403(b) Plan Compliance Issues Unearthed: Problems Encountered in 2010

By Jewell Lim Esposito On October 25, 2010

In the past, unless a 403(b) program (or plan) was subject to the Employee Retirement Security Act of 1974, it had no documentation requirements and, even if subject to ERISA, very few reporting obligations. The last several years changed all that. In 2007, the Internal Revenue Service and the U.S. Department of Labor issued regulatory guidance[1] that vastly altered documentation and reporting obligations for 403(b) plans. As a result, the 403(b) plan environment is overhauling itself: learning plan administration duties, applying new regulations, complying with deadlines, re-examining single- and multi-vendor relationships. . . . And, not surprisingly, the 2010 year is *the* year that is illuminating retirement plan problems plaguing 403(b) plan sponsors.

We assume that the reader has at least a medium level of understanding regarding the 403(b) plan environment. Listed below are the most common problems we have seen thus far. The astute plan adviser will anticipate and resolve these issues for his or her 403(b) plan.

Written Plan Document Requirement

Final 403(b) regulations required all 403(b) plan sponsors (whether ERISA or non-ERISA) to adopt new written plan documents or amend existing plan documents. The final plan document had to contain all "material terms." IRS Notice 2009-3 allowed plan sponsors until December 31, 2009, to meet this written plan document requirement. Problems we are continuing to see include the following:

- *Lack of timely execution*. Some plan sponsors did not timely execute a proper plan document, thus risking the possibility that all contributions and earnings under the 403(b) plan will become immediately taxable.
- *Lack of material terms*. The purpose of the plan document is to provide information to employees; consequently, a plan document must disclose material terms, including eligibility critieria, benefits, limitations, contracts available under the plan, and the time and form for distributions under the 403(b) plan.
- *Lack of coordination*. As noted above, the contracts available under the plan is a material term. Some plan sponsors did not *coordinate* the language in the executed plan document with the underlying investment contract. Still other sponsors permissibly used multiple documents (insurance policy or custodial account provisions) that, together with other literature, became the "plan document"; yet the terms of the underlying documents conflicted with one another. The result here is that, almost immediately, plan operations did not conform to the plan document. From the perspective of the IRS, the 403(b) plan sponsor has a defect that requires correction.
- The IRS is expected to see an increase in voluntary corrections related to the plan document and operation aspects, so that the participants can retain the tax benefits.

- *Fiduciary concerns*. A 403(b) plan fiduciary under ERISA must operate in accordance with its plan document. Some plan sponsors did not know whether their plans were even subject to ERISA and its reporting and disclosure rules.
- Generally, a 403(b) plan is subject to ERISA if a tax-exempt organization "establishes" or "maintains" the plan on behalf of its employees.
    - However, a safe harbor under DOL regulations provides that a 403(b) plan is not subject to ERISA if 1) employer participation is completely voluntary; 2) only the employee can enforce all rights under the plan's annuity contracts or custodial accounts; 3) the employer's involvement is limited to enumerated tasks including publicizing the 403(b) plan and forwarding payroll contributions; and 4) the employer receives no compensation (except reasonable amounts for payroll deduction costs). Once a plan is subject to ERISA, so too are its fiduciaries.[2]

Audit Requirement

Before 2009, 403(b) plans had reporting obligations that were summary in nature. Generally, 403(b) plans with 100 or more participants at the beginning of 2009 needed to attach audited financial statements to their 2009 Form 5500s.[3] Some 403(b) plan sponsors did not know that they had to have an audit. Problems we are continuing to see include the following:

- *Inability to count proper number of participants*. A plan sponsor must count employees who are eligible to contribute into its 403(b) plan, *but do not contribute,* as "participants" for purposes of Form 5500 (and thus the audit requirement). DOL Regulation § 2510.3-3(d) more specifically defines how to perform the count.
- *Poor quality of supporting documentation from 403(b) plan sponsor.*
    - Auditors found the quality of personnel file data to be slim or non-existent. For example, when auditors strove to verify whether the employer was honoring a 5 percent deferral election, there was no documentation to support the withholding and transmittal of the deferral.
    - Because of the lack of records, some plan sponsors had difficulty determining the location of all of its plan assets, contract balances, and number of former and current employees.[4]

Filing Form 5500[5] *without audited financials*. Rather than not file the Form 5500, some 403(b) plan sponsors simply filed tax returns without the audit attached (as some plan sponsors did not *know* an

audit was needed, or even if they knew, they did not retain an auditor in time or the auditor could not complete its work before the filing deadline).

About five months after the due date of the Form 5500, the plan sponsor should expect to receive a notice from the DOL asking the plan sponsor to supplement its Form 5500. The DOL is treating the plan sponsor's incomplete return as a return that is not a return at all (and thus not timely filed). The exposure to the plan sponsor here is a penalty for failure to file.

- However, if the plan sponsor can then provide the appropriate financials soon after receipt of the letter, then the DOL will probably waive any late filing penalty (which, in total, can be steep).
- 403(b) plan sponsors who thus did not have their audits finished before the Form 5500 filing should (hire an auditor and) direct that the audits be performed and finalized. They could then either amend the already filed return or await the notice from the DOL.

Employee Money

The DOL finalized regulations that establish a seven-business-day "safe harbor period" for employers to deposit participant contributions and loan repayments to small plans (those with fewer than 100 participants at the beginning of the plan year). Employers who make their deposits during the safe harbor period will be treated as having timely contributed those amounts to the plan for certain ERISA and Internal Revenue Code purposes.[6] The final regulations do not apply with respect to large plans (plans with 100 or more participants at the beginning of the plan year). For now, that timeframe still remains "as of the earliest date on which [they] can reasonably be segregated from the employer's general assets."[7] Problems we are continuing to see include the following:

- *Late transfer of employee money.* The 403(b) world appears to be like the 401(k) world when it comes to transferring employee money. This year, 403(b) plan auditors have found that, even though employers withheld contributions from employee paychecks, the employers did not timely forward the contributions to the vendor who was responsible for investing the money. In some instances, the contributions were only a few days late; but in other cases, the contributions were months late.
    - This late deposit issue has been a huge part of the enforcement initiatives of both the IRS and DOL. As with 401(k) sponsors, both agencies know this is an area of significant non-compliance in the 403(b) context.
    - The failure of a plan sponsor to timely transfer employee money is a prohibited transaction under IRS and DOL rules. It is a breach of a fiduciary duty that can result in both civil and criminal penalties, depending upon the severity, frequency, and dollar amounts involved.
- The DOL has a voluntary fiduciary correction program available to plan sponsors. Under this program, the plan sponsor will have to contribute the amounts on behalf of employee participants and provide earnings.

- Relatedly, once a plan sponsor has proceeded under the DOL program (and received a "no action letter" from the DOL), it can then attempt to ensure the 403(b) plan's continued tax benefits with an application to the IRS.

What Should a 403(b) Plan Do?

More compliance issues will most certainly arise, as 403(b) plan sponsors around the country finish up their audits and file their Forms 5500. Just becoming familiar with and being able to vet out the compliance issues confronting 403(b) sponsors – as described here – will be helpful.

For additional help, the IRS has compliance and enforcement material on its website.

[1] 72 Fed. Reg. 41128 (July 26, 2007) and 72 Fed. Reg. 64710 (November 16, 2007).

[2] 29 C.F.R. § 2510.3-2(f). Those 403(b) plan sponsors who want to make employer contributions (such as matching) maintain an *ERISA* plan.

[3] Under DOL regulations, all 403(b) plans are subject to more detailed annual reporting requirements including, for certain plans, a financial audit. These enhanced reporting requirements are effective for plan years beginning on or after January 1, 2009. Plans with fewer than 100 participants generally file a simplified Form 5500 without audited financial statements.

[4] The DOL recognized that employer records might be problematic. Thus, for the 2009 Form 5500 and financial audit, an employer could exclude an annuity contract or custodial account issued to a current or former employee before January 1, 2009, if (1) the employer ceased to have any obligation to and did not contribute to any contract or account before January 1, 2009; (2) only the individual owner of the contract or account could enforce all the rights and benefits under such contract or account; and (3) the individual owner was fully vested in the contract or account. Field Assistance Bulletin 2009-02. Moreover, the employer did not have to count current or former employees who held these contracts or accounts (as described here) as "participants" for the Form 5500 reporting purposes.

[5] Neither an ERISA § 3(32) "governmental" 403(b) plan nor an ERISA § 3(33) non-electing "church" 403(b) plan under is subject to the annual Form 5500 reporting requirements of Title I of ERISA. A tax-exempt organization that "establishes" or "maintains" a 403(b) plan, however, has a "pension plan" within the meaning of ERISA § 3(2) that Title I would cover.

[6] 75 Fed. Reg. 2068 (January 14, 2010).

[7] 29 C.F.R. § 2510.3-101.