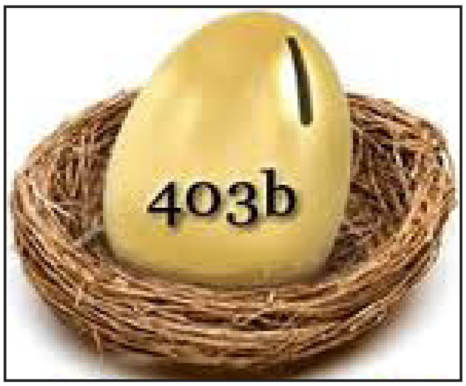
403(b) Plans: (b) as in Boy, They Can Be a Mess

By Ary Rosenbaum, Esq.

Law is a system of rules and guidelines, usually enforced through a set of institutions. If society didn't have laws, there would be absolute chaos. Law creates order and acts as a social mediator between people. The Wild West was a society with few laws and even less law enforcement which has inspired films until today. When dealing with qualified retirement plans, we work within a system of laws codified in the Internal Revenue Code and ERISA. Without these laws, retirement plans would not be run correctly and benefits under these plans would discriminate in favor of highly compensated employees. While much consideration and concern has been shown to 401(k) plans, 401(k) plans have a step-sibling straight out of the wild, wild, west called 403(b) plans. As bad as people think 401(k) plans are, governmental and employer neglect have made 403(b) plans far greater compliance concerns.

In the Godfather Trilogy, it was Michael Corleone's dream to turn his crime family into a legitimate family business. The same thing can be said of 403(b) plans as the Internal Revenue Service (IRS) has struggled to turn what was simply known as a tax sheltered annuity into a qualified plan such as 401(k) plans. As Michael Corleone would attest, turning legitimate is an extremely difficult transformation. 403(b) plans which are now governed by regulations by the IRS that have tried to make them on equal footing as qualified plans have had a difficult transformation because 403(b) plans have many compliance issues because of years of neglect.

A 403(b) plan is a tax-advantaged retirement savings plan available for public education organizations, Internal Revenue Code 501(c)(3) non-profit organizations, cooperative hospital service organizations, and self-employed ministers in the United States. 403(b) plans were first established in 1958, but it's hard to believe that they had no written plan requirement until 2009 (unless they were covered under ERISA and already had that written plan requirement under ERISA). Yes, the rules of a 403(b) plan could have been written out on the back of a matchbook or didn't have to be written at all. This is just one reason that 403(b) plans have compliance issues.



403(b) plans have tax treatment similar to a 401(k) plan. Like 401(k) plans, 403(b) participants can make employee salary deferrals before income tax is paid or as an after tax Roth contribution. In some instances, 403(b) plans do offer some type of employer contributions, but many 403(b) plans (especially on the public school level) are salary deferral only. While 403(b) plans are called tax sheltered annuities because in the past, most 403(b) plans were invested in annuities. However today, 403(b) plans could be invested in an annuity account or a custodial account where mutual funds could be offered as an investment. Since 403(b) plans are still not considered qualified plans, they do lack some of the compliance controls that qualified plans have adopted to maintain tax qualification.

The Problem with 403(b) Plan Compliance

As discussed, unless a 403(b) plan was an ERISA based plan, there was no written plan requirement until 2009. Obviously, the lack of a written plan document for so many years is a plan compliance issue in and of itself. However, the written plan requirement isn't as serious as whether a 403(b) plan is ERISA based or not because there are so many 403(b) plans that are treated as if they are not required to abide by ERISA because of a major misconception of 403(b) plans and ERISA.

An ERISA based 403(b) plan is required to file a Form 5500 as its annual return, while a non-ERISA based 403(b) plan does not. An ERISA based 403(b) plan is required to include an audit with their Form 5500 if the plan has more than 100 participants while a non-ERISA based plan does not because of the lack of a 5500 filing. So many people in the retirement plan industry believe that a 403(b) plan only becomes an ERISA based plan when there are employer contributions. That assumption is absolutely wrong and there are so many 403(b) plans with catastrophic plan errors because they should have complied with ERISA and made the proper filing and audits for years when they did not. Failure to consistently file a Form 5500 can result in hundreds of thousands of dollars in penalties (unless a 403(b) plan sponsors seeks redress with the Department of Labor's delinquent filing program in a preemptive move).

What makes a 403(b) plan ERISA based is not employer contributions, it is based on the plan sponsor's (the employer) involvement in running the plan. While all 403(b) plans that offer employer contributions are ERISA based, there are a quite a few 403(b) plans that are ERISA based that are salary deferral only. By appropriately limiting employer involvement, the 403(b) plan is considered voluntary by employees (so it is exempt under ERISA), and the contracts or 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. If a plan sponsor 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 plan sponsor will be deemed to have taken over control and the plan will no longer be exempt from ERISA. Every 403(b) employer that considers itself as a non-ERISA based 403(b) plan sponsor should consult with an ERISA attorney to determine whether their assumption regarding ERISA compliance is founded or not.

Too Many Plan Providers Don't Understand 403(b) Plans

They often say people mock what they don't understand and there so many plan providers whether they are third party administration (TPA) firms or financial advisors that knock 403(b) plans without understanding their benefits. I have known many TPAs that want a new client of theirs to terminate their 403(b) plan (prior to 2009, it could not be allowed) and start a 401(k) plan.

There are two major reasons why a 403(b) plan sponsors shouldn't opt for a 401(k) plan instead. First off, a major compliance test for 401(k) plans called the actual deferral percentage (ADP) test that tries to ensure that highly compensated employees don't disproportionally defer more that non-highly compensated employees. If a plan fails an ADP test, a 401(k) plan sponsor has to make additional contributions to correct the test or make refunds of salary deferrals to highly compensated employees who are taxed on these refunds or start using a safe harbor design. 403(b) plans don't have such a test; they have a universal availability requirement which means that everyone must be able to defer. There is no age and service requirement permitted for deferrals under 403(b) plans (there are some allowable eligibility exclusions such as non-resident aliens, work study students, and those employees with a normal work week of less than 20 hours), so the reward for that is the lack of an ADP test. The second reason why 403(b) plan sponsors shouldn't opt for a 401(k) plan instead is because it would automatically make plan sponsors that may not be subject to ERISA (see the discussion above) to being required to be subject to ERISA. Being subject to ERISA increases plan compliance, compliance costs, and requires plan sponsors to become fiduciaries (which includes a duty of care and potential liability).

In addition to issues with TPAs, I have come across two 403(b) plan sponsors who were sold on the value of 403(b) plans by financial advisors that were ineligible plan sponsors because one was a union and one was a governmental entity not authorized to be 403(b) plan sponsors. This major error required huge plan compliance costs. Any employer interested in a 403(b) plan should consider whether they are eligible to actually sponsor a 403(b) plan.

403(b) Plans can be loaded with fees.

Thanks to its legacy as a tax sheltered annuity, many 403(b) plans are serviced by very expensive plan providers including insurance companies and a company geared towards educators that I once joked that the only reason there are 403(b) plans was so that this company could still exist. Despite my attempt at humor, 403(b) plans tend to have high cost providers because there is a certain lack of low cost unbundled providers in the marketplace because of the lack of economies of scale. The main reason for this lack of economies of scale is the fact that many 403(b) plans (especially educator plans) offer multiple providers and multiple custodians instead of the exclusive provider that a 401(k) plan will use. While choice may be considered good, the multiple choices increases plan costs because a low cost provider won't be able to garner enough assets to be competitive over the larger, more expensive plan providers. 403(b) plan sponsors should ensure of the expenses their plan participants pay as well as making sure that they use an exclusive plan provider/custodian.

There has been so much written about the problems issued with 401(k) plans, but based on my experience in the retirement plan industry, I believe that 403(b) plans can be a bigger mess because of the former laissez faire attitude that these plans had before regulations were implemented. As the IRS and the Department of Labor take a further look at these plans, we will find many 403(b) plans out of compliance and many plan participants suffering as a result. 403(b) plan sponsors should seek counsel to diagnose or remedy any plan errors.

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