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Final regulations under tax code Section 403(b) released in 2007 reflect changes made under the Small Business Job Protection Act of 1996, the Economic Growth and Tax Relief Reconciliation Act of 2001, and the Pension Protection Act of 2006. The new rules diminish the extent to which Section 403(b) plans differ from qualified plans that include tax deferred salary reduction contributions, such as Section 401(k) plans and governmental plans under Section 457(b). In this article, attorneys Candace Quinn and Jose Jara discuss the effect of the changing 403(b) landscape on employers and plan sponsors.

Modernization of the Section 403(b) Plan and Its ERISA Implications

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Background.

Modernization of retirement plans has led to the increased focus on Internal Revenue Code Section 403(b) plans. These plans are sponsored by state and local governments or tax-exempted entities under Section 501(c)(3) of the tax code. Historically, these plans have not been a target of the plaintiff's bar in filing class action suits. However, the IRS issued Section 403(b) regulations last year which will go into effect Jan. 1, 2009. These final regulations are the first issued by the IRS in 40 years. The IRS's intention is to mirror the structure under Section 401(k) plans. To achieve parity in design and operation, Section 403(b) plans will require major attention. In addition, certain

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Section 403(b) plans that were not considered Employee Retirement Income Security Act (ERISA) plans may now be subject to ERISA and its fiduciary requirements due to actions taken by plan sponsors as they remodel their Section 403(b) plans to be compliant with the IRS mandates.

As such, plan sponsors and the directors and officers and other senior officials managing these Section 403(b) plans should be alert to their fiduciary duties owed to the plans under ERISA as well as their responsibilities under the tax code. Notwithstanding the status of an ERISA plan, these persons should be mindful of their particular state laws governing their actions, which usually follow trust fiduciary laws—those laws from which ERISA was derived.

Recently, class action lawsuits have been filed against plan sponsors and fiduciaries of section 403(b) plans, specifically, alleging breach of fiduciary duty by paying excessive fees to plan service providers, and failure to provide sufficient investment information to inform participants.[1]

Therefore, plan sponsors and fiduciaries of Section 403(b) plans need to quickly come up to speed and understand the new tax code requirements as well as ERISA's impact on any actions taken.

Requirements of the Section 403(b) Regulations.

Pursuant to the recently released final Section 403(b) regulations,[2] plan sponsors must adopt formal, written 403(b) plan documents by Jan. 1, 2009, in order to continue to maintain a Section 403(b) tax-deferred annuity retirement program.

Many employers are in denial. They do not believe that they could be considered a plan sponsor that has to comply with these new regulations, especially if their 403(b) plan only provides for employee salary reduction contributions and is a non-ERISA plan. However, the final regulations apply to both ERISA and non-ERISA 403(b) plans. In fact, the Department of Labor (DOL) issued Field Assistance Bulletin 2007-02, which provides that a tax-deferred annuity contract funded by employee contributions will not lose its ERISA exemption merely if it complies with the plan document requirement. The status of the plan under ERISA will be determined on a case-by-case basis.

Other employers are still unaware of the requirements mandated by final the regulations or, if they are aware of the rules, expect the vendor who issued the tax-deferred annuity contracts for the 403(b) plan to satisfy these requirements. However, the regulations require the employer to establish a plan and set forth compliance procedures with the vendors to ensure the plan is operating in accordance with the regulations. Even non-ERISA salary reduction plans must now not only be in writing but they must comply with these new requirements. Additionally, the employer-plan sponsor must make sure there are no conflicts between terms in the written plan and the terms of each vendor's 403(b) contract. If there are in consistencies between the contract and the terms of the plan, the contract could be disqualified and the amounts included in the employees' income.

If the employer fails to create a plan or operate the plan according to its provisions as provided under the regulations then all contracts for all participants in the plan could lose their tax-deferred status and amounts deferred under the contracts would have to be included in each employee's gross income.

As mentioned, the IRS adopted these extensive final 403(b) regulations as part of its overall interest in achieving parity with 401(k) qualified retirement plans. Accordingly, the goal was to increase the oversight of 403(b) plans and eliminate many types of abuses of such programs that had been discovered during IRS audits of the 403(b) plans.

To address these abuses, the regulations require employers to have significant involvement and responsibility in many areas, including plan documentation, investments, administration, participant information, and vendor relationships regarding the plan. Further, the employer must make sure the 403(b) plan document contains a number of key provisions regarding nonforfeitability of employees' contributions; nondiscrimination; statutory annual limitations on employer (nonelective) contributions and employee elective deferral limitations; universal eligibility generally, except for persons working less than 20 hours per week; distribution limitations; minimum distribution requirements; and rollover distribution provisions.

There are also a number of optional provisions that can be included in the plan such as provisions for making elections, investment changes, and catch-up contributions of up to $5,000 per year by employees age 50 or older; catch-up contributions of up to $3,000 per year by employees with 15 years of credited service subject to certain limitations; hardship withdrawals; loans; in-service distributions for individuals over age 59½; Roth contributions; nonelective contributions; rollover from other retirement plans; transfers between employers; and transfers between vendors subject to certain requirements.

The critical element for an employer to successfully comply with the regulations will be satisfying the requirement to identify plan vendors and determine if they are approved vendors. Over the years, many 403(b) plans have accumulated multiple vendors that provide employees with annuity contracts. In order to ensure that 403(b) plans are in compliance with the regulations and administered accurately, employers are now required to verify the status of the vendors providing annuity contracts to their employees.

In order to be considered an approved vendor for the plan, the vendor must be willing to sign an Information Sharing Agreement (ISA). With an ISA, the employer and the unapproved vendor agreed to share information to comply with the regulations, including participants employment status, eligibility for hardship distribution, and requirements for plan loan limits. As a vendor cannot rely on employee representation of this information under the regulations, the ISA has become an important compliance component and requires the employer's direct involvement. Plans with multiple vendors will have to work with each vendor to meet the requirements, including obtaining vendor approvals and maintaining compliance with the terms of the plan, or employers will have to eliminate noncompliant vendors.

[1] See, e.g., *Beary v. Nationwide Life Ins. Co.*, 2007 U.S. Dist. LEXIS 83137 (D. Ohio 2007); *Montoya v. ING Life Insurance & Annuity Co.*, No. 1:07-cv-02574 (S.D.N.Y. March 28, 2007).

[2] 72 Fed. Reg. 41,128-41,160 (July 26, 2007).

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As of July 1, 2009, employers are only allowed to make contributions directly to approved vendors identified in the plan. Although contributions to "payroll slot" vendors are only allowed to these approved vendors, the accounts with vendors that are not recognized under the plan will not lose their tax status but no future contributions will be allowed. Transfers of accounts into vendors approved under the plan may be made up until July 1, 2009.

Are You Now an ERISA Plan? Does It Matter?

Will implementation of these final regulations make all Section 403(b) plans subject to ERISA? As the saying goes, "If it Talks Like a Duck. . . and Walks Like a Duck . . . It is . . ." an ERISA plan.[3] ERISA Section 4(b) exempts certain plans sponsored by governments, churches, and certain tax-exempted entities. Tax-exempt entities can be exempted from ERISA if they meet the prescribed requirements under DOL regulations. The regulations provide, in part:

> a program for the purchase of an annuity contract or the establishment of a custodial account described in section 403(b) . . . shall not be "established or maintained by an employer" as that phrase is used in the definition of the terms "employee pension benefit plan" and "pension plan" if
>
> (1) Participation is completely voluntary for employees;
>
> (2) All rights under the annuity contract or custodial account are enforceable solely by the employee . . . ;
>
> (3) The sole involvement of the employer . . . is limited . . . to
>
> (i) Permitting annuity contractors . . . to publicize their products to employees,
>
> ...
>
> (iii) Summarizing . . . information . . . in order to facilitate review and analysis by the employees;
>
> (iv) Collecting . . . considerations as required by salary reduction agreements;
>
> (v) Holding in the employer's name one or more group annuity contracts covering its employees;
>
> ...
>
> (vii) [L]imiting the funding media or products available to employees, or the annuity contractors who may approach employees, to a number and selection which is designed to afford employees a reasonable choice in light of all relevant circumstances;[4] and
>
> (4) The employer receives no . . . consideration . . . [other] than reasonable compensation to cover expenses . . . incurred in the performance of the employer's duties pursuant to the salary reduction agreements.[5]

The main focus here is employer involvement. The selection of service providers, such as the investment provider, could be considered employer involvement, subjecting the plan to ERISA's requirements. Other actions such as having employer contributions or negotiating special features with the service provider could also make the Section 403(b) plan an ERISA plan.

DOL's Field Assistance Bulletin 2007-02—Is Your Plan Subject to ERISA?

The DOL addressed whether complying with the Section 403(b) regulations will take the plan out from the exemption and make it an ERISA-covered plan. The DOL generally concluded tax-exempted entities can remain within the safe harbor by complying with the new regulations.

However, the DOL provided a major caveat to its conclusion, stating that "the question of whether an employer, in complying with the Section 403(b) regulations, has established a plan covered under ERISA must be analyzed on a case-by-case basis applying the criteria set for the 29 C.F.R. Section 2510.3-2(f) and section 3(2) of ERISA." The DOL further stated that the plan documents should lay out the employer's limited role as well as the annuity provider's and participant's discretionary power.

The DOL provided that negotiating with annuity providers to change the terms of their products for other purposes, such as setting the conditions for hardship withdrawals, which are required to be in conformity with the plan terms, would be a form of employer involvement outside the safe harbor.

With Congress and the DOL focusing on more fee transparency in an effort to assist plan sponsors' and fiduciaries' determination of reasonable fees, it would be difficult to obtain fee transparency and negotiate a reasonable contract for reasonable fees with annuity providers without any employer involvement. Accordingly, it appears that many 403(b) plans will be subject to ERISA.

ERISA Reporting and Disclosure.

Historically, the DOL provided a limited exemption with regard to annual reporting requirements under ERISA for Section 403(b)—essentially limiting the reporting to basic plan information. The DOL has found that:

- Section 403(b) plans have grown in size and number,
- IRS has found a significant number of operational tax compliance issues (regarding timing of contributions, loans, hardship withdrawals, participation), and
- a high percentage of DOL investigations into Section 403(b) plans have detected violations of ERISA Title I (with frequent violations involving the improper handling of employee contributions).[6]

These findings have led the DOL to eliminate the limited exemption formerly provided to Section 403(b) plans. Section 403(b) plans subject to ERISA Title I will be treated in the same manner as any other Title I pension plan and be subject to annual reporting requirements.[7]

The implications for this is that Section 403(b) plans will now have to disclose the same detailed financial information as traditional defined benefits plans and 401(k) plans. In this regard, the DOL has revised the an-

[3] *Donovan v. Mercer*, 747 F.2d 304, 305, 5 EBC 2512 (5th Cir. 1984).

[4] DOL regulations provide that relevant circumstances may include, but not limited to, the following types of factors: (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. See 29 C.F.R. § 2510.3-2(f).

[5] 29 C.F.R. § 2510.3-2(f).

[6] 71 Fed. Reg. 41,616 (July 21, 2006).

[7] 71 Fed. Reg. 64,710 (Nov. 16, 2007).

nual reporting Form 5500 requirements to provide for additional disclosures in Schedule C, effective for the 2009 plan year filings.[8] The Schedule C would require, among other things, disclosure of any service provider receiving any compensation of $5,000 or more, as well as separate disclosure of amounts received directly from those received indirectly.[9] It also requires that the plan administrator identify any service provider not providing the required disclosures. Through increased disclosure, plan administrators should be able to negotiate reasonable contracts by being able to better monitor compensation arrangements, understand the impact of fees, and better evaluate the value of the services retained.[10] Therefore, Section 403(b) fiduciaries not only need disclose more financial information than ever before, they also need to be aware of these new requirements impacting all Title I pension plans.

ERISA's Statutory and Regulatory Framework.

Fiduciary analysis begins with determining who is a fiduciary. A person is a fiduciary to the extent that one exercises discretionary authority or control regarding plan management, management of the plan's assets, or to the extent that one has any discretionary authority or responsibility in plan administration.[11] Certain plans have named or designated fiduciaries. However, courts impose a functional test to determined fiduciary status by the actions taken and not by title designated.[12]

Fiduciary Duties—ERISA Section 404. ERISA Section 404 requires a fiduciary to act solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan.[13] In addition, a fiduciary must act prudently and loyally, diversify investment to minimize large losses, and operate in accordance with the plan documents (unless contrary to ERISA).

Prohibited Transactions Section 406 and Exemptions.

ERISA prohibits certain transactions between a plan and a party in interest.[14] A party in interest would include, among others, a fiduciary, plan sponsor, or any person providing services to a plan.[15] ERISA prohibits a fiduciary from causing a plan to engage in with a party in interest in (1) the sale or exchange, or leasing, of any property; (2) the lending of money or extension of credit: (3) the furnishing of goods or services; and (4) the transfer to, or use by or for the benefit of, any assets of the plan.[16]

ERISA also prohibits certain transaction between the plan and fiduciaries. A fiduciary must not: (1) deal with the assets of the plan for his own interest, (2) act in a transaction adverse to the participants, and (3) receive any kick-backs.

Without exemptions to these prohibitions, a plan could not operate. There are statutory, class, and individual exemptions. For example, ERISA Section 408(b)(2) provides a statutory exemption from these prohibition for certain arrangements between plans and service providers if: (1) the contract or arrangement is reasonable,[17] (2) the services are necessary for the establishment or operation of the plan,[18] and (3) no more than reasonable compensation is paid for the services.[19]

Currently, the DOL has proposed an amendment to the regulations under ERISA Section 408(b)(2) to expand its guidance on when a contract or arrangement is "reasonable." The proposed amendment requires additional disclosures by a service provider to fiduciaries concerning all compensation it will receive and any conflicts of interest that may adversely affect the service provider's performance.

Liability for Breach of Fiduciary Duty ERISA Section 409.

ERISA Section 409 imposes personal liability on fiduciaries to make good any losses to the plan resulting from a breach of their fiduciary duty. In addition, a fiduciary must restore to the plan any profits the fiduciary realized through the misuse of plan assets. Last, ERISA subjects the fiduciary to other equitable or remedial relief.

Section 403(b) Lawsuits.

Plan sponsors and fiduciaries of Section 403(b) plans are subject to lawsuits by either the state attorney general's office or private plaintiff class action suits.

In 2006, the New York State Attorney General's Office charged the teachers' union New York State United Teachers (NYSUT) and the insurer ING alleging both employed deception or concealment in the purchase, sale, or promotion of securities and demonstrated a persistent fraud or illegal conduct of business. Basically, ING would transfer $3 million to the NYSUT member benefit division and in exchange NYSUT promoted ING's retirement product (mostly high cost annuities) through events portrayed as investment seminars, which were ING-sponsored sales pitches. This case eventually settled.

The terms of the settlement require NYSUT to pay $100,000 to the state to cover the costs of the investigation. It further required certain policy changes, such as conducting open bidding for future retirement plan endorsements; providing full disclosure on any payment made by NYSUT; and allowing members to roll out from the plan into a new endorsed plan free of charge. In addition, the NYSUT had to hire an independent consultant to oversee changes to the NYSUT Trust and Trust employees had to be trained on product endorsement and potential conflicts of interest. ING had to pay $33 million in fines, waiver surrender fees, and provide

[8] 72 Fed. Reg. 64,710 (Nov. 16, 2007).
[9] 72 Fed. Reg. at 64,712 (Nov. 16, 2007).
[10] 72 Fed Reg. 64,719 (Nov. 16, 2007).
[11] ERISA § 3(21), 29 U.S.C. § 1002(21).
[12] See generally *Blatt v. Marshall & Lassman*, 812 F.2d 810, 812, 8 EBC 1495 (2d Cir. 1987); *Eaves v. Penn*, 587 F.2d 453, 458-59, 1 EBC 1592 (10th Cir. 1978).
[13] ERISA § 404, 29 U.S.C. § 1104; *Donovan v. Bierwith*, 680 F.2d 263, 3 EBC 1417 (2d Cir.), *cert denied,* 459 U.S. 1069, 3 EBC 2490 (1982) (all decisions must be made with an "eye single" to the interests of the plan's participants and beneficiaries).
[14] ERISA 406(a), 29 U.S.C. § 1106(a).
[15] See ERISA § 3(14)(B), 29 U.S.C. § 1102(14)(B).
[16] ERISA § 406(a)(1)(D), 29 U.S.C. § 1106(a)(1)(D).
[17] See 29 C.F.R. § 2550.408b-2(c) for the DOL's clarification on "reasonable contract or arrangement."
[18] See 29 C.F.R. § 2550.408b-2(b) for the DOL's clarification on "necessary service."
[19] See ERISA § 408(b)(2), 29 U.S.C. § 1108(b)(2); see 29 C.F.R. § 2550.408c-2 for the DOL's clarification "reasonable compensation."

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additional fee disclosures to all client plans going forward.

Stemming from this investigation, a class action suit was brought against ING, NYSUT, and the NYSUT Trust's board of trustees, individually.[20] The plaintiffs allege:

- NYSUT Trust and individual defendants breached their fiduciary duty by exclusively endorsing the plan in exchange for payment of millions of dollars, resulting in excessive costs amounting to tens of millions of dollars;
- ING breached its fiduciary duties by charging excessive fees;
- ING engaged in prohibited transactions through its revenue sharing scheme with investment advisers; and
- all defendants breached their fiduciary duties of prudent and loyal management.

Currently, NYSUT must file its motions to dismiss by September 2008. Accordingly, this one particular case has been a long, arduous, and painstaking matter to the NYSUT in connection with its Section 403(b) plan.

Conclusion.

Employer sponsors should begin reviewing their Section 403(b) plans to be compliant by the IRS's Jan. 1, 2009, deadline. In addition, any changes or action taken should be analyzed to determine whether this affects the plan sponsors' status under the DOL safe harbor. Next, plan sponsors should extract fees being charged and determine their reasonableness along with the qualifications and quality of services being retained. ERISA, tax code, and fiduciary mock audits should be conducted to ensure compliance. In addition, plan sponsors should avail themselves of self-correction opportunities and opportunities to mitigate fines, penalties, or personal liability. Lastly, in this litigious environment and the growth of more sophisticated representation of plaintiff-employees, it would be prudent to obtain fiduciary liability insurance, which can be paid with plan assets.

[20] *Montoya v. ING Life Ins. & Annuity Co.*, No. 1:07-cv-02574 (S.D.N.Y. 2006)