SOCIETY OF ACTUARIES®

Article from
Taxing Times
February 2019
Vol. 15 Issue 1

In the Beginning . . . A Column Devoted to Tax Basics

How Does ERISA Apply to Annuities?

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In the October 2018 issue of *Taxing Times*, my "In the Beginning" article discussed the basic taxation rules for "qualified" annuities. "Qualified" is the term used for annuities that are issued in connection with a qualified Code section 401(a) pension or profit-sharing plan, section 403(b) plan, section 457(b) plan, or individual retirement account or annuity (IRA), all of which receive special tax treatment under the Internal Revenue Code. I pointed out that there was not space to address the Employee Retirement Income Security Act of 1974 (ERISA), which is the key law governing the design and operation of employer-based retirement plans. I foolishly suggested a future article could discuss it, and the editors have taken me up on that. But fear not—while ERISA is sometimes viewed as impenetrable and hopelessly complex, it is possible to understand the basics, in particular the ways that ERISA impacts annuities sold to employer-based retirement and other benefit plans.

To regulate employer-based retirement plans, Congress has settled on a "carrot" and "stick" approach, and a well-administered annuity issued in connection with an employer-based plan should be cognizant of both. The "carrot" is very favorable tax deferral of contributions and earnings, but with myriad complex rules under the Code. The "stick" is ERISA. ERISA imposes reporting, plan design, fiduciary and other requirements on certain employer-based retirement plans, which from now on I'm going to refer to as "ERISA-governed plans." Most of the obligations under ERISA fall on the employer or other fiduciary administering the plan, although some obligations are imposed on issuers of annuities sold to ERISA-governed plans, such as certain disclosure obligations.

When I speak with life insurance companies that are currently issuing or planning to issue annuities to ERISA-governed plans, I typically go through a series of questions that I will use as our entry into the basics of ERISA.

- Is the annuity being issued in connection with an ERISA-governed plan?
- What will be treated as plan assets?
- Who are the fiduciaries of the plan, and more to the point, is either the insurance company or the distributor (broker or agent) a fiduciary under ERISA?
- What disclosures will be generated because this plan has purchased this annuity?

At the end of the article, I will also say a brief word about Title IV of ERISA, which governs the termination of an ERISA-governed defined benefit plans and thus is relevant to what the industry calls "terminal funding" contracts, *i.e.*, annuity contracts issued to settle the obligations of a terminating defined benefit plan. I will also mention when it makes sense to get an ERISA expert involved.

> So, let's say you've concluded that the annuity is issued in connection with an ERISA-governed plan. Don't panic—everything will be OK.

One last preliminary point. You have surely heard something about the Department of Labor's (DOL) ill-fated "Fiduciary Rule," which was struck down by a court in March 2018. This article is not about that regulation, although I will mention in a couple places how it would have fit into the overall ERISA regulatory structure. OK, let's get started.

IS THE ANNUITY BEING ISSUED IN CONNECTION WITH AN ERISA-GOVERNED PLAN?

The terms "qualified" annuity and "ERISA-governed" plan do not mean the same thing. Qualified annuities, as the term is used in our industry, includes arrangements not governed by ERISA, such as IRAs.[1] And ERISA-governed plans can hold contracts that do not have the hallmarks of a qualified annuity and, of course, many other kinds of assets.

ERISA applies to a plan that is established or maintained by an employer and that either provides retirement income or results in the deferral of income for employees to periods extending beyond termination of employment. This is called a "pension plan" in ERISA, and it includes both defined benefit plans and defined contribution plans. However, since in common parlance the term "pension plan" is often used to refer only to defined benefit plans that provide a "pension," I'm going to use the term "retirement plan" to refer to both defined benefit plans and defined contribution plans such as 401(k) and 403(b) plans. ERISA also applies to what are called "welfare" plans, that is, plans established or maintained by an employer that provide health, disability or death benefits; but in this article, we will focus on retirement plans.

In other words, ERISA applies to a plan that an employer establishes to provide retirement or deferred income to its employees. But there are, of course, some very important exceptions, and sometimes a life insurance company will focus its annuity sales solely on plans exempt from ERISA. But each of the exceptions come with traps that should be kept in mind.

- **Governmental plans and church plans.** When ERISA was passed in 1974, there was a concern about imposing rules on plans established and maintained by state and local governmental employers (because of federalism concerns) and by churches (because of First Amendment concerns).[2] Instead, these plans are subject to state law and, of course, must also meet the requirements of the Internal Revenue Code to receive favorable tax treatment. The trap here is that many states have enacted "mini-ERISA" laws that apply similar rules to the plans offered to state and local government employees.[3] When dealing with a state or local government plan, do not assume there is a free pass from ERISA-like rules.

- **Plans covering no employees.** To be an ERISA-governed plan, the arrangement must cover at least one employee. Thus, a plan covering only a business owner (and spouse)—which you will sometimes see referred to as a "solo 401(k) plan," "Keogh plan" or "H.R. 10 plan"—is not subject to ERISA.[4] But beware of a trap—if you issue a contract to a plan not currently subject to ERISA because the business has no employees yet, do not assume the plan will forever be exempt from ERISA.

- **Plans with minimal employer involvement.** Just because a retirement savings program is funded through payroll contributions does not mean it is a plan "established or maintained" by an employer. DOL rules include exemptions from ERISA for voluntary savings arrangements where no employer contributions are involved and the involvement of the employer is minimal.[5] The most commonly encountered of these arrangements are non-ERISA 403(b) plans of tax-exempt employers, which involve only payroll contributions. But here the trap is that the employer must be extremely careful to avoid any more than minimal involvement, which has become increasingly difficult since the Internal Revenue Service (IRS) rewrote the section 403(b) regulations in 2007.

- **Deferred compensation plans for executives.** Deferred compensation plans that cover only a select group of highly compensated and management employees—which are given the fairly old-fashioned name "top hat plans"[6]—are exempt from the vast majority of ERISA's requirements.[7] The thinking behind this exemption is that ERISA is designed to protect employees and ensure promised benefits are paid, but the most senior executives in a company can adequately protect their own interests. The trap here is that there are some ERISA requirements that apply (*i.e.*, a filing is due with DOL, and a few ERISA requirements, like claims procedures, must be written into the plan documents).

WHAT WILL BE TREATED AS PLAN ASSETS?

So, let's say you've concluded that the annuity is issued in connection with an ERISA-governed plan. Don't panic—everything will be OK. The next step is to determine which assets associated with the plan are considered "plan assets." The reason this is the next step, and not the disclosure or fiduciary rules, is because many of ERISA's requirements are targeted to the plan's assets. Therefore, figuring out what the plan "owns" is critical to understanding where we must be careful.

ERISA requires that all of the plan's assets be held either in a trust or in insurance contracts. Thus, the plan's assets will include the assets held in the trust and the interests represented by the insurance contract. But DOL has also issued what are called the "pass-through" rules, which look through certain investment arrangements and treat the underlying assets of the investment as also constituting plan assets. For example, subject to a number of exceptions, if a plan's trust invests in a limited partnership or unregistered collective investment trust, the plan's assets include not only the shares of the limited partnership or unregistered collective trust but also those investment vehicles' *underlying assets*, which means that the investment managers of those investments are ERISA fiduciaries.[8] This does not apply with all investments. For example, if a plan purchases shares of a registered mutual fund, or the shares of an operating company (like Facebook or IBM), the plan is deemed to own only those shares and not underlying assets of the company.

Applied to annuity contracts, the "pass-through" rules (a) do not apply to fixed annuities that are supported by the insurance company's general account, but (b) do apply to variable annuities that are supported by a separate account. (This is true whether the contract is a group or individual annuity.) There are some nuances and caveats to this general rule, and it has been the subject of litigation, but for a basic summary, that's close enough. ERISA uses the term "guaranteed benefit policy" to refer to fixed annuities that are exempt from the "pass-through" rule.[9]

In other words, when a plan pays premiums to a variable annuity, the assets in the insurance company's separate account are treated as plan assets and ERISA's fiduciary rules attach. Again, don't panic; variable annuities can be structured easily to ensure compliance with ERISA.

WHO ARE THE PLAN FIDUCIARIES?

Who are the fiduciaries of the plan, and more to the point, is either the insurance company or the distributor (broker or agent) a fiduciary under ERISA? Every ERISA-governed plan has one or more fiduciaries. In fact, ERISA requires that every plan must have a governing plan document and that the document must name one or more fiduciaries who are, big surprise, called the plan's "named fiduciaries."[10] But even if a person is not named in the plan's governing document, fiduciary status can still apply if the person exercises a function that is fiduciary in nature.

There are three functions that trigger fiduciary status:

- **Investment discretion.** A person is a fiduciary to the extent that person exercises any discretionary authority or discretionary control respecting management of the plan or exercises any authority or control respecting management or disposition of its plan assets. In English, this means anyone who can or does make investment decisions, including determining which investments will be available on the 401(k) plan's menu, is a fiduciary.[11]

- **Plan administration.** A person is a fiduciary to the extent that person has any discretionary authority or discretionary responsibility for the administration of the plan. For this purpose, "administration" includes functions like hiring and monitoring service providers to the plan, making decisions about eligibility for contributions and benefits, and keeping the plan tax-compliant.

- **Investment advice.** A person is a fiduciary to the extent that person renders investment advice for a fee or other compensation, direct or indirect, or has any authority or responsibility to do so. The DOL's Fiduciary Rule that caused such a brouhaha during the past five years or so was focused solely on what constitutes investment advice and did not involve the two other fiduciary functions.

With most plans, the employer names itself to take on the first two functions (investment decisions and plan administration). The employer typically designates an internal committee that meets regularly to make these decisions. The committee may hire other fiduciaries, such as investment managers and investment advisers to assist. But the plan's primary service provider (*e.g.*, the "recordkeeper" or third-party administrator) generally does not act as a fiduciary.

Here's the punchline to why this is so important. The key thrust of ERISA is to regulate, and it's fair to say *heavily* regulate, the conduct of fiduciaries. They must live by what I think of as the five commandments of ERISA:[12]

1. **Thou shalt be loyal.** ERISA requires that plan fiduciaries act solely in the interests of plan participants and beneficiaries and allow plan assets to be used solely to benefit plan participants and pay reasonable expenses.

2. **Thou shalt be prudent.** ERISA requires fiduciaries to abide by the "prudent expert" standard in all decision-making—that is, to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

3. **Thou shalt diversify.** ERISA fiduciaries must diversify plan investments to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

4. **Thou shalt follow the plan.** A fiduciary must follow the plan documents that govern the plan unless doing so would otherwise violate ERISA.

5. **Thou shalt avoid prohibited transactions.** ERISA contains a list of transactions that the fiduciary may not allow to occur, including avoiding the fiduciary engaging in any conflicts of interest, unless a specific exemption applies.

If a fiduciary fails to follow these five commandments, ERISA provides that the fiduciary is personally liable for any losses that result from a breach of the duties.[13] Fiduciaries must also disgorge any profits resulting from a breach of fiduciary duty, and there are additional civil and even criminal penalties in extreme cases.

This all sounds scary, and it is supposed to be**. And that's why it is important that financial services firms that sell products and services to ERISA-governed plans work hard to avoid fiduciary status or take it on only with eyes wide open to the obligations.** It is also why class action plaintiff lawyers that bring ERISA cases against financial services firms always begin with an allegation that the firm has done something to trigger fiduciary status; without that, the case will quickly fall apart, because ERISA does not impose significant obligations on non-fiduciary service providers.

Let's talk about how an insurance company and its distributors prevent fiduciary status. We always start with the point that decision-making should reside with the named fiduciaries. So, for example, the persons who decide to purchase an annuity to fund the retirement plan are fiduciaries.

I said earlier that when a plan invests in a variable annuity, the separate account supporting the contract consists of plan assets because of the "pass-through" rule. Isn't that a problem for the insurance company? Properly structured, no. Even though the separate account assets are plan assets, the insurance company avoids any investment discretion or control and does not provide any investment advice. The plan's fiduciaries always retain final decision-making authority to invest in the variable annuity, retain the authority to reallocate within the funds in the contract,[14] and retain the authority to surrender the annuity (subject to the terms the fiduciary agreed to in purchasing the contract). But it is the case that the insurance company has to be more careful in the terms of the contract where a separate account is involved.

Insurance agents and brokers that sell annuities also prevent, if they can, fiduciary status by not providing any investment advice, as ERISA defines it. It's OK to provide investment *education* under DOL rules. DOL has rules dating back to shortly after ERISA was passed in 1974 that explain the activities that constitute fiduciary investment advice, and it is a high standard, meaning most recommendations incidental to the sale of an annuity would not be considered fiduciary investment advice. DOL's ill-fated Fiduciary Rule was designed, in large part, to expand the activities that constitute investment advice, particularly for insurance agents and brokers.

> The key thrust of ERISA is to regulate, and it's fair to say *heavily* regulate, the conduct of fiduciaries.

Before we leave the issue of fiduciary obligations, we have to mention the prohibited transaction rules. ERISA prohibits a fiduciary from causing the plan to engage in a transaction with certain "parties-in-interest," which includes almost every person who is involved in the plan.[15] ERISA also prohibits certain "self-dealing" by fiduciaries: A fiduciary may not deal with plan assets in the fiduciary's own interest, may not act on both sides of a transaction involving the plan, and may not receive any consideration from a party dealing with the plan.[16] All of the prohibitions apply even if the transaction is advantageous to the plan.

ERISA's prohibited transaction rules are so broad that almost any time a plan interacts in the commercial market, the rules could be triggered. Accordingly, most ordinary transactions operate under an exemption of some kind, whether in ERISA itself or issued by the DOL. (There is, for example, an exemption allowing an insurance company to use its own contract to fund its in-house plan.[17])

By and large, ERISA's rules are most strict when a fiduciary has a potential or actual conflict. And again, we return to DOL's ill-fated Fiduciary Rule. Because that rule would have turned brokers and agents into fiduciaries, the simple act of paying a commission in connection with the sale of an annuity contract would have violated ERISA's prohibited transaction rules, meaning every sale would need to occur under an exemption of some kind.

WHAT DISCLOSURES WILL BE GENERATED BECAUSE THIS PLAN HAS PURCHASED THIS ANNUITY?

Even when the issuers of annuity contracts to ERISA-governed plans are not fiduciaries, either the insurance company or the selling broker or agent must still make a number of disclosures. In addition, some disclosures must be made by the fiduciary plan administrator but effectively require information that is in the hands of the insurance company. Thus, in many cases, the implication, in terms of operations, of issuing a contract to an ERISA-governed plan is really to ensure that these disclosures are generated. The key disclosures include:

- **Schedule A of Form 5500.** Form 5500 is the annual report that most ERISA-governed plans must file with the DOL, IRS and the Pension Benefit Guaranty Corporation (PBGC) to satisfy a range of reporting requirements. Schedule A must be attached to the Form 5500 if any benefits under the plan are provided by an insurance company, including through annuity contracts. While the Form 5500 must be filed by the plan administrator, like many parts of the Form 5500, Schedule A requires information in possession of a third party, in this case the insurance company.[18]

- **PTE 84-24.** The vast majority of transactions that a plan undertakes may implicate what we call the prohibited transaction rules. Even the simple purchase of an annuity can cause a problem, especially if the insurance company already has a relationship with the plan. The DOL has issued an exemption, PTE 84-24, that provides relief, and it requires a disclosure to the fiduciaries of the commission and certain other information at the time of purchase of an annuity contract.

- **The service provider disclosure, also known as the 408(b)(2) disclosure.** Section 408(b)(2) of ERISA allows a plan to contract for services if (1) the services are necessary for the establishment or operation of the plan; (2) the arrangement is reasonable; and (3) no more than reasonable compensation is paid. DOL regulations require that certain "covered service providers" disclose, reasonably in advance of entering into a contract or arrangement, information on the service provider's direct and indirect compensation, whether it will act as a fiduciary, fees for termination, and certain other information.[19] A commission paid to an agent or broker would be considered "indirect compensation" that would generally trigger reporting at the time of the sale of the contract. Whether this disclosure applies to the insurance company itself is less clear and depends in part on the range of services the insurance company is providing. Certain kinds of annuities, such as group variable annuity contracts used to provide plan administrative services and a platform of investments through a separate account, would trigger reporting under the service provider disclosure.

- **The participant fee disclosure, also known as the 404a-5 disclosure.** The participant fee disclosure rules require, in broad terms, that participants in plans that allow participants to allocate the investment of their own accounts (as most 401(k) plans do) receive basic information on the plan, its fees and its investments on the plan's menu.[20] When the plan offers an annuity investment or annuity distribution option, the disclosure must include additional specific information about the annuity. The plan administrator must provide the participant fee disclosure. In practice, however, much of the information needed to complete the disclosure is in the hands of the annuity issuer.

- **Benefit statement.** At regular intervals (the interval depends on the type of plan; for most 401(k) plans, it is quarterly), participants in plans must receive a benefit statement regarding the plan.[21] As with the participant fee disclosure, when the plan has invested in an annuity, the plan administrator will often need information from the issuer to complete the benefit statement.

A FEW WORDS ABOUT TITLE IV OF ERISA

Everything I have discussed so far comes from Title I of ERISA, which sets forth the reporting and disclosure, plan design and fiduciary responsibility rules. Life insurance companies will also interact with Title IV of ERISA, which describes the defined benefit pension insurance program, administered by the PBGC. Because defined benefit plans may not have sufficient assets to pay all liabilities, most defined benefit plans pay into the PBGC, which provides insurance if an employer is bankrupt and unable to fund its plan. But defined benefit pension plans also terminate when they are fully funded, which is called a "standard" termination. In that case, Title IV requires that the plan purchase annuity contracts from an insurance company to pay the promised benefits.[22] These contracts are often called "terminal funding" contracts because they fund the termination of the plan.

Once the plan is terminated, the rules of ERISA *generally* no longer apply, since there is no longer any plan and thus there are no fiduciaries overseeing the plan. The contract itself ceases to be "plan assets." The contract must still be administered in connection with some rules that carry over from the plan, such as the requirement to pay required minimum distributions and to comply with the spousal consent rules. ERISA does allow a cause of action to be brought by the Secretary of Labor or anyone who was a participant under the plan to ensure receipt of the benefits to which the individual is entitled.[23] Accordingly, it is important to pay close attention to the administration of a terminal funding contract, because ERISA liabilities may still apply if former participants in the plan are not paid in full and on a timely basis.

Speaking of funding, since this is a publication for actuaries, a word about what ERISA has to say about the need to adequately fund a defined benefit plan. ERISA contains rules that parallel the minimum funding rules in the Internal Revenue Code. ERISA, being the "stick" part of retirement regulation, imposes on employers the obligation to fund the plan and imposes a lien on the employer's real and personal assets and the assets of affiliated entities, if the required contribution is not met.[24]

WHEN DO I GET AN ERISA EXPERT INVOLVED?

ERISA should not be intimidating, once you understand that the vast majority of ERISA's obligations fall on the employer (or whomever else has been designated as a fiduciary) sponsoring the plan. So, just because an ERISA-governed plan is in the picture does not mean you need to speed dial your ERISA expert. But I do think it is valuable to consult an expert (a) the first time the company is accepting investments from ERISA plans or selling a product to the plan market; (b) when managing plan assets and engaging in a transaction with someone who may be associated with a plan; (c) when signing agreements with ERISA warranties or covenants; and (d) when a financial service provider's in-house plan is using proprietary investments. As with all laws, it is always better to think about compliance at the beginning, not at the end. Hopefully this "In the Beginning" article has helped the reader have enough of a compass to navigate the world of annuities in ERISA-governed plans. ■

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ENDNOTES

1 A word about DOL's Fiduciary Rule. You may have heard that DOL's Fiduciary Rule was such a big deal because it covered IRAs as well as ERISA-governed plans. To explain: Internal Revenue Code section 4975 contains rules that parallel some of ERISA's rules, particularly the prohibited transaction rules described later. Because of the parallel nature, DOL has been given authority to interpret both the Code and ERISA versions of these rules. So DOL's Fiduciary Rule would have changed the landscape for IRAs, not because they are subject to ERISA but because the prohibited transaction rules in Code section 4975 were covered by DOL's rule.

2 ERISA § 4(a), (b).

3 For example, section 38.1133 of the Michigan Public Employee Retirement System Investment Act requires that those who manage assets of the public retirement system are fiduciaries and that they act with certain duties of care, prudence, skill and diligence very similar to the duties that ERISA imposes.

4 29 C.F.R. § 2510.3-3(b). The terms "H.R. 10" and "Keogh" plan come from a law passed in 1962, which was originally H.R. 10 and co-sponsored by Representative Eugene Keogh (D-NY). The law allowed self-employed individuals to save in qualified retirement plans by treating their self-employment income as qualifying compensation for plan contributions. The name stuck, and when DOL issued regulations after the passage of ERISA explaining that plans without employees are not subject to ERISA, the regulations referred to "Keogh" or "H.R. 10" plans. So, lucky Keogh has a fame that continues well past his death in 1989.

5 29 C.F.R. § 2510.3-2(f).

6 Yes, that's right. The assumption is that the most senior executives in a company will be wearing top hats.

7 ERISA §§ 301(a)(3), 401(a)(1); 29 C.F.R. § 2520.104-23.

8 29 C.F.R. § 2510.3-102.

9 ERISA § 401(b)(2).

10 ERISA § 402(a).

11 You may hear people talk about an ERISA "3(21)" fiduciary as being different from a "3(38)" fiduciary. Section 3(21) of ERISA sets out the three kinds of fiduciaries in the bulleted list in the text. Section 3(38) of ERISA describes an "investment manager" who meets certain requirements. Under ERISA, if investment discretion is handed over to an investment manager who meets the requirements of section 3(38), the appointing fiduciary receives some protection for decisions that the investment manager makes. But a "3(38)" fiduciary is really just a subset of fiduciaries described in section 3(21) of ERISA.

12 ERISA § 404(a).

13 ERISA § 409(a).

14 In most modern 401(k) and 403(b) plans, the authority to make investment decisions is delegated to individual employees with respect to their accounts. This occurs under section 404(c) of ERISA, which provides some protection for the plan's fiduciaries when employees have that right. In such a plan, the plan's fiduciaries will reallocate the investments within the annuity based on the instructions of the employees.

15 ERISA § 406(a).

16 ERISA § 406(b).

17 ERISA § 408(b)(5).

18 ERISA § 103(a)(2).

19 29 C.F.R. § 2550.408b-2.

20 29 C.F.R. § 2550.404a-5.

21 ERISA § 105(a).

22 ERISA § 4041(b)(3)(A).

23 ERISA § 502(a)(9).

24 ERISA § 303(k).