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Is Your 403(b) Plan Covered by ERISA, Must it Be—and Does it Matter?

A Slight Twist in the 403(b) Plan Kaleidoscope Provides Another Picture

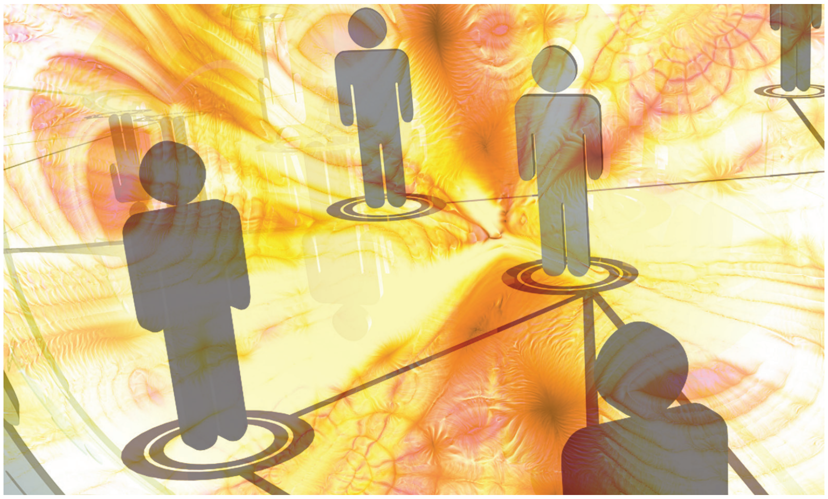
by James H. Culbreth, Jr. and Russ Dempsey

The market for retirement arrangements that qualify for favorable income tax treatment under Internal Revenue Code (IRC) Section 403(b) [a "403(b) plan"] has experienced considerable legal development in recent years. The Internal Revenue Service (IRS) and Department of Labor (DOL) have been active with regulatory action and administrative guidance for 403(b) plans. Significantly, the legal changes may impact whether a plan is subject to the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

A critical first step for 403(b) plan sponsors and service providers is to determine whether the plan is an ERISA or non-ERISA plan. Some employers are statutorily exempt from ERISA, other organizations may desire ERISA coverage and yet others may inadvertently take actions causing such entities to unintentionally fall under the purview of ERISA. Understanding the applicable legal framework is necessary for compliance, as well as expense management and forecasting.

Eligible Plan Sponsors under the IRC

Employers eligible to sponsor a 403(b) plan include public education institutions, select governmental employers and IRC Section 501(c)(3) organizations.[1] Examples of employers eligible to sponsor 403(b) plans include public schools, colleges, universities, county hospitals, charitable and religious organizations, community service organizations and hospitals.



Overview of 403(b) Plans

Historically, 403(b) plans functioned more like a group of individual annuity contracts than a single plan. This lack of centralized control and responsibility kept employers from assuming the "ownership" role towards the 403(b) plan that the IRC requires for benefit plans qualified under IRC Section 401, such as 401(k) plans. Consequently, compliance in 403(b) plans often

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1 As such organizations are defined in the Internal Revenue Code. Further, State, political subdivisions of a State, or agency or instrumentality of the State or political subdivision that are educational organizations described in 26 U.S.C. §170(b)(1)(A)(ii) are eligible.

was less monitored by both the employers and the IRS. This era effectively ended with the Final Regulations under IRC Section 403(b), which became effective January 1, 2009 and represented a significant transition by requiring, among other things, a written plan document and more involvement by the plan sponsor with 403(b) plan administration.

Application of ERISA to 403(b) Plans—The DOL Safe Harbor

In general, ERISA applies to employee pension benefit plans established or maintained by an employer, unless specifically excluded from the statute. However, the terms "established" and "maintained" are not defined in ERISA. In an effort to clarify the application of ERISA to 403(b) plans, the DOL issued a safe harbor regulation in 1979.[2]

According to the DOL regulatory safe harbor exemption, 403(b) plans funded solely through salary reduction agreements or agreements to forego an increase in salary are not "established" or "maintained" by an employer and are thus exempt from ERISA provided that:

- Participation of employees is completely voluntary;
- All rights under the annuity contract or custodial account are enforceable solely by the employee or beneficiary of such employee, or by an authorized representative of such employee or beneficiary;
- Involvement of the employer is limited to certain optional specified activities, such as permitting annuity contractors to publicize products to employees, offering reasonable funding choices and summarizing or compiling information regarding funding products, and;
- The employer receives no direct or indirect compensation in cash or otherwise other than reasonable reimbursement to cover expenses properly and actually incurred in performing employer's duties.[3]

Employer involvement, including employer discretion, is a critical factor in the analysis of whether the plan is an ERISA or non-ERISA plan.

Governmental entities and public education institutions are statutorily exempt from ERISA, so such eligible 403(b) plan sponsors need not be concerned with the regulatory safe harbor exemption. Religious organizations have a different status, in that these organizations may *elect* ERISA coverage, an option that is not available to governmental entities and public education institutions.

Complying with the DOL Safe Harbor

The additional plan sponsor involvement required by recent regulatory changes makes compliance with the ERISA safe harbor exemption much more difficult for plan sponsors. Consistent with the safe harbor, a plan sponsor may adopt a written plan document, comply with the benefit terms of the contracts, process payroll contributions, coordinate administration among different contract issuers and address tax-driven nondiscrimination requirements, such as universal availability. Plan sponsors seeking to maintain the exemption must use caution not to have responsibility for, or make, any discretionary determinations regarding plan administration. The DOL has been clear that discretionary determinations such as authorizing plan-to-plan transfers, processing distributions, satisfying qualified joint and survivor annuity requirements and having discretion over hardship distributions, qualified domestic relations orders (QDROs), and eligibility or administration of loans will place a plan sponsor squarely outside of ERISA's safe harbor exemption and place the 403(b) plan under ERISA.[4]

On the surface, complying with the safe harbor exemption appears to be as simple as avoiding discretion with respect to administration of the plan. Practically, however, a sponsor must balance the reasonable choice obligation regarding funding products against the duty to avoid any discretionary activity in plan administration. The requirement means that plan sponsors must offer participants a reasonable choice as to funding products and annuity contractors in order for the sponsor to be viewed as not to have established or maintained a plan. Plan sponsors must select providers that will accept the discretionary decisions related to loans, hardship requests, QDROs, distributions, etc., while at the same time not materially impacting reasonable choice.

Recent Clarifications on the DOL Safe Harbor

Recently, in Field Assistance Bulletins (FAB) 2009-02 and 2010-01, the DOL provided some clarification on these matters. Although welcomed, the FABs do not resolve all questions related to reasonable choice. The DOL confirmed that reasonable choice applies to both administrative service providers and investment products used by 403(b) plans. The DOL further emphasized that the facts-and-circumstance analysis takes into account whether the choice of providers and investment products is reasonable. The size of the employer is a relevant factor, since the expense of facilitating contributions to multiple providers and the administrative burdens of compliance may weigh more heavily on small employers. Without specifying a number of providers that must be offered, the DOL stated that there may be facts-and-circumstances that would justify the selection of a single provider if employees are permitted to transfer or exchange their interest in the plan to another provider.[5]

In the DOL's view, an employer may allocate discretionary determinations to an annuity provider, but may not directly delegate discretionary authority to a third party administrator (TPA).[6] The rationale for this position is that an employer seeking to comply with the safe harbor exemption may not have any discretion regarding the administration of the plan. Thus, an employer has no ability to delegate that which it may not possess (*i.e.,* an employer may not have discretion, therefore may not delegate discretionary activities). Interestingly, a provider may engage a TPA to perform services on behalf of the plan, including discretionary activities related to the administration of loans and hardship distributions.

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2 29 C.F.R. §2510.3-2(f).
3 Id.
4 Department of Labor Field Assistance Bulletin No. 2007-02.
5 Department of Labor Field Assistance Bulletin No. 2010-01.
6 Id.

Practical Considerations for Plan Sponsors of 403(b) Plans Covered by ERISA

A 403(b) plan that is not covered by ERISA avoids the rules governing the reporting and disclosure of employee benefit plans, as well as the ERISA fiduciary rules, all of which are contained in Title I of ERISA. Part 1 of Title I of ERISA is the source of the annual reporting and disclosure requirements, and Section 4 of Title I contains the rules regulating fiduciary conduct. Thus, a 403(b) plan that for any reason falls under ERISA's jurisdiction [*e.g.,* by providing employer contributions or having the plan sponsor too involved in administering the 403(b) plan] must comply with ERISA's mandates concerning annual reports and fiduciary conduct. Coverage under ERISA requires a plan sponsor to take additional steps in order to protect plan participants (and thereby avoid liability) in the operation of the 403(b) plan. Among these considerations are:

Form 5500 Audit for Large 403(b) Plans Covered by ERISA

Any 403(b) plan that is subject to ERISA must file an annual report using Form 5500 and its schedules. Beginning with the 2009 plan year, 403(b) plans *with 100 or more participants on the first day of the plan year* are required to have an annual audit of the plan's financial statements. Under ERISA, the audit must be made by an independent party and is required each year in which the 403(b) plan has 100 or more participants. FAB 2009-02 provides guidance on how a plan sponsor can align its duty to produce an annual report with the unique character of 403(b) plans [*i.e.,* the likelihood that many plan assets may be held by financial service providers that no longer are part of the 403(b) plan]. This relief does not eliminate the need for large ERISA-covered 403(b) plans to obtain and file the audit as part of the Form 5500 annual report, but it permits the auditor to certify that "grandfathered" annuity contracts are not reported in the audit.

The Need for a Summary Plan Description (SPD) and Other Disclosures

Even though the IRC now requires all 403(b) plans to have a written plan document, ERISA-covered 403(b) plans must also produce an SPD of the 403(b) plan and distribute it to participants within 120 days of coverage under the plan. Because the 403(b) plan requirements under the IRC may be satisfied by using multiple documents for service providers, the SPD for an ERISA 403(b) plan may require a new document in order to contain the specific information necessary under ERISA.[7] Periodic amendments to a 403(b) plan under ERISA must be reported to participants through a summary of material modifications within 210 days of the change.

ERISA's Fiduciary Requirements

The increased emphasis on a plan sponsor's fiduciary duties regarding investment of plan assets under ERISA is well known, along with the heightened risk of participant complaints and possible litigation related to plan fees. A plan sponsor of an ERISA 403(b) plan is subject to ERISA's standards for fiduciary conduct, including performing their duties solely in the interests of plan participants:

- for the exclusive benefit of providing benefits and defraying the plan's reasonable costs;
- with the care, skill and diligence of a prudent person acting in like capacity and familiar with such matters would use;
- by diversifying investments to minimize the risk of large losses; and
- in accordance with the plan documents.[8]

Also, a fiduciary must prudently invest assets by considering the facts and circumstances relevant to each investment.[9] This responsibility has been the focus of a number of DOL regulations and some participant litigation. The plan sponsor of an ERISA 403(b) plan must carefully consider and document the process used in all steps of plan administration, none more important than the selection of the annuity or custodial account providers used by the plan. Failure to comply with ERISA's fiduciary standards can lead to liability for plan sponsors and other plan fiduciaries.

Although deferral-only 403(b) plans generally are not subject to ERISA, the transfer of employee deferrals to the service providers under an ERISA 403(b) plan must be made under the DOL's interpretation of 29 CFR §2510.3-102 (requiring that such transfers occur as soon as practical after the deferrals are segregated) that generally the funds must be transferred within three business days, or seven days for small employers. This timeframe is shorter than the time permitted under the IRC 403(b) Final Regulations, which has a similar rule but uses 15 days in the example provided.[10]

Practical Considerations for Plan Sponsors of 403(b) Plans Not Covered by ERISA

A plan sponsor of a 403(b) plan that avoids mandatory ERISA coverage (*e.g.,* all governmental plans, plans with only employee deferrals and other

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7 29 C.F.R. §2520.102-3 et seq.
8 29 U.S.C. §1101(a).
9 29 C.F.R. §2550-404a-1(b).
10 26 C.F.R. §1.403(b)-8(b).

Because the 403(b) plan requirements under the IRC may be satisfied by using multiple documents for service providers, the SPD for an ERISA 403(b) plan may require a new document in order to contain the specific information necessary under ERISA.

plans satisfying ERISA exemptions discussed earlier) must still comply with legal requirements, often without the clarity of ERISA's fully-developed regulatory framework. Thus, while there is no need for a plan sponsor of an exempt plan to provide an SPD or file annual reports, such plan sponsor must follow applicable state laws concerning fiduciary conduct and the rights of beneficial owners of assets managed by a third party.

This lack of clarity may become an issue in several ways. Unlike ERISA, which clearly states that the plan sponsor must either use only appropriate investments or delegate that duty to an investment advisor, the sponsor of an exempt plan must first look to state law to determine its fiduciary duties. Case law and state statutes are relatively undeveloped in this area when compared to ERISA, and the consequence is less clarity for a plan sponsor regarding fiduciary duties and legal obligations. For example, a plan sponsor's selection of investment alternatives or service providers may be a fiduciary function under state law. However, state fiduciary laws developed over time, primarily in situations where one party is responsible for maintaining or investing assets for the benefit of another party (*e.g.,* in general to regulate investment responsibilities in trusts and similar private interests). Unfortunately, such case law provides little guidance where a group of funds is selected by a fiduciary and the beneficial owner makes the actual allocation of assets, as occurs in a 403(b) plan.

If the plan sponsor is a fiduciary under state law for such decisions, state laws concerning prudent investment by fiduciaries do not follow the ERISA standard but instead codify (fully or in modified fashion) the "prudent investor rule" found in Section 227 of the American Law Institute's Third Restatement of Trusts. Moreover, not all states have adopted the Uniform Trust Code, which further describes the investment standards. As a result, plan sponsors of exempt 403(b) plans should consult with advisors who are familiar with the nuances of state laws concerning fiduciary standards for investments when selecting or limiting the plan's investment alternatives (as permitted under the DOL safe harbor).

In addition, issues with participants arising under exempt 403(b) plans will be handled in state court, since the access under ERISA to federal courts is not automatically available. The consequences of a state law forum vary because the claims will depend upon the available statutes, which may include state labor and compensation laws, contract laws and tort laws. As a result, plan sponsors of exempt plans may be liable for punitive damages under state law (*i.e.,* pain and suffering). In contrast, punitive damages are generally unavailable under ERISA as damages are primarily limited to the actual losses. Also, unlike the laws in most states, ERISA permits claims for attorney fees to successful litigants, a fact that may be helpful (or a deterrent) to sponsors of a 403(b) plan. Finally, state courts are not required to use the extensive DOL guidance and ERISA regulations when calculating losses for imprudent investments or late transmittal of salary deferrals, and this may affect the damages under state law litigation.

Conclusion

As a result of the DOL's structure for providing a useful but narrow avenue to avoid having a 403(b) plan covered under ERISA, a plan sponsor seeking to avoid ERISA coverage should focus on two broad criteria:

- Do not place employer contributions in the 403(b) plan; and
- Maintain minimum administrative involvement in the plan.

A plan sponsor whose 403(b) plan is subject to ERISA (intentionally, unintentionally or unavoidably) must comply with significant parts of ERISA's regulatory structure and must comply with annual reporting requirements, disclosure mandates and heavily-regulated fiduciary standards. While these produce additional burdens on operating the 403(b) plan, they also offer predictable regulation and protect the plan sponsor from claims under state laws that may prove more costly due to ERISA's preemption of state law. Plans exempt from ERISA avoid the extensive federal regulatory framework, but such plan sponsors are required to follow applicable state laws in the operation of the 403(b) plan.

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