model employers understand that the consolidation of providers through a competitive request for proposal (RFP) process enables them to use their combined plan assets to reduce fund fees and administrative expenses. RFPs can provide 403(b) plan sponsors with a way to effectively reduce the number of providers they are using. Employers with a single provider can view RFPs as an effective means to renegotiate their contract, thereby paving the way for maximizing investment returns for participants.

Many defined contribution plan sponsors also utilize investment policies to describe, in detail, their fund options: their characteristics; the basis upon which they are selected; benchmarks against which they will be evaluated; and the process by which they will be monitored, evaluated and, if necessary, replaced.

Good fiduciary behavior means regularly evaluating fund options. Therefore, by reducing the number of fund options available to participants, plan sponsors reduce their administrative responsibility as well. More and more plan sponsors are beginning to recognize this and are steering clear of the increased complexity, confusion and oversight responsibility that offering many funds creates.

Regardless, plan sponsors who use any professional third party or consulting services to assist them with their retirement programs are expected to act prudently and ensure all other parties are likewise acting prudently, thereby requiring a closer scrutiny of plan providers. This can be accomplished through the incorporation of specific performance standards delivered by plan providers via contractual service guarantees. Plan providers who fail to deliver promised services must then face financial consequences.

A thoughtful investment policy and competitive RFP process, together with service provider accountability, are a powerful combination of tools employers can use to select and maintain top performing providers and investment options.

Increased Employer Responsibilities: More Means More

403(b) employers entering the world of fiduciary due diligence — a world that 401(k) plan providers have grown to embrace over the last several decades — will see that the benefits come with a price. The more employers actively manage their 403(b) programs, the more costly the plan becomes. Yet, the new regulations require that section 403(b) programs be “maintained pursuant to the plan.” This means that employers will have greater responsibilities in assuring that their plan documents(s) accurately reflect the operation of the plan while complying with IRS requirements.

Additional costs associated with increased oversight, plan compliance and regular investment reviews can be incorporated into the provider estimates in RFP responses. In this way, most 403(b) plans can remain competitive on both a fee and expense basis despite the higher costs that the employer’s increased role generates.

403(b) FAQs

Separating Fact from Fiction

Why did the IRS propose changes to its 403(b) code?

While the law, code section 403(b) itself, had undergone many changes over the years, no comprehensive changes have been made to the 403(b) regulations since the 1960s. The IRS also wanted to make 403(b) regulations more consistent with other defined contribution plans, such as 401(k) plans, offered by businesses and corporations. The new rules are intended to simplify the regulations and offer guidance for both participating employees and plan employers.

What is the effective date of these proposed changes?

The regulations are expected to become effective on January 1, 2008.

What are the changes that are included in the new regulations?

The new regulations offer clarification regarding contribution limits, post-severance contributions, hardship distribution rules and the availability of salary deferrals. Additional changes include:

- Contracts or accounts must be maintained in accordance with a written plan document
- Employers must designate approved investment providers and products under the plan
- Transfers must be restricted to approved investment providers and products under the plan
- No new incidental life insurance is allowed

What is a plan document?

A plan document sets forth all material terms governing the 403(b) plan, including those relating to eligibility to participate, benefits under the plan, applicable contribution limits and restrictions on distributions.

How will transfers be affected?

Revenue Ruling 90-24 transfers will no longer be allowed as they are today.

Transfers within a plan, or “exchanges,” will only be allowed to approved investment providers and products. If a participant wants to exchange an account or contract within a plan, the investment provider and product must be approved. Transfers outside of the plan will be allowed to a contract or account under another employer-sponsored 403(b) plan in which the employee is eligible to participate.

Will the investment options offered in a 403(b) plan have to change as a result of the new regulations?

No. The regulations do not require employers or investment providers to make changes to their investment options or the type of investment products offered under the plan other than to discontinue stand-alone incidental life insurance benefits. Providers, however, can develop products containing death benefit features within an annuity contract configuration, if desired.

Are Roth contributions permitted under the new regulations?

Yes, on an optional basis. If the employer wishes to permit Roth and traditional contributions, the plan document(s) must identify the types of contributions permitted.

How are distributions affected?

The regulations retain the restrictions on distributions for custodial accounts. Distributions may be made only upon severance from employment, disability or attaining age 59½.

Distributions from an annuity contract may only be made to participants upon separation from service or the occurrence of an event such as a fixed number of years of service, the attainment of a specified age, or the event of a disability. Therefore, the regulations restrict distributions of employer contributions from 403(b) annuities. Hardship distributions will continue to be permitted under a 403(b) plan and must follow the same rules that apply to 401(k) plans.

Can employers terminate their 403(b) plan?

Yes. The new regulations state that an employer may terminate a 403(b) plan and then distribute assets to the employees.

Are employers required to notify employees regarding the availability of the plan?

Yes. Employers must notify employees annually about the availability of salary deferrals under the plan and employees must have an opportunity at least annually to make, revoke or modify a deferral election.

403(b) Audit Requirements at a Glance

The requirements for operating your 403(b) retirement plan should be reviewed annually. Use this checklist to help keep your plan in compliance with many important tax rules.

- Your organization must qualify as a public educational institution or as a charitable organization exempt from tax under IRC 501(c)(3).
- All employees (with very few exceptions) who normally work 20 hours or more per week must be given the opportunity to make a salary deferral.
- Elective deferrals, including any designated Roth contributions, must be limited to the amounts under IRC 402(g) for a calendar year.
- The total employer and employee contributions must not exceed the IRC 415 (c) limits.
- If IRC 402(g) “15 years of service catch-up” contributions are being made, the employee must have the required 15 years of full-time service with the same employer.
- If age 50+ catch-up contributions are permitted, each of your employees age 50 or older must be informed of their rights to make catch-up deferrals.
- The 403(b) annuity contract or custodial account must contain the non-transferability provisions (annuity contract only), state the limits under IRC 402(g) and contain the direct rollover provisions of IRC 401(a)(31).
- If your plan offers a five-year post severance provision, the amounts must be contributed through a non-elective method.
- You and your plan provider(s) must enforce participant loan repayments and limit aggregate loan amounts as required under IRC 72(p).
- You and your plan provider(s) must require documentation that hardship distributions meet the definitions and requirements for hardship under the IRC 401(k) regulations.

Note: The above information is not intended to be an exhaustive list of all issues pertaining to the new 403(b) regulations. The information presented here is intended to provide answers to some of the most commonly asked questions.

Get Prepared Now

In anticipation of the forthcoming effective date for the new regulations, plan employers should take several steps to ease plan administration while addressing the new fiduciary responsibilities and due diligence requirements.

1. Review existing provider contracts for the current sales and servicing performance requirements as well as current investment performance and expenses. Determine benchmarks for periodic due diligence reviews of the plan.
2. Consider initiating a competitive RFP process that will allow for a formal comparison of investment services and fund performance. Employers equipped with this information will be well positioned to decide whether to transition to or remain with a single provider.
3. Develop an investment policy statement to specifically outline what investment options will be included in the plan and how they will be selected, evaluated, and if necessary, removed and replaced.
4. Consider renegotiating provider contract(s). Remember, plan providers are usually more inclined to reduce fund expenses and improve service performance standards before they would allow existing participant accounts to be subjected to the competitive marketplace.

403(b) Due Diligence & Fiduciary Responsibilities Checklist

- Form a 403(b) advisory board of five to seven members.
- Review existing provider(s) for investment performance, investment options, fees, expenses, service standards, etc.
- Develop an investment policy statement.
- Develop the 403(b) plan document(s).
- Create standards for the ongoing monitoring of the plan.
- Establish fiduciary criteria.
- Develop and issue an RFP.
- Assess the need for outside advisory experience.

Because we're a single source provider, plan employers can benefit from the lower expense ratios that our aggregate buying power can generate.

The Standard's Solution: The Power of One

The Standard is uniquely positioned to partner with you as you strive to comply with all of these new 403(b) regulations. Our comprehensive service offering will provide you with the plan administration, investment options, investment guidance and employer support you need to meet the anticipated January 1, 2008 effective date for these new rules.

The Standard offers a wide range of investment options to help develop a complete and diversified portfolio. And because we're a single-source provider, plan employers can benefit from the lower expense ratios that our aggregate buying power can generate.

Additionally, StanCorp Investment Advisers, Inc. can assume fiduciary responsibility for investment selection and monitoring as well as the advice we provide plan employers.

- **Monitor investment performance:** The Standard uses stringent selection and monitoring criteria for our investment offerings. If a fund doesn't meet our standards, we consider it for termination. We offer registered investment advisor services for some plan sponsors at no additional cost.
- **Enhance participant services:** Participants have full access to support systems for online enrollment, loan processing, account information and investment option changes. The Standard also offers asset allocation portfolios to help participants select an appropriate asset allocation for their own investment styles — in minutes.
- **Monitor fund fees:** As the plan's single provider, The Standard can offer investments at lower expense ratios than individual fund providers. Revenue sharing from funds is passed directly to the plan to reduce expenses and ensure that decisions and advice are unbiased.
- **Written plan document:** Our experienced staff can help the sponsors create a plan document and administer the plan accordingly.

We view our partnership with plan sponsors as a true union — one which allows employers to assume more responsibility through the comprehensive solutions we stand ready to offer. The end result will be an improved, more competitive 403(b) program that will deliver the best net return to plan participants.

For more information about The Standard's comprehensive 403(b) solutions, call us today at 877.805.1127.



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StanCorp Equities, Inc.
1100 SW Sixth Avenue
Portland OR 97204
877.805.1127

<http://retirement.standard.com>

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