2011 ERISA Advisory Council
Current Issues for 403(b) Plan Sponsors and Fiduciaries
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Having worked with section 403(b) programs since before the enactment of ERISA in 1974, I appreciate this opportunity to appear before the ERISA Advisory Council to address current issues relating to section 403(b).

Before addressing certain of the specific questions that the Council has identified for this hearing, I would like to make some general observations about section 403(b) plans. There is a perception among some that, at least for periods before the Treasury's adoption of the current section 403(b) regulations in 2007, a high percentage of section 403(b) plans were administered without regard to applicable requirements under ERISA and the Code. Though my exposure to the section 403(b) market may not be wholly representative, in my experience the level of compliance for section 403(b) plans has been at least as high as that for section 401(a) plans of comparable size. While it is certainly the case that smaller employers are less likely than large employers to fully understand the terms of their plans and their responsibilities as plan sponsors, I have seen no indication that these problems are more pronounced for section 403(b) plans than for section 401(a) plans.

There are several reasons why I believe section 403(b) plans have fared relatively well from a compliance perspective as well as having provided valuable benefits to participating employees. Most importantly, under the provisions of the Internal Revenue Code governing section 403(b) arrangements, the annuity contracts and custodial accounts established under the arrangement must themselves satisfy substantially all applicable requirements. Thus, the section 403(b) contracts are not merely plan investments, but are contracts the terms of which are integral parts of the plan. This is recognized in the current Treasury regulations, which provide that the plan document for a section 403(b) plan may consist in part of the terms of the section 403(b) contracts purchased under the plan; in particular, the provisions of section 403(b) contracts commonly define and govern the benefits distributable under section 403(b) plans. In addition, most providers of section 403(b) contracts have assumed substantial compliance responsibilities pursuant to the terms of their contracts (and related agreements with plan sponsors), often providing hands-on administrative assistance and advice to employers and participating employees. The active involvement of providers has promoted participation as well as compliance and has enabled employers to establish and maintain their plans without incurring substantial professional fees.

Further, the limited types of investments permitted under section 403(b) plans (other than church plans that are not subject to ERISA) has served to maximize benefit security and limit the risk of prohibited transactions. Since section 403(b) plans (other than church plans) must be funded through the purchase of annuity contracts from regulated life insurance companies or custodial accounts (held by a bank or IRS-approved nonbank custodian) that hold shares of regulated investment companies ("RICs"), ERISA-covered section 403(b) plans are vulnerable to none of the risks associated with plans funded with employer securities or highly speculative investments. And, as defined contribution plans, section 403(b) plans do not pose the risk of funding shortfalls.

Moreover, since active participants, former employees, and beneficiaries typically have individual ownership rights in the annuity contracts or certificates purchased on their behalf, and comparable rights under the agreements governing custodial accounts holding RIC shares on their behalf, there is virtually no risk that funds allocated to their accounts under annuity contracts or held for them in custodial accounts will be diverted to other purposes by employer action or otherwise. In addition, the direct contractual relationship between the providers of section 403(b) contracts and employees and former employees has made it possible for the issuers of section 403(b) contracts to assume substantially all responsibility for distributions to plan participants.

Finally, the tax and ERISA regimes applicable to section 403(b) plans have been simpler in a number of respects than those applicable to qualified plans. For example on the tax side, elective deferrals under a section 403(b) plan are not subject to the ADP test applicable to section 401(k) plans, and the top-heavy rules and certain other qualification requirements applicable to section 401(a) plans do not apply to section 403(b) plans.[1] On the ERISA side, there is the safe harbor exemption for section 403(b) plans wholly funded with elective deferrals (assuming sufficient availability of funding options and lack of employer involvement), and there was simplified annual reporting for section 403(b) plans for plan years prior to 2009 and continues to be for small section 403(b) plans eligible to use Form 5500-SF. One of the most effective ways to promote the establishment of retirement savings arrangements as well as compliance is to keep the compliance requirements as simple and practical as possible, a point which is relevant to both of the specific areas addressed below.

Issues regarding safe harbor plans under section 2510.3-2(f)

Section 2510.3-2(f) of the ERISA regulations reflects the longstanding position of the Department that a section 403(b) program is not a pension plan "established or maintained by an employer" if (1) it is funded solely by voluntary salary reduction contributions, (2) benefit rights under the annuity contracts or custodial accounts are enforceable solely by employees and beneficiaries, and (3) the sole involvement of the employer is to designate available products (annuity contracts or RICs) that give employees a reasonable choice (including the computation and dissemination to employees of information relating to such products), allowing providers to market their products to employees, and processing salary reduction contributions. It has been the Department's position that a section 403(b) program must generally offer the products of two or more contractors or providers in order to fall under this safe harbor exclusion from Title I coverage. *See* 2010-01, Q/A-16. (Feb. 17, 2010).

The Department has recognized that, in order to maintain tax compliance, an employer that sponsors such an arrangement may need to take certain administrative actions in addition to the elements of employer involvement expressly referenced in section 2510.3-2(f). Thus, the

[1] While the IRS reported numerous instances of noncompliance with the tax rules governing section 403(b) plans in the audits that it conducted before the current Treasury regulations were proposed, the most common tax compliance errors during that period related to complex and easily misunderstood rules governing contribution limits and salary reduction agreements that had been repealed by Congress before those regulations became effective. For periods after the effective date of those regulations, the most common tax compliance problems have related to the Code's "universal availability" requirement for salary reduction contributions. In my view, the ill-advised complexity of the Treasury regulation governing the "universal availability" requirement, which deviates substantially from the Code requirement itself, predestined the occurrence of such problems. Though this particular issue is not relevant for ERISA purposes, it underscores the general point that simpler rules minimize the risk of technical non-compliance.

written plan document governing a safe harbor arrangement may require the employer to discontinue salary reduction contributions to a provider that is not complying with Code provisions. *See* FAB 2010-01, Q/A-17. In the same vein, it seems clear that, in order to assure compliance with the distribution restrictions imposed by the Code, an employer is permitted to confirm or inform product providers that participating employees have terminated employment and thus are permitted to withdraw balances attributable to salary reduction contributions.

Similarly, since the providers of section 403(b) contracts under safe harbor arrangements that offer the products of multiple providers may need access to information from other providers to assure compliance with the Code's limits on tax-free plan loans and the restrictions on hardship withdrawals, it would be constructive for the Department to confirm that a sponsoring employer may authorize such information sharing among providers, or itself provide such information to providers, without jeopardizing the safe harbor status of its arrangement. While participation in such information-sharing may augment the employer's administrative involvement with the operation of a safe harbor plan, it does not necessitate any discretionary action with respect to the section 403(b) contracts held by employees and does not alter the essential character of the arrangement. It follows that the employer should also be permitted to take the nondiscretionary steps to assure tax compliance under safe harbor section 403(b) contracts where the employer maintains a plan that is subject to Title I, whether that plan is established under section 403(b) or section 401(a). Indeed, it is difficult to see how an employer could refuse to provide the information necessary to assure compliance with these tax requirements for section 403(b) contracts held by employees under a safe harbor plan, if compliance could be affected by actions taken under an employer-sponsored plan that is covered by Title I.

With respect to participant loans, the Department has recognized that an employer sponsoring a safe harbor sections 403(b) arrangement may exercise discretion to allow or not allow that optional feature under available section 403(b) contracts. *See* FAB 2010-01, *supra*, Q/A-14. The Council has asked whether this discretion should extend to an employer's agreement to service loan repayments out of payroll when that is the only basis on which a provider offers participant loans. In my view, an employer should retain the latitude to decide whether loan repayments will or will not be serviced out of payroll without introducing fine and easily misunderstood distinctions between the situation where that is the only basis on which a provider or providers will offer loans, and the situation where an employer decides to do so as an accommodation to its employees. There are many contexts in which employers agree to make remittances out of payroll to third parties on behalf of employees, and I do not think such an exercise of discretion should be regarded as material to the safe harbor status of a section 403(b) arrangement.

The general premise of section 2510.3-2(f) is that Title I protections are unnecessary and inapposite if an employer merely allows its employees to make tax-deferred purchases of annuity contracts or RIC shares out of amounts otherwise payable as current compensation, and the employer does not recommend particular products or make any other benefit commitment to employees. In my view, the elements of employer involvement discussed above are fully consistent with this premise. The Department has recognized that, based on the facts and circumstances, a section 403(b) salary reduction arrangement may be excluded from Title I coverage even if all of the conditions of the safe harbor regulation are not satisfied. However, since the administrative issues discussed above are relevant to a high percentage of employers that maintain section 403(b) salary reduction arrangements, the Department should provide clear guidance on these issues and not leave them to the uncertainties of facts and circumstances judgments.

Distributions of section 403(b) annuity contracts

The Council has asked witnesses to address ERISA issues relating to the distribution of annuity contracts out of section 403(b) plans, including at termination of employment and upon termination of a section 403(b) plan. For purposes of discussing those issues, it is important to understand that the term "distribution" is something of a misnomer in this context. By definition, a section 403(b) plan requires the "purchase" of an annuity contract — that itself provides for distributions in accordance with the requirements of section 403(b) and satisfies certain other requirements — "for an employee." In the great majority of cases in which employees terminate employment and thereafter hold annuity contracts (or individual annuity certificates) purchased under section 403(b) plans (whether or not safe harbor plans) they simply continue to own the same section 403(b) contract purchase for them during their active participation in the plan.

Therefore, for most IRS purposes, a former employee's ownership of a section 403(b) contract purchased on his or her behalf under the plan is not treated as a distribution from the plan, but simply a continuation of the contract purchased under the plan. When a section 403(b) plan is terminated, the Treasury regulations require all accumulated benefits under the plan to be "distributed" in order for the Code's distribution restrictions to become inapplicable, and for this purpose "delivery" of a fully paid annuity contract is treated as a distribution. Treas. Reg. § 1.403(b)-10(a)(1). However, the IRS has clarified that, for employees who held annuity contracts or certificates prior to plan termination, "no further action is required to be taken in order to distribute the contracts." Revenue Ruling 2011-7, 2011-10 I.R.B. 534. In other words, continued ownership of a section 403(b) annuity contract is treated as a distribution.

In the case of plan termination as well as termination of employment, unless the individual is also the owner of a custodial account established under the section 403(b) plan, the annuity contract (or contracts) held by the employee or former employee comprises the entirety of his or her benefit rights under the plan. That is, once contributions for an employee have ceased, the only plan benefits to which the individual is entitled are those provided by the life insurance company under the annuity contract, for that is how the employee's benefit entitlements are defined under a section 403(b) plan. Moreover, in the case of plan termination, and typically in the case of termination of employment, the individual's rights under the annuity contract are directly enforceable by the individual against the life insurance company that issued the contract without need for further employer involvement.

Section 2510.3-3(d)(2)(ii)(A) of the regulations provides that an individual is not a "participant" in an employee pension plan (or a beneficiary under a plan) if "the entire benefit rights of the individual" (1) are "fully guaranteed" by a licensed insurance company and legally enforceable by the sole choice of the individual against the insurance company, and (2) a contract, policy, or certificate describing the benefits to which the individual is entitled under the plan has been issued to the individual. Based on this regulation, it has long been our understanding that a former employee or other individual who is no longer entitled to contributions under a section 403(b) plan and who holds an annuity contract that represents the entirety of his or her benefit rights under the plan and that is enforceable by the individual directly against the issuing life insurance company is not a "participant" in the plan for ERISA purposes, and thus that the annuity contract is not a plan asset.[2] Although such an annuity contract will not typically provide fixed dollar benefits that are guaranteed by the life insurance company, section 2510.3-3(d)(2)(ii)(A) simply provides that "the entire benefit rights" of the individual are "fully guaranteed" by the issuer of the contract. When "the entire benefit rights" of the individual consist of the benefits payable under an annuity contract, there is nothing else to be guaranteed.

This part of the regulatory definition of the term "participant" is separate and distinct from the reporting exemption provided under section 2520.104-44(b)(2) of the regulations for plans funded with "allocated" insurance contracts under which "benefit payments are fully guaranteed" by an insurance company. It is the Department's longstanding view, as set forth in the instructions to Form 5500, that such "allocated" contracts must guarantee fixed dollar obligations.[3] By contrast, the portions of the Form 5500 instructions that reflect section 2510.3-3(d)(2)(ii)(A) of the regulations describe no such restriction. Nor, as near as I can ascertain, has the Department issued any guidance suggesting that section 2510.3-3(d)(2)(ii)(A) is so limited in the 36 years that the regulation has been on the books.

The scope of section 2510.3-3(d)(2)(ii)(A) differs from that of section 2520.104-44(b)(2) in another important respect that is relevant to the issues considered in this hearing. Whereas "allocated" insurance contracts may be held by employees who continue to accrue benefits under a plan — *i.e.*, employees who unquestionably are plan participants — section 2510.3-3(d)(2)(ii)(A) treats an individual as a non-participant only if the "entire benefit rights" of an individual are guaranteed under an annuity contract. Thus, we do not believe section 2510.3-3(d)(2)(ii)(A) can apply to a current employee who is eligible for contributions under an ongoing plan, and that it must be limited to former employees and to active employees in terminated or frozen plans who hold annuity contracts that guarantee all of the benefits to which they are entitled under the plan, provided such individuals' rights under such contracts are directly enforceable by them without further employer control.

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[2] Although section 2510.3-3(d)(2)(ii)(A) of the regulations does not address the status of such an annuity contract as a plan asset, it is difficult to conceive how an annuity contract owned and solely enforceable by an individual who is not a plan participant could or should be treated as a plan asset.

[3] *See* also ERISA Opinion Letter 2010-01A (Mar. 4, 2010).

From a policy standpoint, it is completely appropriate that such individuals not be treated as plan participants: such individuals no longer have any reason to look to the plan or the plan sponsor for their benefits under the plan, and the plan and the plan sponsor should no longer be viewed as having any responsibility for the benefits payable to such individuals under the plan. For this purpose, it should be irrelevant that the benefits promised under the annuity contracts may vary based on investment performance or interest-crediting rates, rather than being guaranteed fixed dollar amounts. Regardless of the form of benefit, there is no continuing relationship between the individuals who hold such contracts and the plans under which the contracts were purchased that provides a basis for such an individual to be treated as a plan participant. With respect to spousal rights under a distributed annuity contract, which is one of the specific questions raised by the Council, the relevant Treasury regulations (which are also applicable for Title I purposes) provide that spousal rights must be preserved where plan benefits are provided under an annuity contract held by a participant or spouse rather than by a trustee, or where annuity contracts are distributed upon plan termination. Treas. Reg. §1.401(a)-20, Q/A-2. Therefore, spousal rights must be part of the "entire benefits rights," as described in section 2510.3-3(d)(2)(ii)(A), that are provided under an annuity contract held by a former participant.

Therefore, I believe the most constructive clarifying step that the Department can take to address the ERISA implications of the distribution of annuity contracts from section 403(b) plans, as well as other plans funded through the purchase of annuity contracts, is to provide clear guidance on the scope and applicability of section 2510.3-3(d)(2)(ii)(A). If the Department provides published guidance that concurs in the interpretation of this provision that we and others have followed, that will establish a coherent framework for addressing other issues relating to the preparation of Forms 5500 and the performance of audits with respect to section 403(b) plans for which annuity contracts are held by former participants.

First, for a section 403(b) plan that has been terminated in accordance with the Treasury regulations (one funded exclusively with annuity contracts or also with custodial accounts that have been liquidated and distributed as part of the plan termination), it would follow that there would be no further requirement to file annual reports on Form 5500 because the plan would no longer have participants or plan assets, assuming annuity contracts were enforceable directly against the issuers of the contracts without further control at the level of the plan or plan sponsor.

Second, where there has been a permanent discontinuance of contributions under a section 403(b) plan, but the plan has not been terminated under the Treasury regulations because assets held in custodial accounts have not or cannot be distributed, recognition of the applicability of section 2510.3-3(d)(2)(ii)(A) to individuals whose entire benefit rights are directly enforceable against the issuers of annuity contracts would reduce the number of participants taken into account for Form 5500 purposes and possibly eliminate the requirement of an audit.

Third, for ongoing section 403(b) plans, confirmation that a former employee is not a participant if his or her entire benefit rights are contained in an annuity contract that the former employee enforces against the issuer of the contract will similarly reduce the number of participants and the plan assets that must be taken into account for purposes of Form 5500 preparation and the determination of whether a plan audit required.

In my view, there is no sound basis for the Department to follow a more restrictive interpretation of section 2510.3-3(d)(2)(ii)(A), based on either the terms of the regulation or the policies underlying ERISA. However, because the Department has provided no guidance on the applicability of this regulation, beyond the indirect references thereto in the instructions to Form 5500, there is no common understanding of its meaning among practitioners and auditors.[4] Unless and until the Department provides further guidance on the meaning of this regulation, it seems inevitable that there will continue to be uncertainty and inconsistent treatment under ERISA of annuity contracts distributed by section 403(b) plans.

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[4] The reporting relief provided for pre-2009 section 403(b) contracts in FAB 2009-02 may have added to the lack of a common understanding of section 2510.3-3(d)(2)(ii)(A). Although that relief is broader than the regulation insofar as it includes custodial accounts and contracts held by active plan participants, it nonetheless might have created an inference that there is no other reporting relief for section 403(b) annuity contracts held by former employees (whether or not contributions ceased before 2009).