U.S. Department of Labor **Employee Benefits Security Administration**
Washington, D.C. 20210

FIELD ASSISTANCE BULLETIN NO. 2007-02

DATE: JULY 24, 2007

MEMORANDUM FOR: VIRGINIA C. SMITH, DIRECTOR OF ENFORCEMENT
REGIONAL DIRECTORS

FROM: ROBERT J. DOYLE
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SUBJECT: ERISA COVERAGE OF IRC § 403(b) TAX-SHELTERED ANNUITY PROGRAMS

ISSUE: How do the Department of the Treasury/Internal Revenue Service regulations governing Internal Revenue Code § 403(b) tax-sheltered annuity programs affect the status of such programs under the Department of Labor's safe harbor regulation at 29 C.F.R. § 2510.3-2(f)?

BACKGROUND:

A tax-sheltered annuity (TSA) program under section 403(b) of the Internal Revenue Code (Code), also known as a "403(b) plan," is a retirement plan for employees of public schools, employees of certain tax-exempt organizations, and certain ministers. Under a 403(b) plan, employers may purchase for their eligible employees annuity contracts or establish custodial accounts invested only in mutual funds for the purpose of providing retirement income. Annuity contracts must be purchased from a state licensed insurance company, and the custodial accounts must be held by a custodian bank or IRS approved non-bank trustee/custodian. The annuity contracts and custodial accounts may be funded by employee salary deferrals, employer contributions, or both. Although not subject to the qualification requirements of section 401 of the Code, some of the requirements that apply to qualified plans also apply, with modifications, to 403(b) plans.

These TSA programs, if established or maintained by an employer engaged in commerce or in any industry or activity affecting commerce, generally are "pension plans" within the meaning of section 3(2) of ERISA and covered by Title I pursuant to

section 4(a) of ERISA.[1] The terms "establish" or "maintain" are not defined in ERISA, and uncertainty as to the application of ERISA to TSA programs funded entirely with employee contributions prompted the Department of Labor in 1979 to issue a "safe harbor" regulation at 29 C.F.R. § 2510.3-2(f).

The safe harbor at § 2510.3-2(f) states that a program for the purchase of annuity contracts or custodial accounts in accordance with provisions set forth in section 403(b) of the Code and funded solely through salary reduction agreements or agreements to forego an increase in salary, are not "established or maintained" by an employer under section 3(2) of the Act, and, therefore, are not employee pension benefit plans subject to Title I, provided that certain factors are present. These factors are: (1) that participation of employees is completely voluntary, (2) that all rights under the annuity contract or custodial account are enforceable solely by the employee or beneficiary of such employee, or by an authorized representative of such employee or beneficiary, (3) that the involvement of the employer is limited to certain optional specified activities, and (4) that the employer receive no direct or indirect consideration or compensation in cash or otherwise other than reasonable reimbursement to cover expenses properly and actually incurred in performing the employer's duties pursuant to the salary reduction agreements. In this latter regard, if an employer, or a person acting in the interest of an employer, receives, for example, other consideration from an annuity contractor, the employer could be deemed to have "established or maintained" a plan.

The safe harbor allows the employer to engage in a range of activities to facilitate the operation of the program. The employer may permit annuity contractors—including agents or brokers who offer annuity contracts or make available custodial accounts—to publicize their products, may request information concerning proposed funding media, products, or annuity contractors, and may compile such information to facilitate review and analysis by the employees. The employer may enter into salary reduction agreements and collect annuity or custodial account considerations required by the agreements, remit them to annuity contractors, and maintain records of such collections. The employer may hold one or more group annuity contracts in the employer's name covering its employees and exercise rights as representative of its employees under the contract, at least with respect to amendments of the contract. The employer may also limit funding media or products available to employees, or annuity contractors who may approach the employees, to a number and selection designed to afford employees a reasonable choice in light of all relevant circumstances.[2]

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[1] Under ERISA § 4(b) (1) and (2), "governmental plans" and "church plans" generally are excluded from coverage under Title I of ERISA. Therefore, § 403(b) contracts and custodial accounts purchased or provided under a program that is either a "governmental plan" under § 3(32) of ERISA or a non-electing "church plan" under § 3(33) of ERISA are not subject to Title I.

[2] The regulation at 29 C.F.R. § 2510.3-2(f) provides a "safe harbor" for TSA programs that conform to its provisions. The safe harbor does not preclude the possibility that programs that do not fully conform (footnote continued)

The Department of the Treasury/Internal Revenue Service has issued final regulations at 26 C.F.R. 1.403(b)-0 et seq. (July 2007) reflecting legislative changes made to § 403(b) since the existing regulations were adopted in 1964. The § 403(b) regulations also incorporate interpretive positions that the Department of the Treasury/Internal Revenue Service have taken in other guidance on § 403(b). This Bulletin is intended to provide guidance to EBSA's national and regional offices concerning the extent to which compliance with the updated regulations would cause employers to exceed the limitations on employer involvement permitted under the Department of Labor's safe harbor for tax-sheltered annuity programs at 29 C.F.R. § 2510.3-2(f).

ANALYSIS:

The new § 403(b) regulations have not led the Department of Labor to change its view on the principles that apply in determining whether any given TSA program is covered by Title I of ERISA. Even though the differences between the tax rules for TSA programs and those governing other ERISA-covered pension plans may have diminished, the Department's safe harbor regulation at 29 C.F.R. § 2510.3-2(f) remains operative. The new § 403(b) regulations allow significant flexibility regarding the employer's functions in the structure and operation of the arrangement. Thus, compliance with the new § 403(b) regulations will not necessarily cause a TSA program to become covered by Title I of ERISA.

The Department has acknowledged that employers have an interest separate from acting as their employees' authorized representatives in ensuring that the annuity contracts and custodial accounts in TSA programs are tax compliant. The Code's qualification requirements impose obligations directly on employers in connection with the employees' annuity contracts and custodial accounts. If individual contracts or accounts fail to satisfy the tax qualification requirements, even if due to actions or errors of an employee or annuity contractor, the employer can be liable to the IRS for potentially substantial penalty taxes, correction fees, and employment taxes on employee salary deferrals. Accordingly, in the Department's view, the safe harbor at section 2510.3-2(f) subsumes certain employer activities designed to ensure that a TSA program continues to be tax compliant under section 403(b) of the Code.

The Department of Labor has issued advisory opinions and other guidance on whether specific employer functions are compatible with the safe harbor. The Department believes that the safe harbor allows an employer to conduct administrative reviews of the program structure and operation for tax compliance defects. Such reviews may include discrimination testing and compliance with maximum contribution limitations

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with the regulation may nevertheless not be "established or maintained" by an employer for purposes of Title I of ERISA.

under the Treasury regulations. As noted in previous guidance issued by the Department, the employer may also fashion and propose corrections; develop improvements to the plan's administrative processes that will obviate the recurrence of tax defects; obtain the cooperation of independent entities involved in the program needed to correct tax defects; and keep records of its activities.[3]

A program could fit within the section 2510.3-2(f) safe harbor and include terms that require employers to certify to an annuity provider a state of facts within the employer's knowledge as employer, such as employee addresses, attendance records or compensation levels. The employer may also transmit to the annuity provider another party's certification as to other facts, such as a doctor's certification of the employee's physical condition. The employer could not, however, consistent with the safe harbor, have responsibility for, or make, discretionary determinations in administering the program. Examples of such discretionary determinations are authorizing plan-to-plan transfers, processing distributions, satisfying applicable qualified joint and survivor annuity requirements, and making determinations regarding hardship distributions, qualified domestic relations orders (QDROs), and eligibility for or enforcement of loans.[4]

An important requirement in the Treasury regulations is that a TSA program must be maintained pursuant to a "written defined contribution plan" that satisfies the Code's regulatory requirements and contains all the material terms and conditions for benefits under the plan. An employer, by adopting such a written plan, does not automatically establish a Title I plan. Compiling the benefit terms of the contracts and the responsibilities of the employer, annuity providers and participants is a function similar to the information collection and compilation activities expressly permitted under the Department's TSA safe harbor. Indeed, the preamble to the final Treasury regulations makes clear that the "plan" required to satisfy the Code does not have to be a single document, but may incorporate by reference other documents, including insurance policies and custodial account agreements and other documents governing the contracts and accounts prepared by the annuity providers. 26 C.F.R. § 1.403(b)-3(b)(3).

The Department of Labor expects that the written plan for a TSA program that complies with the safe harbor would consist largely of the separate contracts and related documents supplied by the annuity providers and account trustees or custodians. An employer's development and adoption of a single document to coordinate administration among different issuers, and to address tax matters that apply, such as the universal availability requirement in Code section 403(b)(12)(A)(ii), without reference to a particular contract or account, would not put the TSA program out of compliance with the safe harbor.

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[3] *See* DOL Information Letter to Siegel Benefit Consultants (Feb. 27, 1996).

[4] *See* Advisory Opinion Nos. 94-30A, 83-23A, and 80-11A.

Because the Treasury regulations allow a plan to allocate responsibility for performing administrative functions to persons other than the employer, the relevant documents should identify the parties that are responsible for administrative functions, including those related to tax compliance. The documents should correctly describe the employer's limited role and allocate discretionary determinations to the annuity provider or participant or other third party selected by the provider or participant.

In addition, an employer seeking to take advantage of the safe harbor may periodically review the documents making up the plan for conflicting provisions and for compliance with the Code and the Treasury regulations. Negotiating with annuity providers or account custodians to change the terms of their products for other purposes, such as setting conditions for hardship withdrawals, would be a form of employer involvement outside the safe harbor.

A tax-sheltered annuity program will not, in the Department's view, become covered by Title I of ERISA merely because the written plan conforms to the new § 403(b) regulations by limiting employees to exchanges of contract funds only among providers who have adopted the written plan, or transfers from the program of a former employer to that of the current employer. Under the safe harbor, the employer may limit funding media or products available to employees, or annuity providers who may approach the employee, to a number designed to afford employees a reasonable choice in light of all relevant circumstances. The Code-mandated restrictions on transfers of funds may, however, require the employer to allow providers to offer a wider variety of products in order to afford employees a reasonable choice in light of all relevant circumstances for purposes of the safe harbor. Alternately, an employer may limit the number of providers to which it will forward salary reduction contributions as long as employees may transfer all or a part of their funds to any provider whose annuity contract or custodial account complies with the Code requirements and who agrees to the plan's division of tax compliance responsibilities among the employer, provider and participant.

Finally, in the event an employer decides that it does not want to continue to perform the ministerial and administrative functions required under the § 403(b) regulations, the Department does not believe that the employer's determination to terminate a TSA program in compliance with the Treasury regulations will cause a program not otherwise covered by Title I of ERISA to become covered.

CONCLUSION:

The Department is of the view that tax-exempt employers will be able to comply with the requirements in the new § 403(b) regulations and remain within the Department's safe harbor for TSA programs funded solely by salary deferrals. We note, however, that

the new § 403(b) regulations offer employers considerable flexibility in shaping the extent and nature of their involvement under a tax-sheltered annuity program. The question of whether any particular employer, in complying with the § 403(b) regulations, has established or maintained a plan covered under Title I of ERISA must be analyzed on a case-by-case basis applying the criteria set forth in 29 C.F.R. § 2510.3-2(f) and section 3(2) of ERISA.

Questions concerning the information contained in this Bulletin may be directed to the Division of Coverage, Reporting and Disclosure, Office of Regulations and Interpretations, 202.693.8523.