

403(b) Plans -- The Overlooked ERISA Dilemma

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Although many 403(b) programs are excluded from ERISA Title I coverage, employers may find that Title I status is a positive feature and should not be avoided. The authors explain why.

Most of the attention currently focused on 403(b) programs centers on compliance with the complicated tax rules, including those introduced by the Tax Reform Act of 1986. While this focus is important, another critical issue is whether, and which, 403(b) programs are subject at all to Title I of ERISA.

Title I applies to a large number of 403(b) programs--or tax-sheltered annuities (TSAs). (TSA is used here to describe 403(b) programs that are funded either with annuity contracts or custodial accounts.) It is likely that many more plans are subject to Title I than employers realize subjecting the employers involved to potentially large liabilities. Although employers may initially want to avoid coverage, the better choice may be to be covered by Title I.

TYPES OF EMPLOYERS THAT CAN SPONSOR TITLE I PLANS

The employers that can sponsor 403(b) programs are government -run schools, churches, and other 501(c)(3) tax-exempt employers, including private schools. 501(c)(3) organizations include entities organized and operated exclusively for religious, charitable, scientific, literary, educational, or public safety purposes or to foster amateur athletics or the prevention of cruelty to children or animals.

The largest 403(b) programs are generally those sponsored by public school systems (including public colleges and universities). These entities are excluded from Title I coverage because they are government plans. [ERISA § 4(b)(1)] Another group that is excluded from Title I coverage is church retirement plans, as well as schools or hospitals that are so closely affiliated with churches that they are considered by the Department of Labor (DOL) to be church organizations. [ERISA § 4(b)(2); see also ERISA Op Ltrs 94-34A (11/3/94), 94-18A (5/23/94), and 94-05A (3/8/94)] That leaves only TSA programs sponsored by nonchurch 501(c)(3) tax-exempts to be covered by Title I.

We believe that most 403(b) programs of 501(c)(3) tax-exempts (other than churches) are Title I plans. We also believe that Title I status is a positive feature and should be accepted rather than avoided. In any case, the Title I issues for 403(b) plans of these types of sponsors must be dealt with because they have serious consequences, as we will outline below.

WHEN IS A 403(b) PROGRAM SUBJECT TO TITLE I?

Fundamentally, whether or not TSAs are covered by Title I depends upon the employer's involvement in the plan. This involvement ranges from adopting a plan document and handling investments to a hands-off approach in which the employer simply complies with the employees' direction to put money into a TSA. 403(b) programs in their "purest" form--that is, when only salary deferrals are contributed to investment vehicles chosen by the employees--have long been considered to be maintained by the employee, not the employer. (For an example of how attenuated an employer's relationship may be to the 403(b) program in which its employees participate, see private letter ruling 9423031 (3/14/94), in

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which a participant contracted on his own with an annuity carrier and then secured approval by his employer (a school district) to have salary deferrals given to that annuity carrier.) If the employer does not maintain the program, how can it be charged with the responsibilities of a plan sponsor under ERISA? On the other hand, when an employer takes affirmative steps to be involved in the program, it undertakes the responsibility to properly complete these steps, and Title I appropriately applies.

A 403(b) program that is sponsored by a nonchurch 501(c)(3) organization is automatically covered under Title I unless certain criteria are met. In general, for a plan to be excluded from Title I, the employer's involvement must be extremely limited. DOL Regulations Section 2510.3-2(f) indicates that a TSA is not subject to Title I *only* if all of the following are true:

1. The employer does not make any contributions to the program;
2. Participation is completely voluntary for employees;
3. All rights under the annuity contract or custodial account are enforceable solely by the employee or by a beneficiary of the employee;
4. The only involvement of the employer is limited to the following:
 - Permitting annuity and custodial account contractors (and their agents or brokers) to publicize their products to the employees;
 - Requesting information concerning proposed funding media, products, or contractors;
 - Summarizing or compiling the information about the proposed funding media or products, or the contractors whose services are provided, in order to facilitate review and analysis by the employees;
 - Collecting and forwarding salary deferral contributions, as required by salary reduction agreements, to annuity contractors or custodians and maintaining records of these contributions;
 - Holding group annuity contracts covering the employees in the employer's name;
 - Limiting the funding media or products available to employees, or the annuity contractors who may approach employees, to a number and selection designed to afford employees a reasonable choice in light of all relevant circumstances.

"Relevant circumstances" referred to in the last item above include:

1. The number of employees affected,
2. The number of contractors who have indicated interest in approaching employees,
3. The variety of available products,

4. The terms of the available arrangements,
5. The administrative burdens and costs to the employer, and
6. The possible interference with employee performance resulting from direct solicitation by contractors.

The last item of the DOL regulations specifies that the employer receive no direct or indirect compensation other than reimbursement of expenses for the employer's duties under the salary reduction agreements. [DOL Reg § 2510.3-2(f)]

At first glance, this appears to be a recipe for avoiding Title I coverage if an employer wants to do so. However, actual circumstances show that the line is not so bright. The DOL tends to cast the net of Title I very broadly.

A plan is *always* subject to Title I if an employer makes contributions to the program. Employer contributions include matching contributions, discretionary profit sharing-like contributions, and fixed-rate money purchase-like contributions.

If the employer exercises sufficient control in establishing the procedures or in limiting the vehicles through which the employees may invest, Title I coverage will result. For example, an employer that has the right to determine the brokers through which investment funds may be purchased, or to terminate contracts with brokers who do not comply with procedures established for the plan, crosses the line of limited involvement and causes the program to be covered by Title I. [ERISA Op Ltr 83-23A (5/18/83)]

The DOL has historically refused to tell employers in advance whether a program constitutes a "reasonable choice" of investment options under the DOL regulation. [ERISA Op Ltr No 94-30A (8/19/94), fn 2] Therefore, it is not easy for an employer to know when it is affording participants a reasonable selection of investment options (or, for that matter, investment vendors). Perhaps DOL regulations relating to participant-directed accounts under ERISA Section 404(c), which use analogous terms, may be reasonably applied here--at least for determining whether the employees have a reasonable choice of investment options. However, the regulations would not be helpful in terms of a reasonable selection among investment vendors. (It is interesting to consider a case in which an employer is approached by only one or two vendors. Does that mean that an employer has some obligation to seek out additional vendors to provide a "reasonable choice" to its employees? And, if so, does that effort subject the plan to Title I in any event?)

Employer control issues relate not only to the choice of investments available within the program, but also to the vendors and custodians through which the program is provided. It may not be administratively feasible for an employer to allow employees to make salary deferral contributions to an unlimited selection of vendors. To what extent may the employer limit that selection without causing the program to be covered by Title I?

The answer to this question is not entirely clear. As noted in the above quoted regulation, a subjective balancing of factors determines when the employer crosses the "limited involvement" barrier. For example, in Opinion Letter 83-23A, the DOL discussed the employer's decision to use only one 403(b)(7) custodian for the plan. Because of the control that the employer exercised in choosing this one custodian, and the procedures the employer established within the custodial accounts, the program was considered covered by Title I. It is interesting to note that the custodian chosen by the employer in

this case provided for an enormous range of investment choices. Nonetheless, the fact that the employees were required to use this one custodian appears to have constituted sufficient employer involvement for Title I to apply.

Because of the subjective nature of the analysis, an employer that limits the vendors with which the employees may establish 403(b) programs can never be certain that this limitation has not invoked Title I coverage.

OTHER ACTIONS THAT CAN RESULT IN TITLE I COVERAGE

A variety of other actions by an employer can cross the line from limited to active involvement in the 403(b) program and bring the program under the coverage of Title I.

In one Opinion Letter, the DOL found that, if the employer controls the grant or denial of a program benefit, Title I coverage may result. For example, if the employer certifies to the custodian or annuity company that the participant is eligible for a hardship or disability distribution, its involvement is no longer "limited." On the other hand, the employer may confirm facts (as opposed to conclusions) to the custodian or annuity company that are within its knowledge as employer without losing its "limited involvement" status. [ERISA Op Ltr 94-30A (8/19/94)]

In the current tax environment, in which the IRS is planning to audit 403(b) programs aggressively, an employer may want to play a larger role in ensuring that its employees' 403(b) program is in full compliance. However, when does that role result in more than limited involvement with the program? Whose responsibility is it to keep a non-Title I plan in compliance with the law? If the employer takes on that responsibility, has the plan become subject to Title I?

These questions become even more significant as the IRS institutes its voluntary compliance program for 403(b) plans, known as TVC. It may be that if the employer takes advantage of this program, it automatically subjects the plan to Title I coverage. This issue is not addressed in the just-released revenue procedure that established this program. [See Rev Proc 95-24, 1995-18 IRB (4/14/95)] Even if the employer's use of TVC would not be sufficient to cause Title I coverage to apply, how will the employer compel the 403(b) fund holders to make the required corrections under the agreement with the IRS? TVC requires the employer to "obtain assurance" that fund holders will cooperate in correcting defects addressed by the TVC. [Rev Proc 95-24, § 3.03, 1995-18 IRB] (Remember that in a non-Title I plan, only the participants and beneficiaries may enforce the contract with the fund holder.) The employer may have a provision inserted in the contracts with the vendors or fund holders which requires them to correct any discovered defects in the program without employer involvement. If this is acceptable to the vendors, this may avoid an employer's having to increase its involvement in the program if and when a defect is discovered. (Realistically, however, the employer would probably initiate the correction process, since it is unlikely that the product vendors would want to undertake the expense and liability of testing and controlling compliance.) It is an open question whether contracting for this provision would also be sufficient involvement to cause the plan to be covered under Title I.

THE SIGNIFICANCE OF TITLE I COVERAGE

If a TSA is subject to Title I, the employer is responsible for making sure that the plan is properly administered. We intend to discuss some of these requirements in detail in our next column. However, some examples are:

- Form 5500 must be filed annually for the plan, although not all portions of the form must be

completed. However, one of the areas of controversy is whether a certified plan audit is required for 403(b) programs with more than 100 participants. The Internal Revenue Code contains no exemption from this requirement for 403(b) programs. On the other hand, the limited items on the Form 5500 that need to be completed by a 403(b) program do not encompass the plan audit section, and at least one representative of the DOL has indicated that the audit is likely not required.

- ERISA's written document requirement would apply, although the 403(b) program may be comprised of a collection of documents, such as the annuity contracts and the employee communications materials.
- Summary plan descriptions and summary annual reports must be given to the participants, as well as account statements upon request.
- Qualified joint and survivor annuity rules apply.

ERISA's fiduciary responsibility rules would apply to Title I plans. However, because of the nature of most 403(b) programs, with participants generally directing the investment of their own accounts, there is the opportunity to transfer much of the responsibility and liability to the participating employees under ERISA Section 404(c). If an employer wants to take advantage of Section 404(c) protection, it is important that it follow all of the required procedures, including the statement to be given to participants that the plan is intended to comply with that section.

The *Patterson v. Shumate* Supreme Court decision [504 US 753, 112 S Ct 2242, 199 L Ed 2d 519 (1992)], which extended bankruptcy protection to "ERISA qualified" plans, is being interpreted by most courts to provide this protection to any Title I plan. Therefore, it appears that a 403(b) program is covered by Title I will be excluded from the employee's bankruptcy estate and therefore will be protected from creditors' claims. See also *In re Nolan* [175 Bankr 214 (WD Ohio 1994)], in which the court found that a 403(b) program was exempt from the bankruptcy estate if it (1) was covered under Code Section 403(b); (2) was subject to ERISA; and (3) satisfied ERISA's anti-alienation requirements. In addition, ERISA preempts most state laws affecting 403(b) plans--which is helpful to multistate 501(c)(3) plan sponsors.

SHOULD TITLE I COVERAGE BE AVOIDED?

Most 501(c)(3) employers believe their 403(b) programs are exempt from Title I. In our opinion, they are mistaken in most cases. Although employers may apply to the DOL for an opinion letter as to whether their TSAs are subject to Title I, there are very few published letters on that point. Although this is such a gray area of law, it appears that few are seeking guidance. Is this the result of an affirmative decision by plan sponsors, or are they undereducated about the issue and simply hold the mistaken belief that Title I does not apply? Clearly, the emphasis in the industry has been on avoiding Title I coverage, if possible. But, what is the basis of objections to Title I coverage? As noted below, Title I coverage has advantages.

While there may be some additional costs for complying with Title I requirements, we believe that employers are better served by taking control of their 403(b) programs. At the very least, it is difficult to be absolutely certain (without applying for a DOL ruling) that an employer hasn't crossed the "limited involvement" line; and the penalty for assuming that a plan is not covered under Title I, and finding later that it is, can be substantial. For example, the DOL may assess a penalty of up to \$1,000 per day for failure to file Form 5500 [ERISA §§ 209(b), 502(c)]; \$100 per day for unreasonable failure to comply with a request by a participant under ERISA [ERISA § 502(c)(1)]; and up to \$5,000 and one

year in prison (or \$100,000 if the bad actor is not a person) for willful violation of Title I. [ERISA § 501] In addition, the penalties relating to prohibited transactions would apply. [ERISA section 502(i)] (Note that the DOL just initiated the Delinquent Filers Voluntary Compliance program to enable sponsors who are late in filing their 5500 returns to secure a reduction of the \$1,000-per-day penalty.) [DOL Rel dated 4/27/95]

The main disadvantages of being covered by Title I are filing Form 5500, being required to have a written document, and providing summary annual reports to participants. Gathering the information for the Form 5500 and the summary annual report may not be as difficult as one might think particularly if the employer plans for it in advance. The written document requirement, on the other hand, is one that we recommend to 501(c)(3) employers in any event. TSAs are too complex to leave to a loose collection of memoranda and employee communications materials and are more likely to run properly if the provisions are reduced into an organized, cohesive document.

There may be additional benefits to accepting Title I coverage. For example, an employer that also sponsors a qualified plan may be obligated to address 403(b) program issues (such as the impact of Code Section 415 on both programs) as part of its administration of the tax-qualified plan. In addition, ERISA's preemption of state law may result in the application of the same federal laws to both tax-qualified and 403(b) programs, allowing the employer to better coordinate its retirement plans. Moreover, the law of employee benefits is a developing area in the federal courts, but tends to be stagnant and uncertain in state courts. And, if the employer has a presence in more than one state, ERISA preemption prevents the application of different and maybe inconsistent state laws to different employee groups.

AUDIT GUIDELINES UPDATE

As this column goes to print, the IRS has just released Revenue Procedure 95-24, 1995-18 IRB (4/14/95), outlining the Tax Sheltered Annuity Voluntary Correction Program (TVC). The IRS also issued Announcement 95-33, 1995-19 IRB, 1995 WL 223244 (IRS), stating that the proposed examination guidelines are available from the Freedom of Information Office in Washington, DC.

We will give more details on TVC and the audit guidelines in an upcoming column. However, TVC essentially combines the elements of the VCR and voluntary CAP programs for qualified plans. Under TVC, certain defects are correctable through an application to the IRS National Office, with the payment of a user fee (comparable to VCR) and a sanction (comparable to voluntary CAP).