

The Source: 403(b) and 457(b) Plans, Second Edition by Kristi Cook, JD and Ellie Lowder, St. Louis, MO: NTSAA

(Required Reading for 2011 TGPC-1 and TGPC-2 Exam is the Second Edition until Third Edition is Available. Third Edition is expected to be available by February 28, 2011.)

Errata

DATE ADDED	PAGE	FOR	READ
9/21/09	2 5, line 9	Any employee who is eligible to participate in another elective deferral plan or 457(b) plan;	Any employee who is eligible to participate in another elective deferral plan or 457(b) plan sponsored by the employer;
07/31/09	2 13, line 30	Post-Employment Salary Reduction Contributions From Severance Pay	Post-Employment Salary Reduction Contributions
07/31/09	2 13, line 35-38	Due to changes included in the final IRC Section 415(c) regulations, it is clear that certain types of severance pay can be used for elective deferrals to 403(b) and 457(b) plans as those amounts are paid before the end of the tax year of severance, or, if later, within 2½ months of the time employment is severed.	Due to changes included in the final IRC Section 415(c) regulations, it is clear that certain types of pay can be used for elective deferrals to 403(b) and 457(b) plans if those amounts are paid before the end of the tax year of severance, or, if later, within 2 ½ months of the time employment is severed. Elective deferrals cannot be made from se-

			verance pay received after separation from service.
12/08/09	2 30, lines 3-5	A participant may borrow the greater of \$10,000 or \$50,000 of the account values in all retirement plans of that employer subject to a lifetime maximum of \$50,000, reduced by the highest outstanding loan value within the most recent 12 month period measure from the date of the loan.	A participant may borrow (1) the greater of \$10,000 or 50% of the vested account balance in all of his or her retirement plans of the employer, or (2) \$50,000, whichever is less. The \$50,000 amount is reduced by the highest outstanding loan balance from the plan(s) during the 12-month period ending on the day before the date a new loan is made, over the outstanding loan balance on the date the new loan is made.
12/08/09	3 26, lines 27-30	The spouse (unless she or he elects to rollover the deceased's account to his or her own workplace plan, or to an IRA) is required to take distributions of no less than the amount calculated using his or her own life expectancy, recalculated each year.	The spouse (unless she or he elects to rollover the deceased's account to his or her own workplace plan, or to an IRA) is required to take distributions in the year following the participant's death based on the spouse's life expectancy (unless the participant's life expectancy in the year of death is longer), recalculated each year.
12/08/09	3 26, lines 30-31	The required minimum distribution is based on the non-spouse beneficiary's life expectancy reduced by one	The non-spouse beneficiary is required to take a RMD in the year following the participant's death based on the

		each year (no recalculation.)	beneficiary's life expectancy (unless the participant's life expectancy in the year of death is longer), reduced by one each year (no recalculation).
06/01/09	4 11		Replacement page provided below.
01/05/10	4 17, line 12	a uniform 2% of compensation contributions	a uniform 3% of compensation contribution
11/09/09	4 26, line 20	These annual reports are required to be filed on the Form 5500 series no later than 7½ months after the end of the plan year.	These annual reports are required to be filed on the Form 5500 series no later than the last day of the seventh month after the end of the plan year. An extension of up to 2½ months may be obtained by filing Form 5558 before the Form's due date. Alternately, an automatic extension (generally, 1½ months) is provided if certain conditions are met.
12/08/09	4 44, line 41	Based on this very simple plan design, Eric's income would be based on his share of \$471,000 of annual premium.	Based on this very simple plan design, Eric's income would be based on his share of \$702,000 of annual premium.
12/08/09	4 45, lines 1-2	Employee contribution \$21,000 (210 employees x \$100/month) + Employer contributions of \$450,000 (3% of \$50,000 x 300 employees) = \$471,000	Employee contribution \$252,000 (210 employees x \$100 x 12 months) + Employer contributions of \$450,000 (3% x \$50,000 x 300 employees) = \$702,000
12/08/09	4 46, line 6	Text is correct, addition is	Note that if the employer

		solely for clarification.	pays the costs to surrender a contract, the payments are not considered restorative payments but are considered employer contributions.
09/21/09	5 8, line 28	the plan must receive a 2% of pay contribution	the plan must receive a 3% of pay contribution
07/14/09	5 17, line 25	,provided that all benefits must vest upon death and normal retirement.	,provided that all benefits must vest upon normal retirement.
07/14/09	5 18, lines 1-3	Defined benefit plans do not permit in-service withdrawals or loans. This is because participants do not have individual account balances from which amounts may be withdrawn or borrowed.	Most defined benefit plans do not permit loans, although they are permitted under the law. In addition, defined benefit plans, like money purchase pension plans, cannot permit in-service withdrawals prior to the participant's attainment of normal retirement date.
7/14/09	5 18, Call out	Defined benefit plans do not permit in-service withdrawals or loans because participants do not have individual accounts balances.	No replacement.
07/31/09	7 12, lines 1-3	The final 415(c) regulations and the final 403(b) regulations together eliminate confusion about whether SRAs can be applied to severance pay that is paid <i>after</i> the severance of employment.	The final 415(c) regulations and the final 403(b) regulations together eliminate confusion about whether SRAs can be applied to pay that is received <i>after</i> the severance of employment.
07/31/09	7 12, lines 4-5	If severance pay that would have been paid or available	If pay that would have been paid or available for use

		for use whether or not the affected employee had terminated employment	whether or not the affected employee had terminated employment
07/31/09	7 12, lines 10-13	Examples of severance pay from which deferrals may be made include payments for unused sick leave or vacation (as long as those unused days would have been available for the employee's use had he/she not left), or bonus pay for job performance, or back pay.	Examples of post-employment pay from which deferrals may be made include payments for unused sick leave or vacation (as long as those unused days would have been available for the employee's use had he/she not left), or bonus pay for job performance, or back pay. Elective deferrals cannot be made from severance pay received after separation from service.
07/31/09	7 18, line 25	certain types of severance pay	certain types of pay
07/14/09	9 18, line 47	modest (\$3,000) filing fee. ²⁹	filing fee. ²⁹
07/14/09	9 28, Footnote 29	See IRS Rev. Proc. 96-1 and Rev. Proc. 96-8	See IRS Rev. Proc. 2009-8
01/04/11	3 20, lines 37-38	1. Any account values derived from employer (non-salary reduction) contributions as of January 1, 2009 to a 403(b)(1) annuity contract, and	1. Any account values derived from employer (non-salary reduction) contributions to 403(b)(1) annuity contracts issued before January 1, 2009, <i>and</i>

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Employer contributions (contributions that are not salary reduction contributions), generally can be deposited any time up to the last day of the plan year, unless the plan document provides to the contrary. IRS regulations have effectively extended the time by which employers must make contributions to fifteenth (15th) day of the tenth (10th) month following the end of the applicable year end.²⁵ This gives employers sufficient time to complete required nondiscrimination testing, coverage and participation testing and other tax related tasks before making the contribution to the plan. However, under ERISA, employers are required to follow the terms of the plan document. If the plan document includes a specific contribution date or deadline, then the contribution must be made by that date notwithstanding the later date permitted under the regulations.

The following is an example of how the restrictions applicable to contributions will be applied. Assume that a 403(b) ERISA plan with a plan year ending December 31 permits an employee to make salary reduction contributions. The employer matches those contributions up to 3%. In addition, the employer makes a discretionary contribution for participants that year. The following is a schedule of when such contributions must be deposited, as plan assets, into the accounts of the participants:

Type of Contribution	Due Date
Employee contribution	On or before the 15th of the following month
Matching contribution	On or before October 15 of the next year
Discretionary contribution	On or before October 15 of the next year

Even though an employer is permitted to delay contributions until the following year, there are several reasons why it may not be in the best interest of the employer to do so. For example, matching contributions are usually made to induce employees to participate in the plan. Often account statements are sent to participants on a monthly or quarterly basis. If a participant joins the plan because he expects to receive a matching contribution and he does not see a matching contribution on his statement because the employer withholds the deposit for more than one year, his incentive to participate is affected. This can affect the continued qualification of the plan because matching contributions are subject to a nondiscrimination test that must be satisfied each plan year.²⁶ If the non-highly compensated employees participate at a reduced level because of poor perception of the plan's benefits, the highly compensated employees will be restricted in the level of their matching benefits. Therefore, it may be in the employer's best interests to deposit matching contributions contemporaneously with the salary reduction contributions upon which they are based in order to motivate lower paid employees to participate in the program.

6. Miscellaneous Technical Requirements

See Section 4.8 for a description various miscellaneous requirements under ERISA.

7. Reporting and Disclosure Requirements

See Sections 4.9 through 4.11 for information on the reporting and disclosure requirements applicable to 403(b) plans under ERISA.

8. Fiduciary Requirements

See Sections beginning at Section 4.12 for a discussion on certain fiduciary requirements and responsibilities applicable to 403(b) plans.

²⁵ *Treas. Reg. 1.415(c)-1(b)(6)*

²⁶ *Matching contributions and after-tax employee contributions must satisfy the actual contribution percentage test of Section 401(m) of the Code.*

The information below is from The Source, **Third** Edition. This information is for candidates who are intending to take the 2011 TGPC-1 and TGPC-2 examinations before the Third Edition is published. It is anticipated that the Third Edition will be available by February 28, 2011. The information below is included in the Third Edition and represents sections of the text that were either extensively updated from the Second Edition or incorporates information not included in the Second Edition.

Chapter 3: Information Added to Section 3.7

3.7 Rollovers: All Plan Types Including IRAs and SEPs

Pension Portability for Roth 403(b), Roth 401(k), Roth 457(b) and Roth IRAs

Roth 403(b), Roth 401(k) and effective with the addition of a Roth 457(b) option to governmental plans on January 1, 2011 (referred to as “designated Roth accounts”), portability is extended to eligible rollover distributions from designated Roth accounts to Roth IRAs. Additionally, effective September 27, 2010, eligible rollover distributions from Roth 401(k), Roth 403(b) and Roth 457(b) plans may be rolled over to a designated Roth account *within* each plan.

As explained in previous chapters, 403(b) plans with the designated Roth accounts will permit tax-free distributions from the Roth portion of the plan if *both* the holding period (5 years) and the qualifying event (age 59½, death or disability) requirements are met.

It is important to note that Roth 403(b) and Roth 401(k) accounts can be rolled to one another or to a Roth IRA; however, a Roth IRA cannot be rolled into a Roth 403(b) or Roth 401(k) account. Once a Roth 403(b) or Roth 401(k) is rolled into a Roth IRA account, the following rules will apply.

1. A new 5-year holding period will be applied *unless* the participant had already established the Roth IRA account. If so, the 5-year holding period applies to the first tax year the already established Roth IRA was funded.
2. After the rollover, Roth IRA rules will apply. This means that subsequent withdrawals will consist of contributions first (without taxes or penalty tax), no required minimum distributions (during the account holder’s lifetime) will apply and qualifying events for tax-free distributions include \$10,000 for a first time home purchase, attainment of age 59½, death and disability.

Rollovers from Qualified Plans, 403(b) Plans and 457(b) Governmental Plans to a Roth IRA

Effective on January 1, 2008, IRC §408A(e) permits the rollover of eligible distributions from 401(a), 401(k), 403(b) and governmental 457(b) plans directly to a Roth IRA. There is, after that date, no longer a need to follow a two-part process – the first to roll over the distribution to a conduit IRA; then convert the traditional IRA to the Roth IRA. These rollovers (often referred to as “conversions”) were available through 2009 for participants that have adjusted gross income of \$100,000 or less. Beginning January 1, 2010, the income limitation was eliminated. Signed into law on September 27, 2010, is legislation which also permits the rollover of pre-tax 403(b) and 401(k) accounts to Roth options within the plan. Rollovers of pre-tax governmental 457(b) assets to the Roth 457(b) option offered in the plan will also be permitted after the January 1, 2011 effective date of the Roth 457(b) option.

Plans are required to permit the recipient of an eligible rollover distribution to elect a direct rollover option to avoid the otherwise applicable 20% mandatory federal income tax withholding requirement. Where the participant does not elect direct rollover treatment, the distribution can be indirectly rolled over to the Roth IRA within 60 days.

While income taxes do apply to the rollover/conversion, there are no IRS premature distribution penalty taxes applied to the rollover. Finally, if the rollover is accomplished in 2010, the participant may choose to include the taxable portion of the conversion as 2010 income– or split the income equally in 2011 and 2012. Once the rollover has been deposited into the Roth IRA, a 5-year holding period applies before distributions from the amount of the rollover that was includible in income can be taken without federal taxes or penalty taxes (if applicable).

Chapter 4: Section 4.2 (Replaces Section 4.2 in the Second Edition)

4.2 When Are 403(b) and 457 Plans Subject to ERISA?

ERISA was originally enacted in 1974 to protect employees' benefits. Under that mandate, the law established rules applicable to most benefit programs offered to employees by employers. Accordingly, ERISA generally applies to any plan, fund or arrangement established or maintained by an employer to provide retirement or deferred compensation income or health or welfare benefits. Therefore, any retirement or deferred compensation arrangement, *including 403(b) programs and 457 programs* will be subject to ERISA, unless specifically excluded by the statute.

Statutory Exemptions

ERISA contains specific exemptions for benefit plans of certain types of employers. For example, plans sponsored by governmental entities as defined in ERISA §3(32) such as public schools, community colleges and state universities or churches as defined in ERISA §3(33) are not subject to ERISA.²⁷ Governmental employers may NOT elect to be covered by ERISA as the statute expressly excludes them from coverage. However, the statute permits churches to elect to be covered by ERISA, so it should not always be assumed that churches are not subject to ERISA. However, the default under the statute for religious organizations sponsoring plans that meet the definition of "church plan" under ERISA §3(33) is that the plan will be exempt from ERISA. When working with religious organizations, coverage under ERISA should always be addressed *before* retirement benefit or deferred compensation programs are installed. If a religious organization has not made an affirmative election to be covered, it will be exempt from the ERISA requirements that follow. See Chapter 10, section 10.10 for more information on how a religious organization elects to be covered by ERISA.

Because of the statutory exemptions, any 403(b) or 457 plan sponsored by governmental organizations or church organizations will be exempt from ERISA, unless the church plan elects to become subject to ERISA. *Therefore, the 403(b) and deferred compensation programs of public school districts, public colleges, public universities, and community colleges and churches, synagogues, mosques or similar houses of worship as well as religious organizations as described in Section 414(e) will not be required to meet the additional requirements of ERISA.*

Regulatory Exemptions for 403(b) Plans

Another exemption from ERISA for certain 403(b) plans is found under DOL Reg. 2510.3-2, which defines the term "employee benefit pension plan." Under that regulation, 403(b) arrangements in which contributions are made solely by salary reduction agreement with an employer whose involvement is limited to certain activities are exempted from the definition of "pension plan" and are therefore NOT subject to ERISA.²⁸ Note that the exemption is a two-part test. The first part re-

²⁷ ERISA §403(b)(1)

²⁸ DOL Reg. Sec. 2510.3-2(f)

stricts the funding source to salary reduction contributions only. The second part restricts the level of employer involvement. A 403(b) arrangement of a non-exempt employer will only qualify for this exemption from ERISA if it satisfies both parts of the test, which include all of the following requirements:

1. Participation must be completely voluntary for employees.
2. All rights under the 403(b) arrangement must be enforceable solely by the employee, his or her beneficiary, or by an authorized representative of the employee or beneficiary.
3. The sole involvement of the employer is limited to the following activities:
 - a. allowing product providers to publicize their products to employees;
 - b. requesting information about the products or product providers;
 - c. summarizing or compiling information provided with respect to the proposed products or product providers in order to help the employees review and analyze the available products;
 - d. collecting and remitting salary reduction contributions and maintaining records of such payments;
 - e. holding group contracts in the employer's name;
 - f. limiting the products available to employees to a number and selection which is designed to offer employees a "reasonable" choice in light of all relevant circumstances. Circumstances that may be considered include, but are not limited to the following:
 - i. the number of employees affected;
 - ii. the number of providers who have indicated an interest in approaching employees;
 - iii. the variety of available products;
 - iv. the terms of the available arrangements;
 - v. the administrative burdens and costs to the employer; and
 - vi. the possible interference with employee performance resulting from direct solicitation by contractors.
 - g. the employer receives no direct or indirect payments of cash or other consideration other than reasonable expenses actually incurred by the employer in the performance of its duties pursuant to the salary reduction agreements.

You can see that the activities of the employer can have a significant impact on whether or not a 403(b) plan becomes subject to ERISA. For example, if a 501(c)(3) employer receives a better rate on health insurance premiums because it gives an insurer access to employees for 403(b) contributions, the employer is probably violating item g. above. Similarly, if an employer becomes too involved in the administration of the plan, it can cause the plan to fall outside of the exemption.²⁹ One way an employer can turn a non-ERISA 403(b) program into an ERISA plan is by restricting the number of

²⁹ See DOL Advisory Opinion Letter 94-30 A (Aug. 19, 1994) under which a product provider required the employer to determine whether participants qualified for hardship withdrawal distributions.

vendors to a number that is not “reasonable” in light of all relevant facts and circumstances.³⁰ There is no “bright line” standard for an acceptable number of vendors, but the factors that the DOL will consider include:

1. The number of employees affected;
2. The number of contractors that 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 the direct solicitation by vendors.

Therefore, unless the employer is exempt from ERISA (such as a governmental organization or church), employers must be mindful of exercising too many restrictions on the number of vendors or they may inadvertently subject their plan to ERISA.

Due to the increased level of employer involvement required under the final 403(b) regulations, it will be much more difficult for non-church plans to qualify for the limited involvement exemption to ERISA. The written plan document requirement, which necessitates the coordination and monitoring of exchanges, loans and hardship withdrawals, make it very difficult for plan sponsors to operate within the list of permissible activities under the DOL exemption. In an attempt to mitigate this result, the DOL issued a series of Field Assistance Bulletins. In the first, FAB 2007-02, the DOL provided very general guidance to employers wishing to maintain a 403(b) plan document that complies with the IRS regulations, yet remains exempt from ERISA.

It acknowledged that an employer could comply with the IRS rules and still qualify for the ERISA exemption, but care must be taken to ensure that the employer’s 403(b) plan and the employer’s actions do not exceed the permitted activities. For example, the Bulletin clearly states that an employer may adopt a written plan document without automatically losing the exemption even though maintaining a written plan is not on the list of permitted activities in Reg. 2510.3-2. However, the Bulletin also states that employers must be careful not to create a plan under which the employer has any discretionary decisions in administering the plan. For example, if under the 403(b) plan, the employer administers loans, determines hardship withdrawals, determines transfer or exchange rights or determines if an order is a QDRO, then that plan would fall outside of the DOL “safe harbor” exemption from ERISA. The guidance further states that the employer may provide factual information on participants and may transmit information between product providers.

Subsequently, the DOL issued FAB 2009-02 to provide guidance to plans that were required to file unabbreviated Forms 5500 beginning with the 2009 plan year. Transition relief was included in that FAB to help identify which partici-

³⁰ DOL Reg. 2510.3-2(f)(3)(vii)

pants' contracts and custodial accounts were considered to be "plan assets" under the employer's 403(b) plan for ERISA reporting purposes under Title I. That guidance permitted contracts and accounts to be excluded from a 403(b) plan provided that ALL of the following requirements were satisfied:

1. The contract or account was issued to a current or former employee before January 1, 2009;
2. The employer had no obligation to make any additional contributions³¹ after December 31, 2008 and did stop making contributions after that date³²
3. All rights and benefits under the contract/account are legally enforceable against the insurer or custodian only by the individual employee without any involvement by the employer; and
4. The individual employee is fully vested in the contract/account.

Thus, it is important to note that certain accounts may be "included" under an employer's plan for IRS purposes, but be excluded under Title I for ERISA purposes. This can happen if a participant's 403(b) contract or account is held with a "de-selected vendor" that accepted contributions after 12/31/2004, but that vendor accepted no contributions after 12/31/2008. The "de-selected" vendor contracts are included under the plan under the final regulations, but may be excluded as plan assets under FAB 2009-02 for Title I purposes.

By 2010, it became clear that additional guidance was needed from the DOL to address ambiguities in the treatment of 403(b) plans under ERISA. In February, FAB 2010-01 was released to address specific questions unique to Form 5500 issues for 403(b) contracts/accounts and to provide additional guidance, in the form of Q&A on the "limited involvement" exemption to ERISA. Under this FAB, the following activities of the employer can affect the exemption in the manner explained:

1. An employer may make optional plan features, such as loans and hardship distributions available only if the vendor (contract issuer or custodian) is responsible for making the discretionary determinations necessary for administering such features. Further, the employer may refuse to include any 403(b) vendor that is unwilling or unable to take on the responsibility for making discretionary determinations under the terms of its contract/account and the plan document if such action is intended to reduce the employers costs in maintaining the plan or could cause the plan to lose its exemption from ERISA.
2. If an employer hires a third party administrator that has discretionary authority over transactions or plan assets, then the plan would lose its ERISA exemption. "The employer's selection of a TPA would be inconsistent with the safe harbor in 29 CFR 2510.3-2(f)."³³ The employer cannot hire a party to do what the employer cannot do on its own. So, if the employer is not allowed to do an activity because the activity would cause the employer to exceed

³¹ Including salary reduction contributions

³² The DOL subsequently clarified that employers could make contributions to these accounts and contracts that were due for the 2008 year in 2009 if they were promptly made within a reasonable time.

³³ See Q/A-15 of FAB 2010-01

the limited involvement “safe harbor,” then the employer cannot hire a third party to perform the activity (and still qualify for the exemption), even though the IRS regulations specifically permit it.

3. Employers must provide a reasonable choice of both 403(b) providers and investment products. The FAB interprets this to mean that a plan that seeks to qualify for the exemption must offer a choice of more than one 403(b) contractor (financial representative) and more than one investment product. There may be an exception, based on facts and circumstances, if the plan can demonstrate that the cost of offering multiple contractors or multiple products would cause the employer to stop contributions to the plan. There is also a very limited exception that permits a single product for salary reduction contributions so long as the employer permits participants to exchange their contracts/accounts to other providers under the terms of the plan document. Finally, there may be circumstances where administrative burdens and increased costs may justify limiting the number of contractors (financial representatives) to one if the product offered is an “open architecture” custodial account platform or multiple fund family annuity contract.
4. A plan may include a provision that permits salary deferrals to automatically cease being forwarded to a provider that is not complying with Code requirements. This activity will not cause the employer to lose the limited involvement exemption.
5. An employer may NOT move employee accounts/contracts from one provider to another without losing the limited involvement safe harbor exemption. The employer may remove providers, change providers and stop contributions, but it cannot move employee contracts or accounts without exceeding the scope of the exemption. Only an employee may move the employee’s accounts/contracts.

Clearly the challenge for employers that wish to avoid ERISA will be establishing a 403(b) plan that restricts the employer’s involvement in administrative functions, but complies with the IRS final regulations. As has become clear from the recent DOL guidance, it is very difficult for employers or their representatives to truly take the “hands off” posture required by the DOL to support the ERISA exemption while also meeting the IRS monitoring requirements. The best strategy may be to design and maintain a very simple plan design and avoid any task that is not purely ministerial. It will be more important than ever to find quality vendors that will agree, in writing, to take on the responsibilities for discretionary determinations based on the terms of their contracts with the participants under the 403(b) plan. See Chapter 7 for supporting materials.

(Authors Note: 457 plans are thoroughly covered in Chapter 9 of this book which is devoted exclusively to those plans. ERISA does affect certain 457 plans. So, to the extent that 457 plans are affected by ERISA, they are discussed in this chapter also.)

ERISA Exemptions for 457 Plans

As previously mentioned, 457 plans are also generally subject to ERISA unless exempted by the statute. Since ERISA exempts all plans sponsored by state or local governments, their political subdivisions or instrumentalities thereof, any 457 plan installed by a public education institution, police department, fire department, public library board, public utility board, etc. will not be subject to the additional requirements of ERISA. IRC §457 plan rules do not apply to churches and qualified church controlled organizations (as defined in IRC §3121(w)) at all. Religious organizations *other than churches or QCCOs as described in IRC 414(e)* are subject to the Code requirements applicable to 457 plans, however, are not subject to the additional ERISA requirements unless those organizations *affirmatively* elect ERISA coverage (covered in Chapter 10).

If a plan is subject to ERISA, then under the terms of ERISA, the plan must be available to a broad based group of employees, must be fully funded and plan assets must be set aside in a protected account, such as a trust, annuity contract or custodial account.³⁴ However, IRC §457(a) requires all nongovernmental 457 plan assets to be unfunded; that is the assets of the plan must be available to the sponsor's general creditors. This creates a "catch-22" for nongovernmental 457 plans. To satisfy the Code, the 457 plan assets *must NOT be set aside* in a protected account, but to satisfy ERISA, the plan assets *MUST be set aside* in a protected account! Therefore, a nongovernmental employer can only satisfy the requirements of both the Code and ERISA if it establishes a 457 plan that qualifies for an exemption from the funding requirements of ERISA. The method used by most 457 plans to avoid the funding requirements of ERISA is to restrict participation in the plan to a "top hat" group of employees. A "top hat" plan is exempted from most of ERISA, including the requirement to fully fund the benefits and protect the assets in a trust.³⁵

What is a "top hat" plan?

A "top hat" plan is a plan that is only available to select groups of highly compensated employees and key management personnel. It is an intentionally *discriminatory* plan only for key executives and other highly compensated employees. Chapter 9 discusses "top hat" 457 plans in more detail.

³⁴ Sections 301 and 302 of ERISA

³⁵ Sections 201(2), 301(a)(3) and 401(a) of ERISA; DOL Reg 2520.104-23(a)

Chapter 4: Information Added to Section 4.11

Section 4.11 What Are the Reporting Requirements for ERISA 403(b) Plans?

For plan years beginning after November 1, 2011, new “fee transparency” regulations require 403(b) plans that permit participants to “self direct” the investment of their accounts under the plan to receive certain mandated disclosures from the plan’s fiduciaries IF the participants’ accounts are charged with the fees. Each participant must receive plan related information and investment related information by the 60th day of each applicable plan year. The following is a brief summary of the required information:

Plan Related Information Must Include:

1. explanation of conditions under which participants and beneficiaries can direct investments
2. description of any limitations applicable to investment instructions
3. explanation of circumstances relating to voting rights and applicable restrictions, if any
4. identification of investment options and designated managers
5. description of brokerage windows or self directed brokerage accounts or similar arrangements (NOT encouraged in 403(b) plans)
6. a description of general plan expenses that are not directly reflected in the investment alternatives themselves if they are allocated to individual accounts (*i.e.*, legal, accounting, record keeping and administration)
7. individual expenses not reflected in the investment option expenses (*i.e.*, loan fees, QDRO charges, brokerage window commissions, NSF charges, etc.)
8. expenses must be shown on a statement provided at least quarterly.

Investment Related Information Must Include:

9. name of each investment option (Not including brokerage windows or similar accounts)
10. description of type of investment by category
11. performance data for 1, 5 and 10 year periods and fixed return data (shorter periods acceptable if life of investment is less than required reporting period)
12. identity of benchmarks for non-fixed investment options
13. fee and expense information and any related information on each investment option
14. the Internet website address for each investment option
15. any materials received by the plan fiduciary relating to voting, tenders or similar rights
16. certain information that is available upon request (such as prospectuses, financial statements, share values, portfolio lists, etc.)
17. information must be expressed as an annual percentage and dollar amount for a \$1,000 investment. It must be presented in a comparative format. The DOL provided a 4 page template that can be used for this purpose.

In general, the disclosures must be made to the participants on or before the date on which a participant or beneficiary can FIRST direct investments under the plan and then annually thereafter. For new participants, the information should be part of the materials that are provided to employees. Changes in the Plan Related Information must be provided at least 30 but not more than 90 days before the effective date of the change (except for unforeseeable emergencies). The Plan Related Information can be incorporated into the SPD, other plan descriptive materials or a participant benefit statement, but actual general and individual expenses must be disclosed on quarterly statements. Investment Related Information can be provided in a disclosure statement. Electronic delivery is acceptable for both disclosures but only for participants with regular access to e-mail.

What Should Fiduciaries Do to Get Ready for These Disclosure Responsibilities?

Get prepared! You need to get commitments from all of the investment providers under the 403(b) plan to provide the necessary expense and performance information in a timely manner. You should also require the information to be formatted according to the DOL template which is available on the DOL website (www.dol.gov). The regulations provide protections for fiduciaries that rely reasonably and in good faith on information provided by investment providers. The fiduciaries also need to determine how the information will be disseminated to participants and beneficiaries. For example, participants may get SPDs, but beneficiaries may need a separate disclosure statement. Then those documents must be prepared for distribution. For calendar year plans, the first distribution date will be the last day of February, 2012!

Finally, do not forget to prepare for inquiries, errors, confusion and fear. Participants may focus on fees or performance data and fiduciaries will need to anticipate how to respond to those types of questions. If the fiduciary is not comfortable or feels unqualified discussing the details of investments under the plan, then a strategy should be developed to handle inquiries of this kind when they begin.

Chapter 4: Information Added to Section 4.13

Section 4.13 Am I a Fiduciary Under ERISA?

Whenever you are dealing with an ERISA plan, you must be very cognizant of the activities you are performing. Generally, if you have any discretion, authority or responsibility relating to the management, investment or administration of the plan, you are probably a fiduciary. Similarly, if you provide investment advice *for a fee*, whether direct or indirect, you are also a fiduciary. You should be aware that the term “for a fee” includes any type of compensation, including commissions, fees, retainers, sales charges, transaction charges, etc. Therefore, if you are providing investment related advice to the participants, the employer, the trustees or the investment manager of an ERISA plan, and you receive any compensation for such services, you may be considered to be a fiduciary. To meet the standard for fiduciary status (from a historical perspective), the advice had to be provided on a regular basis and had to be the primary basis for the investment decision.

However, the proposed regulations expand the definition of “fiduciary” for ERISA purposes while eliminating some of the historical conditions that had previously provided a level of protection for many financial representatives in the 403(b) marketplace. Under the proposed regulations, investment advice has been expanded to include the routine valuation of investments, advice and recommendations regarding the management of investments (in addition to acquiring and disposing of investments), advice given, whether regular or one-time, and whether or not it serves as the primary basis for the investment decision.

Under the regulations, a person will be deemed to be rendering investment advice for a fee or other compensation if the person provides advice to a plan, plan fiduciary, plan participant or plan beneficiary about the value of securities or other property, recommendations as to advisability of investing in, purchasing, holding or selling the securities or property or recommendations as to the management of the securities or other property AND the person receives compensation, direct or indirect from any source incident to the transaction, including brokerage, mutual fund sales and insurance sales commissions.

A person who is rendering investment advice for a fee will only be considered a fiduciary under the proposed regulations if the person also meets one of the following conditions:

1. the person acknowledges his or her fiduciary status under ERISA with respect to providing the advice;
2. the person is a fiduciary for reasons other than providing investment advice;
3. the person is an “investment advisor” under section 202(a)(11) of the Investment Advisors Act of 1940 (the “40 Act”), whether or not the person is registered under the 40 Act; or
4. the person provides investment advice pursuant to an agreement (written or not) between the per-

son and the plan, a plan fiduciary, a plan participant or a plan beneficiary and such advice may be considered in connection with investment decisions made concerning plan assets and will be individualized to the needs of the party with whom the person has the agreement.

The regulations provide four exceptions for certain categories of persons who will not be deemed to be providing investment advice under the regulations, as follows:

Known Adverse Interests. If a person can demonstrate that the recipient of the advice knew or reasonably should have known that the person providing the advice in the capacity as a purchaser or seller of a security or other property whose interests are adverse to the plan, the participants or beneficiaries and the provider of information is not seeking to provide impartial advice.

General Compliance Valuations. A person that prepares general reports that reflect the values of plan investments solely for the purpose of compliance with reporting and disclosure requirements under ERISA, the Code and applicable regulations is not considered to be providing investment advice. However, if it involves assets for which there is no generally recognized market and serves as a basis for which distributions may be made, then it may be considered to be providing “advice, or an appraisal or a fairness opinion.”

Plan Information. A person that provides information on the plan, including investment education information and materials to individual account participants under existing DOL regulations permitting asset allocation models and interactive materials will not be considered to be providing advice.

Product Provider Marketers. A person representing an investment product who markets the product to a plan fiduciary that has the authority to select the investment options to be available to participants under the plan will not be considered to be providing advice if the marketer discloses in writing to the plan fiduciary that the person is not trying to provide impartial investment advice

Chapter 4: Information Added to Section 4.17

Section 4.17 If I Am a Fiduciary, Are My Activities Restricted in Any Way?

The DOL issued interim final rules that require certain service providers to disclose fee information to plan fiduciaries. These new rules are effective July 16, 2011 and require the disclosure of fees as part of item 3 above to justify to the plan's fiduciary that the service being provided to the plan is reasonable and in the best interest of the plan's participants. Under ERISA, a PT exemption applies for any service provider if the contract or arrangement between the plan and the provider is reasonable, the services are necessary for the establishment or operation of the plan and no more than reasonable compensation is paid for the services. Therefore, to qualify for the PT exemption, the new rules require sufficient disclosure of fees from all service providers so that the fiduciaries can evaluate whether the service contracts are reasonable, necessary and properly priced. Providers are required to provide specified information to plan fiduciaries if they expect to receive at least \$1,000 by providing one or more of the following services:

5. fiduciary services or registered investment advisory services
6. recordkeeping or brokerage services provided directly to participant directed defined contribution plans if one or more investment options is an "open architecture" platform product
7. services for which the provider expects to receive indirect compensation, including accounting, auditing, actuarial, appraisal, banking, consulting, legal, recordkeeping, Securities or other investment brokerage, third party administration or valuation services provided to the plan. (If any of these services result in direct compensation to the provider, they are not required to be disclosed.)

The disclosures must include a description of the services provided, a statement of fiduciary status, a description of direct compensation and indirect compensation, as well as information on compensation shared among related parties (bundled services). If there is compensation expected upon the termination of the contract, that must be disclosed and the manner in which the provider will be paid (direct billing, deduction from participant accounts, etc.) must be disclosed. Certain providers, recordkeepers, brokers and investment fiduciaries have additional disclosure requirements. A complete listing of the disclosure requirements can be downloaded from the DOL website. See Interim Final Regulation at §2550.408b-2 at www.dol.gov or 75 Federal Register 41600 (July 16, 2010). The disclosures must be provided to the plan fiduciaries reasonably in advance of the date the service contract is entered into, extended or renewed. Subsequent changes to the information should be made as soon as practicable, but no later than 60 days from the date the service provider has knowledge of the change. This is not an annual disclosure requirement. Finally, the rule offers relief to plan fiduciaries if a service provider fails to disclose required information so long as the conditions for the relief are met.

Chapter 5: Section 5.1 (Replaces Section 5.1 in the Second Edition)

5.1 Traditional Model 403(b) Plans

Prior to the issuance of the final 403(b) regulations, most 403(b) plan sponsors offered only the “Traditional Model” 403(b) plan in which the employer provided payroll accommodations for salary reduction contributions by employees. The employer made no contributions and, in general, tried to avoid direct support or apparent endorsement of any vendor. We learned in the last chapter why this strategy was essential for nonexempt employers trying to avoid ERISA. However, the release of the final 403(b) regulations significantly changed the Traditional Model 403(b) plan as employers were required to be more involved in all aspects of their 403(b) plans. For purposes of this chapter, any discussion of the Traditional Model 403(b) plan will assume its conformity with the final 403(b) regulations.

The Traditional Model is often made available to employees of employers that also support another retirement program that provides a basic retirement benefit for employees. For example, most public schools that offer 403(b) plans also participate in a state retirement program that provides a basic pension plan benefit to employees. The 403(b) program is used to *supplement* the pension benefit. For this reason, 403(b) programs that are funded exclusively with employee salary reduction contributions are often referred to as “supplemental 403(b) plans” or “voluntary 403(b) plans.”

The Traditional Model is also used by some governmental employers to fund Optional Retirement Plans (ORPs) which are sometimes also called Alternative Retirement Plans. You may also hear of variants called DROPs which are deferred retirement optional plans. Generally, in ORPs, ARPs and DROPs, an individual receives contributions in a 403(b) contract in lieu of participating in the employer’s regular defined benefit plan. In the ORP or ARP programs, these plans may be instituted for part-time employees; they may be established to conform with state law mandates or they may truly be an option for employees who “opt out” of the pension plan because they prefer to have individual account retirement plans over a defined benefit plan. A DROP plan generally establishes a 403(b) contract for each individual who agrees to “retire” from service with the governmental organization, thus ceasing all funding obligations by the employer under the defined benefit plan. The individual’s pension benefit is frozen at whatever level it was when he or she retired. However, the “retiree” continues to work (usually for a limited number of years), but no longer accrues benefits under the pension plan. The retiree’s incentive to continue working is, besides salary, a cash contribution is paid into the 403(b) contract as part of the DROP, so the retiree accumulates a significant cash benefit in addition to his or her pension under the state system. The DROP accumulation then can either be used to purchase additional service under the pension plan, be taken as a lump sum, or left in the 403(b) to be spent down as needed. Other types of individual accounts can be used for ORPs, APRs and DROPs, but 403(b) contracts are the most popular because the contribution limits are the highest.

Beginning in 2006, employers could incorporate Roth 403(b) contributions into their 403(b) plans.³⁶ If permitted under the plan's design, employees could make both pre-tax employee contributions and after-tax Roth contributions. For lower paid employees who may not be motivated by current tax savings, Roth 403(b) contributions may be more appealing since future taxes could be avoided upon distribution.

If an employer relies exclusively on the Traditional Model to provide a retirement benefit, most employees will not be able to retire comfortably or "on time." Employee salary reduction funding alone generally will not provide a sufficient benefit during retirement unless there have been outstanding investment returns. Therefore, employers are usually interested in learning about alternative benefit options. What follows is a brief explanation of the various plan design alternatives for employers wishing to provide a more comprehensive retirement benefit. Each alternative will be described and the advantages and disadvantages of each will be presented. As you read on, the most important fact to remember is that there is no single plan design that always works well for every employer.