ERISA vs. Non-ERISA 403(b):
Making the appropriate decision

Introduction

Shortly after ERISA was enacted in 1974, federal regulations carved out a “safe harbor,” referred to as “non-ERISA status,” that provided an exemption for certain 403(b) plans from coverage under Title I of ERISA (non-ERISA safe harbor). Since that time, many employers have elected to meet the requirements of the non-ERISA safe harbor because they believe it is the best way to provide 403(b) plan access to employees.

Over the years, the tax-exempt retirement plan market has seen tremendous growth in the choices of investment products and administrative structures for defined contribution plans. More importantly, recent regulatory guidance from the Employee Benefits Security Administration (EBSA) of the Department of Labor (DOL) and from the Department of the Treasury and the Internal Revenue Service (IRS) has directly affected the feasibility and desirability of maintaining non-ERISA status.

Should your 403(b) plan remain a non-ERISA safe harbor plan in light of these changes? This Fidelity Perspectives brief discusses the current regulatory landscape and examines several commonly held beliefs regarding non-ERISA safe harbor status. We then take a close look at the plan sponsor’s important choice: whether to maintain non-ERISA safe harbor status for their 403(b) plan.¹

¹It is important to note that this paper does not address many of the complexities of other plan designs similar to the voluntary-only 403(b) plan in the tax-exempt market, such as governmental and nonelecting church plans that are by law not subject to ERISA. It also doesn’t address the complexities of state fiduciary laws. In addition, an employer with a non-ERISA safe harbor 403(b) plan may sponsor a 403(b) plan or a qualified 401(a) plan that is concurrently subject to ERISA, which may have additional considerations not specifically covered in this brief.
When evaluating whether or not to maintain non-ERISA safe harbor status for a 403(b) plan, sponsors may find the following:

1) In this era of increased compliance, ERISA plans may have a cost equality in basic plan operations because of nationally consistent guidance and the ability to outsource benefits eligibility determinations.

2) ERISA plans may also show advantages in terms of fiduciary protections that are not typically available under state law.

3) Most importantly, under ERISA, employers have the ability to selectively choose cost-effective providers and high-quality investments, which may simultaneously reduce plan costs and fiduciary risk.

A Brief History of Non-ERISA Status

Over the last few decades, the guidelines for non-ERISA status have seen a number of changes. Let’s begin with a brief recap of key regulatory events that have led up to the current environment.

DOL Establishes Non-ERISA Safe Harbor

In the late 1970s, the DOL issued regulations that defined the non-ERISA safe harbor as including certain 403(b) programs that are not “established or maintained” by the employer if certain requirements are met. Many 403(b) plan administrators opted for the safe harbor, primarily because they wanted to continue to limit their involvement in plan administration.

One unintended consequence of the safe harbor was that many employers thought of these plans as the vendors’ (insurance company or mutual fund company) plans rather than as the employer’s own plan. As a result, these employers often viewed their vendors—and not themselves—as responsible for most of the compliance with the Internal Revenue Code’s rules and regulations. However, monitoring compliance with IRS rules was difficult, because most plans had multiple vendors and the vendors did not have access to the necessary data from other vendors or from the employer. Many administrative procedures, such as loan availability or hardship eligibility, relied instead on employee “self-certification.”
Exhibit 1: ERISA vs. Non-ERISA Time Line

1974 ERISA Legislation

1979 DOL Title I Regulations

2007 IRS 403(b) Regulations

2010 DOL Field Assistance Bulletin

2007 DOL Field Assistance Bulletin

IRS Issues Final 403(b) Regulations

In 2007, the IRS issued new final 403(b) regulations that clarified 403(b) plan sponsors’ compliance responsibilities in three important ways:

1) **Responsibility for compliance**: The regulations confirm that the employer has responsibility for compliance with the tax rules.

2) **Designation of vendors and investment options**: The plan sponsor is required to designate the vendors and investment options that are available under the plan.\(^2\)

3) **End of self-certification**: The regulations generally eliminated the ability of certain plan participants to self-certify information that entitled them to certain benefits under the plan, such as loans or hardship withdrawals, and required the employer to confirm the participant’s eligibility for certain transactions.

These regulations, which became generally effective in 2009, were a major turning point toward increasing plan sponsor responsibility over their non-ERISA safe harbor 403(b) plans. As noted previously, one significant change was to end the

\(^2\) The plan must specify the vendors and investment options that are available under the plan for future contributions and exchanges, and with respect to which information sharing between the vendor and employer must occur.

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perception that vendors were totally responsible for transaction compliance. To facilitate compliance, the IRS generally requires vendors to provide employee information needed for plan administration and compliance to the employer. Oftentimes, vendors may require information from other vendors to process transactions, which is facilitated by the employer.

Anticipating that some plan sponsors might have questions as to whether they could still remain non-ERISA while complying with the new IRS regulations, the DOL issued two Field Assistance Bulletins (FABs) on the topic. In 2007, the DOL concluded that it is possible for a plan sponsor to comply with the IRS regulations and remain within the non-ERISA safe harbor. In other words, the IRS regulations did not automatically compel all voluntary-only 403(b) plans to become covered by ERISA. However, the guidance left some ambiguity as to how compliance is to be achieved, stating that ERISA status needs to be determined on a case-by-case basis by comparing the plan sponsor’s specific facts and the ways in which it chooses to comply with the IRS regulations with the criteria in the safe harbor regulations.

In February 2010, the DOL published additional clarifications regarding the limits of the non-ERISA safe harbor—for example, clarifications on the use of third-party administrators, the control over plan assets, and the reasonable choice of providers and products. These elements all painted an evolving picture, in essence, retaining the DOL’s longstanding policy of strict limits on employer involvement in plan administration, yet requiring adherence to the Internal Revenue Code.

Caught Between the IRS and the DOL

Despite years of fine-tuning, plan sponsors are pulled in two directions. On one hand, the DOL non-ERISA safe harbor imposes limitations on employer involvement, exercise of control, evaluation of benefits eligibility, and exercising judgment over plan features. On the other hand, the IRS requires greater employer control and oversight of the plan to ensure tax compliance. Non-ERISA safe harbor plan sponsors are caught in the middle of conflicting directions from the IRS and the DOL.
Examining Three Common Beliefs About Non-ERISA Plan Structure

Some employers have long believed that exemption from ERISA has afforded them benefits in terms of minimizing compliance oversight and lowering costs. Let’s examine three long-held common beliefs and see whether they remain true today.

Belief #1: Non-ERISA safe harbor status means less administrative responsibility and burden.

A common perception of ERISA is that all its requirements are additional work for the plan sponsor; therefore, avoiding ERISA status reduces the employer’s administrative responsibilities. This view may not be entirely accurate. Congress, in fact, provided for broad federal ERISA preemption of state laws affecting retirement plans for the purpose of creating consistency and efficiency that would benefit both plan sponsors and plan participants.

One misperception regarding non-ERISA status is that there are no fiduciary requirements—thus less administrative burden—for employers. In the absence of ERISA preemption at the federal level, state fiduciary laws will apply—legal requirements are not avoided but rather shifted to the state level, where they may not be as clear or consistent as ERISA’s fiduciary requirements.

As mentioned earlier, the IRS has generally eliminated employee self-certification of qualification for benefits such as loans or hardship withdrawals. As a result, non-ERISA plan sponsors must now absorb this compliance responsibility. This change has, in effect, leveled the playing field between ERISA and non-ERISA plans for these tasks—except that non-ERISA plans cannot outsource this activity.

ERISA requires certain participant disclosures, such as summary plan descriptions. Some non-ERISA plan sponsors already are, as a best practice, providing a level of disclosure to their participants similar to ERISA’s requirements. The additional effort required to meet the ERISA standard may be minimal for them, while the additional benefits of ERISA coverage, such as 404(c) protection (detailed below), may be significant.

ERISA also requires employers to file a Form 5500, and, for large plans, to also conduct an annual audit, but the DOL’s recent reporting guidelines for Form 5500 have eased some burdens for 403(b) plans. Although not federally mandated, the leadership of many tax-exempt organizations often requires an annual financial audit, including an audit of all retirement plans. For these plans, the additional cost of auditing the plans for the purposes of Form 5500 would likely be minimal.

When taken in totality, the ERISA advantages of uniform administration, and the ability to outsource benefits eligibility certification and other key administrative functions, may outweigh the additional burden of filing a Form 5500, conducting an annual audit, and other requirements, which in some cases the plan sponsor may be close to fulfilling anyway.
Belief #2: The fiduciary standard of conduct is less diligent in a non-ERISA plan.

A second common perception is that ERISA plans impose a higher standard of fiduciary responsibility and conduct on plan sponsors and administrators compared with non-ERISA plans. Some plan sponsors are concerned that the ERISA standard is higher because ERISA defines the standard specifically for retirement plan fiduciaries.

How do state law fiduciary standards of conduct for plan administration compare with ERISA’s standard of conduct? Is one higher than the other? Although this question is difficult to answer definitively for all plans, in general it is fair to say that state laws are not uniform—and a higher or a lower standard of fiduciary responsibility may apply based on state laws and court decisions.

ERISA plan status may also be more desirable because plan fiduciaries may be protected against charges of breach of fiduciary duty if certain requirements are met. For example, plan sponsors can take advantage of ERISA Section 404(c), relieving fiduciaries of some liability for the investment performance of the funds participants choose. Additionally, the DOL’s qualified default investment alternatives (QDIA) regulations are intended to protect ERISA plan fiduciaries when default investment decisions are made on behalf of plan participants.

Belief #3: Under the non-ERISA safe harbor, investment options are not the plan sponsor’s responsibility.

A third common perception is that plan sponsors are not responsible for the investment options available under a safe harbor plan. Before the current IRS regulations, employers may have been encouraged to offer an unlimited number of investment options or allow unrestricted transfers by participants to other 403(b) providers in order to avoid any fiduciary responsibility. However, completely unlimited participant investment choices are no longer possible under the IRS’s final 403(b) regulations because information sharing must occur among the plan sponsor and all the plan’s active vendors (as listed in the plan document), for compliance purposes.

Although employers can limit the number of vendors based on reasonable administrative considerations under the safe harbor, employers generally cannot select the specific investment options offered by each vendor under the safe harbor or negotiate with the vendor regarding the terms of their 403(b) contracts or accounts.

The non-ERISA safe harbor leaves employers with a difficult choice in managing their investment lineups. They can limit investment options and service providers—but in a nonselective way, such as random choices or “first come, first served.” This approach keeps the plan non-ERISA, but plan participants may end up with inferior investment options and fees that are higher than the industry average.

In today’s environment, significantly more attention is being paid to optimizing investment lineups and reducing total plan fees. Unfortunately, non-ERISA safe harbor status can inhibit an employer’s ability to effectively manage these important aspects of the 403(b) retirement plan.
Key Considerations for Making the ERISA vs. Non-ERISA Decision

The defined contribution retirement plan landscape has changed, making the ERISA structure potentially more attractive to 403(b) plan sponsors for a number of reasons. The following table outlines some of the key considerations of making the ERISA vs. non-ERISA decision:

Exhibit 2: ERISA Plan vs. Non-ERISA Plan: Comparing Plan Attributes (Overview)

<table>
<thead>
<tr>
<th>Retirement Plan Attribute</th>
<th>ERISA</th>
<th>Non-ERISA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Administration and Plan Operations</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ability to select best-in-class providers and administrators</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Extensive administrative guidance for IRS compliance</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Required Form 5500 filing</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Required annual audit for Form 5500 filing (depending on size of plan)</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Plan features: loans and hardship withdrawals</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Ability to use third-party administrators to manage loans and hardship withdrawals</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Beneficiary spousal consents</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Joint and survivor rules and spousal consents</td>
<td>Yes (but only if it is the normal form of benefit)</td>
<td>No (but may be required in an insurance contract)</td>
</tr>
<tr>
<td>Universal availability notice</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Summary plan description</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Investments and Fiduciary</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ability to select best-in-class investments</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Nationally consistent application of fiduciary standards of care</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Default investment / 404(c) protection</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Heightening the stakes of the ERISA vs. non-ERISA choice, the IRS and the DOL have publicly stated that they will be increasing their audit and enforcement efforts with respect to 403(b) plans (both ERISA and non-ERISA). A quick scan of DOL/EBSA auditing statistics shows that, in 2009, EBSA closed 3,669 civil cases. Of these cases, 72% were closed with “positive results,” meaning some type of corrective action was taken, resulting in $1.36 billion dollars in monetary penalties/recoveries.
Conclusion

The 2007 IRS regulations require non-ERISA safe harbor 403(b) plans to adhere to a more stringent tax compliance standard—a much higher level of compliance than has been required in the past. Additionally, DOL guidance issued since 2007 has placed the non-ERISA plan sponsor in a precarious situation where compliance with IRS regulations is pushing it closer to “exercising control” and potentially exceeding the DOL safe harbor requirements.

In this era of increased compliance, plan sponsors may want to reexamine the various attributes of ERISA and non-ERISA plans. ERISA plans may have cost equality in basic plan operations because of consistent and national guidance on many important topics that may offset the additional ERISA-related costs of Form 5500s and annual audits.

A risk assessment of the two options may also show an ERISA advantage: ERISA offers potential fiduciary protections, such as 404(c) and QDIA, that are not typically available under state laws. Most importantly, the employer’s ability to choose cost-effective providers or third-party administrators, and high-quality investments, may simultaneously reduce plan costs and fiduciary risk.

Should your plan be ERISA or non-ERISA?

One thing is certain: plan sponsors should not undertake the decision lightly and should consider reaching out for legal and consultative assistance to help weigh the pros and cons of non-ERISA safe harbor status for the 403(b) plan. If you are ready to consider your 403(b) plan’s ERISA status, Fidelity has extensive experience in helping with complex plan-design questions and stands ready to help.

Contact your Fidelity representative to further discuss ERISA vs. non-ERISA fiduciary requirements, compliance standards, and implementation opportunities.
Additional Resources

Visit fiduciary resource section on Fidelity Forum plan sponsor web site

www.Fidelity.com/forum

DOL

EBSA Field Assistance Bulletin No. 2010-01 (Issued February 17, 2010)

http://www.dol.gov/ebsa/regs/fab2010-1.html

EBSA Field Assistance Bulletin No. 2007-02 (Issued July 24, 2007)


IRS

IRC 403(b) Tax-Sheltered Annuity Plans—Recent Guidance Affecting 403(b) Plans

http://www.irs.gov/retirement/article/0,,id=223947,00.html

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