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Non-ERISA Safe Harbor for Section 403(b)(7) Custodial Accounts

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INTRODUCTION

Rev. Rul. 2020-23 provides rules for distribution of §403(b)(7) individual custodial accounts (ICAs) in-kind to participants or beneficiaries in a 403(b) plan upon termination.[1] Section 403(b)(7) requires a terminated plan to distribute the ICA to a custodian or roll over the ICA into an eligible individual retirement account (IRA) or other eligible retirement plan directly or within 60 days.[2] In some instances, a plan administrator may rely on certain certifications and documentation that a rollover contribution that is not a direct transfer is being made no later than 60 days following receipt.[3]

Rev. Proc. 2020-46 sets forth Covid-19 relief for self-certification of eligibility for a waiver of the 60-day rollover requirement applicable to distributions from certain plans, including §403(b) annuities.[4] Rev. Proc. 2020-46 adds a distribution that was made to a state unclaimed property fund as an instance, in which a self-certification procedure may apply, effective October 16, 2020.[5] A plan administrator or IRA trustee accepting the rollover contribution may rely on the self-certification of taxpayer in determining whether the conditions for a waiver of the 60-day rollover requirement were met.[6]

Notice 2020-80 requests comments on applicability of annuity waiver and spousal consent requirements under §205 of the Employee Retirement Income Security Act of 1974, as amended (ERISA) to ICA in-kind distributions, which may be rolled over to an eligible plan or IRA.[7] This article examines Treasury and Department of Labor (DOL) guidance to determine the scope of the regulatory safe harbor that exempts a §403(b)(7) custodial account from ERISA and examines how the safe harbor may impact compliance with §403(b) requirements, including recent §403(b) legislation and guidance. The article refers to the ERISA exemption under 29 C.F.R. §2510.3-2(f) alternatively as the regulatory safe harbor, the non-ERISA safe harbor, or simply, the safe harbor unless otherwise indicated.

Thus, the non-ERISA safe harbor would avoid attachment to a 403(b)(7) plan of ERISA §205 rights in the event of in-kind distribution of an ICA upon plan termination. Therefore, an in-kind ICA distribution that involves an indirect rollover subject to a self-

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[1] §403(b)(7). All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated. *See* Further Consolidated Appropriations Act, 2020, Div. O, §110, Pub. L. No. 116-94, 133 Stat. 2534 (2019) (SECURE Act) (directing Treasury to issue guidance permitting ICA in-kind distributions to a participant or beneficiary of a terminated 403(b)(7) plan, treating the distributed ICA similarly to a fully paid individual annuity contract under Rev. Rul. 2011-7, thereby preserving its tax-deferred status until amounts are actually distributed to a participant or beneficiary); §403(b)(10) (plan termination requirements); Reg. §1.403(b)-10(a); Rev. Rul. 2011-7 (403(b) plan termination requirements).

[2] *See* §403(b)(7), §403(b)(10), §408(d).

[3] *See* §401(a)(31), §402(c)(3)(A), §403(b)(8)(B); Reg. §1.401(a)(31)-1, Q&A 14; Rev. Proc. 2020-46.

[4] Rev. Proc. 2020-46, *modifying* Rev. Proc. 2016-47, §3.02(2).

[5] §402(c)(3)(B); Rev. Proc. 2020-46,, §3.02(2)(l), §5.

[6] Rev. Proc. 2020-46, §3.04(2).

[7] Pub. L. No. 93-406, 88 Stat. 829 §1 *et seq*. (1976); ERISA §205; §403(b)(7).

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certification safe harbor also would avoid triggering ERISA §205 rights. Accordingly, the non-ERISA safe harbor clarifies the nexus among rules for an ICA in-kind distribution, ERISA annuity, and spousal rights and a self-certification safe harbor for an indirect rollover of an ICA.

In addition, the non-ERISA safe harbor delineates division of authority for sponsoring employers, plan providers, custodians and third-party administrators (TPAs) for a §403(b)(7) custodial account. Limitation on employer in taking certain actions with respect to a 403(b) plan that provides for §403(b)(7) custodial accounts cuts into compliance with §403(b) requirements, including a bevy of recent legislation and guidance. Thus, the scope of the non-ERISA safe harbor must be taken into account for compliance with §403(b) new plan amendment and qualification procedures, required amendment lists, SECURE Act and CARES Act relief for required minimum distributions (RMDs), participant loans, and hardship distributions.[8]

BACKGROUND

Section 403(b)

A 403(b) plan is a retirement plan, contributions to which are eligible for tax-deferred treatment, and under which a public school, a §501(c)(3) organization, or a self-employed minister [9] purchases one or more annuity contracts or contributes to custodial accounts or retirement income accounts, as applicable, for its employees or the minister.[10] Section 403(b) plans are specifically exempted from the requirements applicable to qualified annuities under §403(a).[11] Section 403(b) plans are also generally known as tax-sheltered annuities, tax-deferred annuities, or annuity contracts.[12]

Section 403(b) plans may be funded through an employee's payroll deductions, by employer nonelective contributions, or by other employee elective deferrals.[13] These funds may be contributed to annuity contracts, retirement income accounts maintained for employees or ministers of religious organizations or affiliates, or §403(b)(7) custodial accounts that may invest solely in mutual funds.[14] Contributions to 403(b) plans generally are tax deferred.[15] Distributions of accrued principal and income from the contract or account to employee or beneficiary generally commence on retirement or other separation from service.[16] Employee or beneficiary under the plan pays income tax on actual distributions of principal and earnings, which may be made as a lump sum or an annuity, [17] under §72 governing taxation of annuities.[18]

Section 403(b)(7): Distinctions Among 403(b) Plan, Contract, Custodial Account

A 403(b) plan is defined as a plan of an employer under which §403(b) contracts for its employees are maintained.[19] If an employer contributes to more than one annuity contract for a participant or beneficiary, all such contracts are aggregated as one contract for purposes of §403(b) compliance.[20] A §403(b) contract must meet the written plan requirement and other applicable I.R.C. provisions regarding plan form and operation.[21]

A 403(b) plan may permit employees to make contributions under a salary reduction agreement to cus-

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[8] *See, e.g.,* Pub. L. No. 115-123 §41113, §41114, 132 Stat. 161 (2018) (BBA 2018); Pub. L. No. 115-97 §11044, 131 Stat. 2087 (2017) (TCJA); 84 Fed. Reg. 49,651 (Sept. 23, 2019) (final regulations under §401(k) and 401(m) reflecting statutory amendments which included TCJA and BBA 2018 changes to hardship distribution requirements and containing conforming amendments to 403(b) plan hardship distribution rules in light of §403(b)(11) not being amended under BBA 2018); Rev. Proc. 2019-39, Rev. Proc. 2019-19; Notice 2020-83, Notice 2019-64, Notice 2020-35, Notice 2020-50, Notice 2020-51, Notice 2020-62 (safe harbor explanations under §402(f) for eligible rollover distributions in light of related SECURE Act legislation).

[9] *See* §1402(a)(8), §1402(c)(4).

[10] *See* §403(b)(1)(A); Reg. §1.403(b)-1.

[11] *See generally* §403(a) (taxability of employee annuities), §404(a)(2) (deductibility by employer of contributions toward purchase of employee annuities meeting the specific requirements under §401(a) and §401(d)).

[12] *See* §403(b)(1); 1995 EO CPE Text, https://www.irs.gov/pub/irs-tege/eotopici95.pdf.

[13] *See* §403(b)(1); Reg. §1.403(b)-4(b), §1.403(b)-4(c) (setting forth contribution limitations for various types of deferrals under §403(b) annuity contracts).

[14] §403(b)(1), §403(b)(7), §403(b)(9). *See* §851(a) (defining a regulated investment company (mutual fund), in the stock of which a §403(b)(7) custodial account may invest, or "RIC"). *See also* §401(f)(2) (setting forth requirements for a custodial account).

[15] §403(b)(1).

[16] §403(b)(11); Reg. §1.403(b)-6(b) (setting forth rules on timing of distributions from various types of §403(b) accounts).

[17] *See* Reg. §1.403(b)-9(a)(5).

[18] *See generally* §72(a), *see* §403(b)(1); Reg. §1.403(b)-7(a) (setting forth rules on taxation of distributions from 403(b) plans).

[19] Reg. §1.403(b)-2(a)(16)(ii).

[20] §403(b)(5); Reg. §1.403(b)-2(a)(16)(i).

[21] Reg. §1.403(b)-2(a)(16)(i); Reg. §1.403(b)-3(b)(3)(i).

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todial accounts subject to §403(b)(7).[22] Contributions to a custodial account are treated as contributions to an annuity contract under §403(b)(1) for income tax purposes.[23] Generally, a custodial account is a plan or a separate account under a 403(b) plan, in which an amount is attributable to §403(b) contributions.

Thus, a 403(b) plan may provide for use of custodial accounts invested in mutual funds as the sole funding option. In this case, this article refers to such a plan as a 403(b)(7) plan. A custodial account must be issued by an insurance company and held by a bank or other institution that meets §401(f)(2).[24] A custodial account may invest only in RIC shares, or mutual funds, held in the account.[25]

Distribution of Section 403(b)(7) Custodial Accounts Upon Plan Termination

Section 403(b)(10) and Treasury regulations finalized in 2007 govern distributions in connection with termination of a 403(b)(7) plan.[26] A 403(b) plan may provide for plan termination and allow accumulated benefits to be distributed upon termination.[27] Generally, termination of a 403(b) plan that provides for custodial accounts and distribution of a §403(b)(7) custodial account is permitted only if the employer, subject to aggregation rules, does not make contributions to any §403(b) contract that is not part of the plan within 12 months of the plan termination date.[28]

In order for a 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable following plan termination.[29] However, an eligible rollover distribution is not included in gross income of participant or beneficiary if paid in a direct rollover or transferred within 60 days to an eligible retirement plan, subject to an updated self-certification safe harbor in Rev. Proc. 2020-46.[30]

ERISA Section 205 Spousal Annuity and Consent Rights

Generally, ERISA §205(a) requires, in the case of a vested participant who does not die before the annuity starting date, for the plan to provide that the accrued benefit will be payable in the form of a qualified joint survivor annuity (QJSA).[31] On the other hand, an ERISA plan must provide, with respect to a vested participant who dies before the annuity starting date, and who has a surviving spouse, that the accrued benefit to such spouse is paid as a qualified preretirement survivor annuity (QPSA).[32] The requirements are subject to certain exceptions, notably, with respect to an individual account plan, if the participant did not elect to receive the accrued, vested benefit in the form of a life annuity.[33]

In addition, a participant may elect to waive a QJSA, a QPSA or both forms of benefits during the applicable election period.[34] The availability of the participant election is mandatory under plan terms, but for the participant, the election is revocable.[35] In addition, for the election to be effective, a spouse must consent in writing to the election of the participant, and the election must designate a beneficiary or a form of benefits, which may not be changed without spousal consent.[36] ERISA §205(c) requires a plan to provide participant communications with respect to the election, which may be waived under certain circumstances.[37]

Interaction of Recent IRS Guidance with Section 403(b)(7) Requirements

In the event of a termination of a 403(b) plan, no income or withholding tax is paid by employee or beneficiary if the distributions are rolled over to an IRA or other eligible retirement plan. Rev. Proc. 2020-46 provides certain exceptions to self-certification requirements in the event of an indirect rollover that exceeds the statutory 60-day period for the transfer of retirement assets, including §403(b)(7) custodial account funds.

Separately, as Congress directed Treasury under §110 of the SECURE Act, Rev. Rul. 2020-23 provides special rules for in-kind distributions of §403(b)(7)

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[22] §403(b)(7).

[23] §403(b)(1), §403(b)(7)(A); Reg. §1.403(b)-8(d).

[24] §401(f)(2); Reg. §1.403(b)-8(d)(2).

[25] §403(b)(7)(A)(i), §851(a); Reg. §1.403(b)-8(d)(i).

[26] *See* §403(b)(10); Reg. §1.403(b)-10(a).

[27] Reg. §1.403(b)-10(a)(1).

[28] Reg. §1.403(b)-10(a)(1) (providing an exception in the event fewer than two percent of eligible employees as of the date of plan termination are eligible under the alternative §403(b) contract).

[29] Reg. §1.403(b)-10(a)(1).

[30] Reg. §1.403(b)-7(b)(1), §1.403(b)-10(a)(1). *See* Rev. Proc. 2020-46.

[31] ERISA §205(a)(1), §205(d)(1) (generally, an annuity for the life of the participant with a survivor annuity for the life of the spouse which is not less than 50% of, and not greater than 100% of the amount of the annuity which is payable during the joint lives of the participant and the spouse).

[32] ERISA §205(a)(2), §205(d)(2)(A) (generally, an annuity for the life of the participant with a survivor annuity for the life of the spouse which is equal to the applicable percentage of the amount of the annuity payable during the joint lives of the participant and the spouse).

[33] ERISA §205(b)(1)(C)(ii).

[34] ERISA §205(c)(1)(A)(i).

[35] ERISA §205(c)(1)(A)(iii).

[36] ERISA §205(c)(2)(A).

[37] ERISA §205(c)(3), §205(c)(8)(B).

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custodial accounts to participants or beneficiaries. The distributed ICAs maintained by a custodian retain their tax-deferred basis if the requirements in the revenue ruling are met, and the recipient pays tax only on actual distribution of the funds.

Additionally, Notice 2020-80 requests comments on applicability of annuity and spousal consent rights under ERISA §205 to ICA in-kind distributions authorized under the SECURE Act and Rev. Rul. 2020-23. Section 205 of ERISA may apply to termination of limited 403(b) plans not exempt from ERISA. However, in those limited instances, ERISA §205 rights may be triggered in situations, in which the Rev. Proc. 2020-46 self-certification safe harbor would apply.

THE NON-ERISA SAFE HARBOR

ERISA Requirements in General

Not-for-profit organizations, including schools, may offer retirement benefits to their employees in the form of tax-advantaged or ''qualified'' retirement or welfare benefit plans.[38] Qualified retirement plans are subject to federal regulation under the joint jurisdiction of Treasury and DOL.[39] Titles I and II of ERISA contain parallel minimum participation and coverage, vesting, benefit accrual and funding,[40] fiduciary responsibility [41] and reporting requirements.[42]

ERISA rules apply to qualified plans,[43] and other retirement programs including §403(b) plans other than certain governmental plans [44] or non-electing [45] plans sponsored by religious organizations [46] or affiliates.[47] Absent an exception, ERISA could apply to a §403(b)(7) custodial account. The preamble to the 2007 Treasury final regulations under §403(b) noted, ''the new section 403(b) regulations offer employers considerable flexibility in shaping the extent and nature of their involvement. The question of whether any particular employer, in complying with the section 403(b) regulations, has established or maintained a plan covered under Title I of ERISA must be analyzed on a case-by-case basis.''[48]

Non-ERISA Safe Harbor: General Requirements

A safe harbor in DOL regulations exempts certain 403(b) plans, including §403(b)(7) custodial accounts from Title I of ERISA.[49] The regulations contain four general requirements for the ERISA exemption.[50] First, employees must participate completely voluntarily in a §403(b)(1) annuity contract or §403(b)(7) custodial account.[51] Second, all rights under the annuity contract or custodial account are enforceable solely by the participant, beneficiary, or authorized representative.[52]

Third, an employer may have only limited involvement in the plan, as prescribed in detail in the DOL regulation.[53] Such involvement in the plan may not rise to the level of the plan being deemed ''established or maintained'' by the employer, a requirement under ERISA §3(2).[54] Fourth, an employer does not receive any compensation other than reasonable costs of performing duties pursuant to the salary reduction agreements or agreements to forego increases in compensation, pursuant to which §403(b) employee contributions are made.[55]

Under Treasury regulations, a 403(b) plan may allocate responsibility for performing administrative functions to comply with §403(b) requirements and other I.R.C. provisions.[56] The allocation of duties must identify responsibility for compliance with the I.R.C. based on aggregate contracts issued to a plan

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[38] *See generally* §401(a) (qualified plan rules), §501(a) (exemption from federal income tax for an employee trust described in §401(a)).

[39] *See* ERISA Tit. III.

[40] *See generally* §401(a), §410, §411, §412; ERISA Tit. I, Subtit. B, Parts 1-3.

[41] §4975; ERISA Tit. I, Part 4.

[42] ERISA §103; §6047; IRS Form 5500.

[43] *See* ERISA §3(1), §201(a), §301(a), §401(a).

[44] ERISA §3(32), §4(b)(1) (Title I exemption for governmental plans); §403(b)(1)(A)(ii), §403(b)(12)(B), §414(d).

[45] *See* §410(d).

[46] ERISA §3(33), §4(b)(2) (Title I exemption for ''church'' plans).

[47] §403(b)(1)(A)(iii), §403(b)(9)(B), §414(e)(3)(A).

[48] 72 Fed. Reg. 41,128, 41,137 (July 26, 2007).

[49] ERISA §3(1); 29 C.F.R. §2510.3-2(f)(3)(i).

[50] 29 C.F.R. §2510.3-2(f).

[51] 29 C.F.R. §2510.3-2(f)(1).

[52] 29 C.F.R. §2510.3-2(f)(2).

[53] 29 C.F.R. §2510.3-2(f)(3).

[54] ERISA §3(2)(A) (effective for plan years beginning before December 31, 2020); 29 C.F.R. §2510.3-2(f); *see, e.g., Daniels-Hall v. Nat'l Educ. Ass'n*, 629 F.3d 992, 1001 (9th Cir. 2010) (in an excessive fee litigation, holding the union's marketing program that promoted §403(b) annuities was not an employee pension benefit plan; holding further that the 403(b) plans sponsored by the school district were governmental plans exempt from ERISA). *See* Pub. L. No. 116-94, §101(b), §101(c), §101(e)(1), 133 Stat. 3141 (2019) (effective for plan years beginning after December 31, 2020, adding new ERISA §3(2)(C), which authorizes establishment and maintenance of pooled employer plans as employee pension benefit plan treated as a single-employer plan and as a plan maintained by more than one employer under ERISA §210(a))).

[55] 29 C.F.R. §2510.3-2(f)(4).

[56] Reg. §1.403(b)-3(b)(3)(ii).

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participant.[57] A 403(b) plan may assign responsibilities to parties other than the eligible employer.[58]

Moreover, a 403(b) plan may incorporate by reference other documents,[59] collectively referenced in the article as plan documents. Plan documents may include individual custodial account agreements or a group custodial account agreement entered into by and among employer, employee and custodian.[60] Therefore, compliance with the non-ERISA safe harbor, including required division of authority should be reflected in the plan documents, particularly in the 403(b) plan and, if applicable, the group custodial account agreement.

PERMITTED EMPLOYER INVOLVEMENT UNDER THE SAFE HARBOR

An employer may undertake certain actions sanctioned by DOL in regulations and guidance to facilitate the administration of a 403(b)(7) custodial account.[61] An employer may permit agents or brokers who make available custodial accounts to market their products to employees.[62] An employer also may request information concerning proposed funding media, products, or custodians, and may compile such information to facilitate review and analysis by the employees.[63]

In addition, an employer may enter into salary reduction agreements, collect custodial account considerations pursuant to the agreements, remit the amounts to annuity contractors and maintain records of such collections.[64] The preamble to the 1979 final regulation clarified that the term annuity contractor includes agents or brokers who make available §403(b)(7) custodial accounts.[65] The preamble also confirmed more broadly the safe harbor was intended to apply to §403(b)(7) custodial accounts.[66]

Furthermore, an employer may hold a group custodial account agreement under a 403(b)(7) plan, or a 403(b) plan that provides for custodial accounts as funding vehicles, in the employer's name covering its employees.[67] An employer also may exercise rights as the authorized representative of its employees under a 403(b) plan or group custodial account agreement in amending plan documents.[68] Thus, an employer may make required amendments to an individually designed 403(b)(7) plan pursuant to 403(b) RA Lists without violating the safe harbor.[69] Likewise, an employer may use the voluntary compliance program (VCP) under the Employee Plans Compliance Resolution System (EPCRS) to bring a 403(b)(7) plan into compliance with applicable plan document or operational requirements under the Code.[70]

However, DOL cautioned in a 1996 advisory opinion that an employer must be careful not to assume responsibilities to correct actions of third parties outside the terms of the 403(b) plan.[71] DOL also advised employers not to undertake ongoing duties with regard to a 403(b) plan as a result of taking a plan through the predecessor of the VCP.[72] Thus, such responsibilities should not be part of a compliance statement in connection with a VCP submission by an employer for a 403(b)(7) plan or 403(b) plan allowing §403(b)(7) custodial accounts.[73]

An employer may also limit funding media or products available to employees, or vendors who may approach the employees, to a number and selection designed to afford employees a reasonable choice in light of all relevant circumstances.[74] Thus, an employer may, but is not required to limit reasonably the custodians or products available to employees under the safe harbor.[75] Conversely, an employer does not have to seek out custodians affirmatively in order to comply with the safe harbor.[76] DOL noted that an employer may meet the reasonableness requirement by

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[57] Reg. §1.403(b)-3(b)(3)(ii).

[58] Reg. §1.403(b)-3(b)(3)(ii).

[59] Reg. §1.403(b)-3(b)(3)(ii).

[60] *See* Reg. §1.403(b)-3(b)(3)(ii).

[61] 29 C.F.R. §2510.3-2(f)(3); Adv. Op. 2012-02A (May 25, 2012).

[62] 29 C.F.R. §2510.3-2(f)(3)(i).

[63] 29 C.F.R. §2510.3-2(f)(3)(ii).

[64] 29 C.F.R. §2510.3-2(f)(3)(iv).

[65] 44 Fed. Reg. 23,525, 23,525, n.1 (Apr. 20, 1979).

[66] 29 C.F.R.§2510.3-2(f)(3)(iv); 44 Fed. Reg. 23,525, 23,526 (Apr. 20, 1979).

[67] 29 C.F.R. §2510.3-2(f)(3)(v).

[68] 29 C.F.R. §2510.3-2(f)(2); DOL Information Letter to Siegel Benefit Consultants, Inc. n.1 (Feb. 27, 1996), https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/02-27-1996 (DOL advisory opinion citing preamble to final regulation); 44 Fed. Reg. 23,525, 23,526 (Apr. 20, 1979).

[69] *See* Rev. Proc. 2019-39; Notice 2020-83 (2020 RA List); Notice 2019-64 (2019 RA List); Notice 2020-35 (extended amendment deadlines).

[70] *See* Rev. Proc. 2019-19, §5 - §8; Notice 2020-35 (extended correction deadlines).

[71] DOL Information Letter to Siegel Benefit Consultants, Inc. (Feb. 27, 1996), https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/02-27-1996.

[72] DOL Information Letter to Siegel Benefit Consultants, Inc. (Feb. 27, 1996).

[73] *See* Rev. Proc. 2019-19 , §10.07, §11.

[74] 29 C.F.R. §2510.3-2(f)(3)(vii) (listing factors to take into account in determining whether employees have been afforded a reasonable choice of an investment product or custodian).

[75] *See* 44 Fed. Reg. 23,525, 23,526 (Apr. 20, 1979).

[76] *See* 44 Fed. Reg. 23,525, 23,526 (Apr. 20, 1979).

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obtaining and providing to employees information regarding available 403(b) providers and investment products as permitted in the regulation.[77]

Also, an employer may add 403(b) plan features, such as participant loan provisions, even if the third-party plan provider has discretion in establishing or administering the plan.[78] But, an employer may refuse to make certain plan features available to participant employees if the exclusion of accounts with the optional features would reduce employer costs.[79] Likewise, an employer may exclude 403(b) plan features in order to avoid otherwise exceeding sanctioned involvement under the safe harbor.[80]

In addition, DOL permitted employers under the safe harbor to discontinue use of a plan provider for employee salary deferrals in order to maintain compliance with §403(b) requirements.[81] Moreover, DOL expressed the view that terminating a 403(b) plan by an employer would not result in the annuity contract or custodial account becoming subject to Title I of ERISA.[82] Thus, an employer sponsoring a 403(b) plan subject to the non-ERISA safe harbor that provides for §403(b)(7) custodial accounts unilaterally may terminate the 403(b) plan. But, in order to comply with the safe harbor, as discussed below, the employer or a TPA acting on behalf of the employer may exercise discretion as to an in-kind distribution of a §403(b)(7) ICA pursuant to Rev. Rul. 2020-23. Therefore, terms of 403(b) plans and custodial agreements relating to in-kind ICA distributions described in Rev. Rul. 2020-23 should reflect this safe harbor limitation on authority of an employer or its representative.

LIMITATIONS ON EMPLOYER INVOLVEMENT UNDER THE SAFE HARBOR

Prohibited Exercise of Employer Discretion with Respect to Custodial Accounts

An employer or its representative may not maintain a custodial account because such conduct would amount to establishing or maintaining a plan by the employer under ERISA §3(2).[83] Thus, it is possible by closing brokerage firm accounts, the employer finds noncompliant or approving brokerages from which a custodian will purchase mutual funds is inconsistent with limited employer involvement under the safe harbor.[84] In addition, an employer may not make discretionary determinations, such as authorizing plan-to-plan transfers, processing distributions or satisfying applicable QJSA requirements.[85] Thus, an employer unilaterally could not move funds in employee contracts or accounts to another provider.[86]

An employer also may not make determinations regarding hardship distributions, QDROs, or eligibility for or enforcement of 403(b) plan loans.[87] Moreover, hiring a TPA to make discretionary decisions on behalf of employer for the 403(b) plan on matters, such as participant loans or hardship distributions would violate the regulatory safe harbor.[88] Conversely, as discussed above, [89] failure of employer to offer 403(b) plan participants a reasonable choice of plan providers and investment options may result in noncompliance with the safe harbor.[90]

In a 1994 advisory opinion, DOL concluded that involvement of employer in the process of determining eligibility for disability or hardship distributions under annuity contracts exceeded employer involvement

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[77] 29 C.F.R. §2510.3-2(f)(3)(ii), 29 C.F.R. §2510.3-2(f)(3)(iii); 44 Fed. Reg. 23,525, 23,526, n.4 (Apr. 20, 1979).

[78] §403(b)(1)(D); 72 Fed. Reg. 41,128 (July 26, 2007) (finalized wholesale revision of Treasury regulations under §403(b), containing among other amendments the written plan requirement for 403(b) plans generally effective for tax years beginning after December 31, 2008); DOL Field Assist. Bul. 2010-01 Q&A 14 (Feb. 17, 2010), https://www.dol.gov/sites/dolgov/files/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2010-01.pdf (reporting, audit and safe harbor guidance for 403(b) plans in connection with applicability of the final regulations). *But see* Reg. §1.403(b)-3(b)(3)(iii) (no written plan requirement for custodial accounts maintained by a ''church'').

[79] DOL Field Assist. Bul. 2010-01 Q&A 14 (Feb. 17, 2010).

[80] DOL Field Assist. Bul. 2010-01 Q&A 14 (Feb. 17, 2010).

[81] DOL Field Assist. Bul. 2010-01 Q&A 17 (Feb. 17, 2010).

[82] DOL Field Assist. Bul. 2007-02 (July 24, 2007) (DOL 403(b) plan guidance following issuance of final §403(b) regulations).

[83] ERISA §3(2)(A); 29 C.F.R. §2510.3-2(f); Adv. Op. 83-23A (May 18, 1983).

[84] Adv. Op. 83-23A (May 18, 1983).

[85] DOL Field Assist. Bul. 2007-02 (July 24, 2007).

[86] DOL Field Assist. Bul. 2010-01 Q&A 18 (Feb. 17, 2010).

[87] DOL Field Assist. Bul. 2010-01 Q&A 18 (Feb. 17, 2010).

[88] *See* DOL Field Assist. Bul. 2010-01 Q&A 15 (Feb. 17, 2010), https://www.dol.gov/sites/dolgov/files/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2010-01.pdf. *See also* 84 Fed. Reg. 49,651 (Sept. 23, 2019) (final regulations under §401(k) and §401(m) reflecting statutory amendments which included TCJA and BBA 2018 changes to hardship distribution requirements and containing conforming amendments to 403(b) plan hardship distribution rules in light of §403(b)(11) not being amended under BBA 2018); Notice 2020-83, Notice 2019-64, Notice 2020-35, Notice 2020-50, Notice 2020-51, Notice 2020-62.

[89] *See* 29 C.F.R. §2510.3-2(f)(3)(vii).

[90] DOL Field Assist. Bul. 2010-01 Q&A 16 (Feb. 17, 2010).

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permitted in the safe harbor.[91] DOL reasoned that the employer had to evaluate circumstances and exercise its judgment in certifying an employee for a disability or hardship in-service distribution. Thus, the determination resulted in employer exercise of discretion over the grant or denial of an important benefit under the annuity program. Therefore, employer control over in-service distributions exceeded employer involvement sanctioned in the safe harbor.

On the other hand, DOL stated the safe harbor allows an employer to transmit to a §403(b)(7) custodian factual certifications necessary for benefit determination.[92] Accordingly, in complying with Covid-19 IRS guidance, implementing relief with respect to an RMD hardship distribution, and participant loan requirements, non-ERISA 403(b)(7) plan sponsors should ensure that employers do not exercise control over in-service distributions.[93] Likewise, plan documents should be conformed to limit employer discretion with respect to in-service distributions and plan loans subject to Covid-19 relief consistent with the safe harbor.

Prohibited Employer Contributions

Generally, only employee salary deferrals may fund a §403(b)(7) custodial account under the safe harbor.[94] An elective deferral under §402(g)(3) includes, in sum with other types of employer contributions, 403(b) plan employer contributions under a salary reduction agreement meeting the definition of §3121(a)(5)(D).[95] However, an employer contribution would not be treated as an elective deferral unless, pursuant to a salary reduction agreement, the employee elected to reduce the compensation pursuant to a cash or deferred election.[96]

Consistently, the preamble to the 2007 final regulations stated, ''Department of Labor continues to be of the view that tax-exempt employers can comply with the requirements in the section 403(b) regulations and remain within the Department of Labor's safe harbor for tax-sheltered annuity programs funded solely by salary deferrals.''[97] Therefore, employer contributions to a 403(b)(7) plan other than salary reduction contributions pursuant to a salary reduction agreement forwarded to the §403(b)(7) custodian generally would disqualify the plan from the regulatory safe harbor.[98]

Accordingly, DOL has advised, and a federal bankruptcy court has held, that matching contributions out of employer assets exceed the level of involvement in the plan sanctioned in the safe harbor.[99] In general, a non-governmental 403(b) plan must meet the nondiscrimination requirements in §401(m) for matching contributions in the same way as a qualified plan.[100] Matching contributions are defined in §401(m)(4)(A) generally as any employer contribution made to a defined contribution plan on behalf of an employee, and on account of the employee contribution to the plan, or on account of an employee's elective deferral. Likewise, basing employer contributions made to a separate ERISA money purchase pension plan on employee contributions to the 403(b) plan also may negate the limited involvement or voluntary participation prongs of the regulatory safe harbor.[101]

DOL safe harbor guidance generally does not distinguish between matching contributions, which are determined based on amounts contributed by em-

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[91] Adv. Op. 94-30A (Aug. 19, 1994).

[92] DOL Field Assist. Bul. 2007-02 (July 24, 2007).

[93] *See* §72(t), §401(a)(9), §402(f); Notice 2020-50 (relief for, among other eligible retirement plans, 403(b) plan coronavirus-related distributions and loans under CARES Act §2202, Pub. L. No. 116-136, 134 Stat. 281 (2020)); Notice 2020-51 (IRS guidance on waiver of 2020 RMDs and transition relief in connection with the change in required beginning date for RMDs under SECURE Act §114); IRS FAQ, *Coronavirus-related relief for retirement plans and IRAs questions and answers* Q&A 9, 10, 11 (Sept. 19, 2020), https://www.irs.gov/newsroom/coronavirus-related-relief-for-retirement-plans-and-iras-questions-and-answers (relating to employer discretion with respect to plan amendments, participant distribution rights, administrator reliance on qualified individual certification of eligibility for relief, respectively).

[94] *See* Rev. Proc. 2007-71, *Cf.* DOL Adv. Op. 80-11A (Feb. 29, 1980) (payment of premiums by employer on annuity contracts purchased for employees exceeding limited employer involvement permitted in the safe harbor); DOL Field Assist. Bul. 2007-02 (July 24, 2007).

[95] §402(g)(3)(C), §3121(a)(5)(D).

[96] §402(g)(3), §3121(a)(5)(D); Reg. §1.401(k)-1(a)(3)(i) (as amended in 2019), §31.3121(a)(5)-2(a)(1).

[97] 72 Fed. Reg. 41,128, 41,137 (July 26, 2007).

[98] *See* §401(k)(2)(A), §402(g)(3), §403(b)(1)(A), §403(b)(7)(A), §3121(a)(5)(D); 29 C.F.R. §2510.3-2(f)(3); DOL Adv. Op. 97-05A (Feb. 12, 1997) (advising that a 403(b) plan does not qualify as a governmental plan, and not able to conclude that the plan qualifies for the regulatory safe harbor because the sponsoring employer makes contributions for employees to the annuity program).

[99] *In re Hunter,* 380 B.R. 753, 768-769 (Bankr. S.D. Ohio 2008) (in a bankruptcy proceeding, finding that employer matching contributions to the 403(b) plan exceeded the limited involvement permitted under the non-ERISA safe harbor, and holding, inter alia, that debtor interests in the plan were subject to transfer restrictions and therefore, were not part of the debtors' estate pursuant to Title I anti-alienation provision in ERISA §206(d)(1)); DOL Adv. Op. 94-30A (Aug. 19, 1994) (advising employer matching contributions out of own assets of employer exceeded limited involvement permitted under 29 C.F.R. §2510.3-2(f)(3)).

[100] *See* §401(a), §401(m), §403(b)(12)(A), §414(s) (definition of compensation for nondiscrimination testing). *Cf.* §403(b)(12)(A)(ii) (elective deferrals instead being subject to a universal availability requirement).

[101] DOL Adv. Op. 2012-02A (May 25, 2012).

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ployee, and other nonelective contributions, which an employer commonly determines based on a percentage of employee compensation. For example, in a 1997 advisory opinion, DOL advised that a nongovernmental plan would not meet the safe harbor based on employer representation that employer made contributions to the supplemental annuity program on behalf of its employees.[102] The opinion was silent on the type of employer contributions made to the annuity program.[103]

Broad prohibition on employer contributions in DOL guidance also suggests qualified nonelective employer contributions (QNECs) treated as elective deferrals would violate the non-ERISA safe harbor.[104] A QNEC is generally defined under §401(m)(4)(C) as any employer contribution, other than a matching contribution, which an employee may not elect to take in cash in lieu of the amount being contributed to the plan. A QNEC also must be subject to restrictions on timing of distribution in §401(k)(2)(B) and is nonforfeitable by the employee as provided in §401(k)(2)(C).[105]

QNECs generally are intended to correct plan operational failures pursuant to safe harbors under the IRS Employee Plans Compliance Resolution System (EPCRS).[106] Thus, QNECs generally are contributions for compensating an employee in the event of automatic contribution failure, failure to implement an employee elective deferral election, or a missed elective deferral election due to improperly excluding an employee from making contributions.[107] In the latter case, under a literal reading of the DOL guidance, a QNEC, which was not actually remitted pursuant to a then-effective salary reduction agreement, may not fund a §403(b)(7) custodial account.[108]

The DOL expressly permits limited employer activity in ensuring the 403(b) plan meets the applicable I.R.C. requirements in order to avoid IRS substantial penalties, correction fees, and employment taxes on employee salary deferrals.[109] The DOL 2007 Field Assistance Bulletin informs that an employer may not have responsibility for, or make, discretionary determinations in administering the program.[110] However, an employer may conduct administrative reviews of the program structure and operation for tax compliance defects.[111] Thus, an employer may 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.[112] Likewise, in a 1996 Advisory Opinion referenced in the 2007 bulletin, the DOL acknowledged that an employer may be required to pay all employment taxes due with respect to the actual (i.e., ''defective'') operation of the program, and to make contributions under the program to rectify past errors in operations.[113] Thus, in the 1996 opinion, the DOL sanctioned, with respect to predecessor VCP ''an employer's payment of a one-time, make-up contribution to a tax sheltered annuity program on behalf of participants who were harmed by past defects in its administration of the program, if the contribution is required as part of the TVC process.''[114] Thus, subject to further clarifying guidance from the DOL, the 1996 opinion and 2007 bulletin suggests QNECs may be permitted as part of authority of employer to take corrective action under the EPCRS.

CONCLUSION

Employer exercise of discretion as set forth in DOL regulations, federal jurisprudence, and administrative guidance delineates the circumstances, in which a 403(b)(7) plan could fail the regulatory safe harbor and be subject to ERISA. Thus, for example, under latest 2020 IRS guidance, if the ICA does not meet the non-ERISA safe harbor, termination of a non-exempt 403(b)(7) plan may give rise to ERISA §205 annuity and spousal rights with respect to an in-kind ICA distribution. Compliance with ERISA §205, with respect to which the IRS requested comments in Notice 2020-80, also may be required upon 403(b)(7) plan termination that involves an in-kind indirect rollover of an ICA subject to an updated self-certification safe harbor in Rev. Proc. 2020-46. As a broader tax year-end consideration, employers, custodians, and TPAs for

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[102] DOL Adv. Op. 97-05A (Feb. 12, 1997).

[103] DOL Adv. Op. 97-05A (Feb. 12, 1997).

[104] *See* §401(m)(4)(C); Rev. Rul. 2020-23, Sit. 1 (plan including both nonelective employer contributions and elective deferrals not subject to ERISA generally or ERISA §205 in particular, but ruling does not specify whether the plan described in the ruling could be exempt from ERISA by virtue of being a governmental plan); DOL Field Assist. Bul. 2010-01 Q&A 14 (Feb. 17, 2010); DOL Field Assist. Bul. 2007-02 (July 24, 2007); 72 Fed. Reg. 41,128, 41,137 (July 26, 2007).

[105] §401(m)(4)(C), §401(k)(2)(B), §401(k)(2)(C).

[106] *See* Rev. Proc. 2019-19, App. A, §.05.

[107] *See* Rev. Proc. 2019-19, App. A, §.05.

[108] *See* Rev. Proc. 2019-19, App. A, §.05(2).

[109] DOL Field Assist. Bul. 2007-02 (July 24, 2007).

[110] DOL Field Assist. Bul. 2007-02 (July 24, 2007).

[111] DOL Field Assist. Bul. 2007-02 (July 24, 2007).

[112] DOL Field Assist. Bul. 2007-02 (July 24, 2007).

[113] DOL Information Letter to Siegel Benefit Consultants, Inc. (Feb. 27, 1996), https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/02-27-1996.

[114] DOL Information Letter to Siegel Benefit Consultants, Inc. (Feb. 27, 1996), https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/02-27-1996.

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non-ERISA §403(b)(7) accounts would be advised to review and conform plan documents to the non-ERISA safe harbor in complying with numerous amendments or updates to §403(b) requirements within the past year, including IRS guidance and statutory and administrative Covid-19 relief.

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