Davis Wright Tremaine LLP

Employee Benefits Advisory Bulletin

403(b) Plans: Covered by ERISA or Exempt?

Considering the pros and cons of ERISA compliance

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In light of the new IRS 403(b) regulations, many tax-exempt employers are evaluating whether to continue efforts to keep their 403(b) plans exempt from the Employee Retirement Income Security Act of 1974 (ERISA). Employers need to consider the various factors, both positive and negative, in deciding whether to subject a 403(b) plan to ERISA.

Background

ERISA applies to employer sponsored retirement plans. Under a long-standing Department of Labor (DOL) regulation, a 403(b) plan can avoid the "employer sponsored" label, and therefore avoid ERISA, if the employer limits its involvement with the plan. For example, an employer may facilitate employee salary deferral contributions to a 403(b) plan, but to avoid ERISA the employer may not make employer-funded contributions.

By appropriately limiting employer involvement, the 403(b) plan is considered voluntary by employees, and the tax-sheltered annuity contracts and custodial accounts funding the 403(b) plan are viewed as contractual arrangements between individual employees and the insurance companies and mutual funds providing the investment.

The chief advantage of avoiding ERISA is that the employer need not comply with ERISA's reporting and disclosure requirements. Instead of ERISA, state law would govern the 403(b) program.

Impact of new regulations

The new 403(b) regulations require an employer to specifically allocate plan administration responsibilities between it and the various 403(b) investment providers. Employers should give special thought to this task. Taking on too many administrative duties will shift an employer into the role of a sponsoring employer, resulting in the plan losing its exemption from ERISA.

The DOL has confirmed that employers can comply with the new 403(b) regulations, including the requirement to have a written plan document, without necessarily transforming a non-ERISA plan into an ERISA plan. However, the employer must continue to limit its discretion in the administration of the plan. For example, an employer can take steps to ensure the 403(b) plan keeps its tax-preferred status, and provide verifying information to plan investment providers, without crossing the line and becoming a “sponsoring employer.”

In contrast, if an employer exercises discretion in authorizing plan-to-plan transfers, processing distributions, or making determinations regarding hardships, qualified domestic relations orders (QDROs), participant loans, and other matters, the employer will be deemed to have taken over control as the plan sponsor, and the plan will no longer be exempt from ERISA.

Deciding whether to have an ERISA 403(b) plan

Most 403(b) plans that only receive employee salary-deferral contributions can fit relatively easily in either category—a plan that is exempt from ERISA or a plan that is subject to ERISA. (As mentioned above, if a plan receives any employer-funded contributions, then the plan is automatically subject to ERISA, unless the employer is a governmental entity or a church, in which case there is a separate exemption under ERISA.) There are several key factors to consider in deciding whether to subject a 403(b) plan, which contains only employee salary-deferral contributions, to ERISA.

The advantages of “embracing ERISA” are:

1. **Certainty**. Employers have a clear legal framework for defining their obligations and duties under the plan. In contrast, under state law, it is not clear what, if any, obligations an employer has with respect to overseeing a 403(b) plan.

2. **Control over assets**. Employers will have greater duties, but correspondingly also more control over the assets of the plans. This allows employers to help protect and educate employees regarding their 403(b) funds.

3. **Control over the plan**. Employers can take more control over the design and administration of the plan. This is more consistent with the general trend in the 403(b) world of transforming the culture of 403(b) plans to be more like the culture of 401(k) plans. Rather than the vendors defining the terms of the plan, the employer can have broader involvement.

4. **Pre-emption of state law**. The plan is no longer subject to state law. This means disgruntled employees generally cannot bring state-law claims against the plan. This eliminates the possibility of punitive damages, consequential damages and a jury trial, and generally limits reliance on oral statements that conflict with plan terms. Additionally, in the event of a conflict with an employee regarding the terms of a plan, employers under ERISA are given the benefit of the doubt in interpreting the plan, and usually any reasonable and consistent interpretation is upheld by courts.

The disadvantages of embracing ERISA are:

1. **Greater employer duties and expenses**. Employers will have broader duties, as defined in ERISA, and in most cases additional plan expenses. Significantly, employers with more than 100 employees must have the plan audited by an independent certified public accountant each year. Since many 403(b) plans have been poorly regulated, audits in the early years could be more expensive

than the typical plan audit.

2. **ERISA disclosure obligations**. The plan must comply with the plan document requirements under ERISA, including providing a summary plan description to plan participants and quarterly and annual investment and financial information.

3. **ERISA reporting requirements**. The plan must comply with the annual 5500 reporting requirements under ERISA (which now include the audit described above).

4. **Fiduciary duties**. The employer is subject to the ERISA fiduciary duty standards. Under state law, it is unclear to what extent an employer is subject to common law fiduciary duties. Under ERISA, a fiduciary must act in the best interests of the participants and in a prudent manner. This requires oversight of 403(b) providers for investment performance and expenses. ERISA also requires plan fiduciaries to make sure that plan terms are followed. (While this is a burden on employers, their oversight of employees' investment funds would tend to help protect employees.)

5. **Claims procedures**. The plan must provide participants with certain rights, including the right to make claims under the ERISA claims procedures. While this is a burden, it offers the advantage of providing a framework for dealing with disputes, and if the employer follows the procedures, the employer's decision regarding the dispute will usually be upheld, unless it is unreasonable.

Each employer will likely place different weight on the factors described above. For this reason, there is no “right” answer for all employers who offer a 403(b) plan with only employee salary-deferral contributions. We recommend that each affected employer consider these factors and decide which way the cost-benefit analysis tips the scales—to embrace ERISA or continue offering an ERISA-exempt plan. The members of our Employee Benefits Group are available to assist with this analysis, or any other 403(b) plan questions, if you have concerns.

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