Ready, Set, Go! The New IRS §403(b)

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Life just got a little more complicated for public education institutions and tax-exempt entities who offer §403(b) programs to employees. Section 403(b) programs suddenly find themselves in the spotlight and subject to new Internal Revenue Service (IRS) regulations intended to make them look and behave more like the §401(k). Passed in July 2007 and effective for plan years beginning on or after January 1, 2009[i], the final §403(b) regulations require ordinarily hands off employers to take a more active role in the design, administration and oversight of their §403(b) programs. In effect, §403(b) sponsors have become Plan Sponsors charged with understanding their new obligations as well as establish a more structured retirement program for employees.

403(b): A Primer: A §403(b) plan, also known as a tax-sheltered annuity (TSA) plan, is a voluntary retirement plan for specific employees of public schools, tax-exempt organizations, and ministers. Historically, employers who offered these retirement programs had limited responsibilities regarding the plan. They allowed funding providers like insurance or mutual fund companies access to their facilities to solicit employees. Additionally, if an employee elected to participate, the employer would forward such employees' elected salary deferrals to the selected fund provider for deposit into an individual annuity or custodial account. The participant or the funding provider was seen as the owner of the individual annuity or custodial account. The employee and funding provider engaged in a range of actions without the involvement or consent of the employer[ii]; which included electing and changing investments, making loans, taking hardship distributions and transferring contracts from one provider to another. As a result, issues arose with non-compliance concerning the rules governing §403(b) programs. To address these non-compliance issues, the IRS enacted new regulations that cover all[iii] §403(b) programs.

Increased Fiduciary Responsibility for §403(b) Plan Sponsors: Starting in 2009, sponsors of §403(b) programs must take responsibility for the §403(b) plan(s) they provide employees. They must create continuity across all §403(b) funding providers and assume more responsibility in the operations of the plan. Traditionally, §403(b) employers did little more than collect and remit funds; however, under the new IRS rules they are required to:

- **F**orm a written document covering the provision of the plan;
- **I**mplement annual notification of eligibility under universal availability rule;
- **D**evelop day-to-day administration rules for the plan, including monitoring catch-up contributions, verifying the accuracy of processing loans and hardship distributions, administering qualified domestic relation orders (QDRO) and assuring that distributable event requirements under the program are followed;
- **U**ndergo an annual independent audit[iv] by a qualified Certified Public Accountant (CPA) (for large §403(b) programs subject to ERISA only);
- **C**ollect and identify all the individual contracts under the plan;
- **I**mpart salary contributions promptly[v] and make sure any excess contributions are timely distributed;
- **A**ddress funding provider's adherence to plan provisions;
- **R**estrict contract exchanges[vi] (when a participant transfers their §403(b) account from one funding provider to another) to those in accordance with the new rules; and if applicable, complete

- Year end comprehensive[vii] Form 5500 tax return to be filed with the appropriate financial statements (for §403(b) programs subject to ERISA only).

The new IRS rules alone significantly change how §403(b) programs work. They also raised a major concern for §403(b) sponsors. To comply with the new IRS rules, §403(b) sponsors may be subjected to Title 1 of ERISA and a host of fiduciary obligations required of ERISA covered 403(b) programs.

ERISA[viii] or Non-ERISA 403(b)

A §403(b) program may or may not be subject to ERISA. To be subject to ERISA, a §403(b) program needs to be "any plan, fund, or program . . . *established or maintained by an employer or by an employee organization [emphasis added]*, or by both, to the extent that . . . such plan, fund, or program . . . provides retirement income to employees,[ix]…". Basically, the test is, "is the plan established or maintained by an employer?" If the answer is YES, the plan is subject to ERISA. Historically, the answer to this question for most §403(b) sponsors has been NO because of a DOL exemption that outlines what activities a §403(b) sponsors can perform without "establishing or maintaining" a program subject to ERISA. Under the DOL exemption[x] a §403(b) plan will NOT be established by an employer, and thus be a non-ERISA plan, if it meets four conditions:

- the plan must be purely voluntary;
- the employer must have minimal administrative involvement;
- the rights under the contracts must be solely enforceable by the employee; and
- there can never have been any employer contribution nor can the employer have received direct or indirect compensation as a result of running the program.

Thus, if any employer contribution (match or non-elective), or any eligibility requirements have been a part of the plan, it is subject to ERISA. The trickier question is, and always has been, just how much involvement violates the minimal administrative involvement test. Neither the DOL nor the IRS have given clear guidance on this, but actions such as collecting and remitting salary deferrals and limiting the number of vendors in light of relevant circumstances have been held not to violate this exemption. Under the new IRS rules, however, there is speculation that all §403(b) programs now become subject to ERISA.

New Rules, New Worries

Section 403(b) sponsors may find, after examining their programs to comply with the new rules, that they were ERISA §403(b) plans all along due to their making of a match or non-elective contribution or restricting eligibility for the plan. Non-ERISA plans may find it hard to maintain non-ERISA status due to the increased responsibilities required by the IRS final rules. For example, if an employee wanted a hardship distribution the employee would self-certify to the vendor that they met the hardship requirements. Under the new IRS rules, if a loan or hardship distribution is available, someone other than the employee has to determine if the request for a loan or hardship conforms to the tax rules. If the employer makes the determination they would seem to have more than minimal administrative involvement in the plan. While the annuity or custodial account vendor may make such a determination, it is unlikely many would be willing to take on that burden. In addition the DOL has determined[xi] that the selection of a third party administrator (TPA) to handle the above matters for a §403(b) sponsor would exceed the minimal allowable involvement and subject the §403(b) plan to ERISA. Accordingly, by trying to adhere to the new IRS rules, non-ERISA plans may find themselves running afoul of the ERISA exemption and

subject to the additional reporting and disclosure rules (most notably the Form 5500 and audit) that come with being an ERISA plan.

ERISA and §403(b)

Section 403(b) programs already subject to ERISA may be wise to look to the §401(k) marketplace and apply some of their best practices to the new §403(b) requirements. A good start would be with some initial due diligence actions, such as:

- **E**valuate the current state of the §403(b) program, including design, current fund providers, investments, and cost structure;
- **R**eview the §403(b) provider marketplace via a Request for Information (RFI) questionnaire to assess capabilities and commitment to the §403(b) marketplace;
- **I**nvestigate whether to engage in an ongoing multiple-provider relationship via a common remitter service or consolidate to a single fund provider, and what that means with regard to ERISA status;
- **S**end a Request for Proposal (RFP) to qualified fund providers as assessed during the RFI process;
- **A**nalyze the RFP responses received and make a selection of a fund provider(s) as the ongoing retirement plan service provider(s);

By establishing a structure or framework around ERISA obligations, §403(b) plan sponsors can manage and administer their plans to meet the new IRS standards and protect themselves from potential liability for breaches of those duties where applicable. For example:

- **O**perate the plan in the sole interest of participants and beneficiaries; for the exclusive purpose of providing benefits and defraying reasonable expenses of administration in accordance with the provisions of the plan and ERISA;
- **B**enchmark vendors and implement a prudent processes for investment selection, ongoing investment monitoring and auditing plan expenses;
- **L**ayout a plan design in a clear written document which explains the features of the §403(b) program and the responsible party (Sponsor, Vendor, Common Remitter, Third Party Administrator) for performing the various administrative and compliance functions now required, including eligibility, coordinating catch-up contributions and determining and distributing excess contributions;
- **I**nvestigate the use of “prudent experts” to assist in processes should the §403(b) fiduciary not feel comfortable or qualified on a topic;
- **G**age and comprehend relationships and costs with vendors and investments;
- **A**void conflicts of interest and prohibited transactions;
- **T**each and educate participants about the §403(b) plan and the new rules particularly with regard to coordination of catch-up contributions, contract exchanges and new rules regarding loan and hardships distributions;
- **I**dentify all[xii] individual contracts and custodial accounts that are part of the program to meet the new reporting (and if applicable audit rules);
- **O**rganize a Committee to be responsible for the §403(b) program and adopt a Committee Charter and Investment Policy Statement;
- **N**otify participants of eligibility annually under the Universal Availability rule;

- **S**et standards (preferably in a written agreement) for information sharing and communication among providers (if multiple providers are used) and other agents and administrators.

Conclusion: With careful review and prudent efforts §403(b) sponsors can meet the challenge of these new IRS rules and reduce the risk of error and liability that may come with them. After 46 years, §403(b) sponsors truly have a reason and an opportunity to take stock of their programs and change them, not only to meet the new IRS regulations, but to strategically align the retirement plan with their business goals and their own desires to provide the best retirement program possible for their employees.

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[i] Some provisions have earlier effective dates, including provisions covering contract exchanges.
[ii] Department of Labor, Field Assistance Bulletin No 2009-02.
[iii] Church plans that have not made a §410(d) election to be subject to ERISA and governmental plans are treated differently.
[iv] Audits are required for plans with 100 or more participants as of the beginning of the year.
[v] Non-ERISA 403(b) plans must transfer contributions to providers within a period no longer than is reasonable for proper plan administration, such as transferring elective deferrals within 15 business days following the month in which these amounts would have been paid to the participant.
[vi] Commonly called 90-24 transfers, contract exchanges were limited effective September 25, 2007, and are only allowed to funding providers that are an active approved provider of the 403(b) plan or have an information sharing arrangement with the employer.
[vii] Form 5500 required of ERISA plans only. On July 20, 2009 in Field Assistance Bulletin 2009-02 the DOL provided relief from inclusion of certain individual contracts and custodial accounts as plan assets provided the contract or account was issued prior to 1/1/2009, the employer has no obligations to make contributions after December 31, 2008 and the contract is fully vested with all rights and benefits legally enforceable by the participant against the funding provider with absolutely no involvement of the employer.
[viii] ERISA is the Employee Retirement Income Security Act (1974). A federal law that sets standards of protection for individuals in most voluntarily established, private-sector retirement plans. ERISA requires plans to provide participants with plan information, including important facts about plan features and funding; sets minimum standards for participation, vesting, benefit accrual, and funding; provides fiduciary responsibilities for those who manage and control plan assets; requires plans to establish a claims and appeals process for participants to get benefits from their plans; gives participants the right to sue for benefits and breaches of fiduciary duty (from IRS.gov, Definitions)
[ix] See IRS regulations (26 CFR Parts 1, 31, 54, 602) at page 37
[x] See 29 C.F.R. 2510.3-2 for full requirements for exemption.
[xi] EBSA Field Assistance Bulletin No. 2010-01, Q&A # 15 (February 17, 2010)
[xii] See endnote vii.