401(k) Plans

401(k) or 403(b)—Tomāto, Tomäto?

The author explores recent IRS regulations impacting 403(b) plans, which match the oversight requirements and fiduciary standards of 401(k) plans. However, there are some key differences between 403(b) and 401(k) plans in terms of testing requirements, contributions levels, investment options, and auditing procedures.

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The last few years have brought significant changes to the 403(b) world. The IRS' first update to the regulations in more than 40 years directly imposed new plan document and oversight requirements and indirectly created renewed focus on the application of fiduciary standards to those who sponsor, manage, and provide services to 403(b) plans. The Department of Labor took the debate one step further when it published Field Assistance Bulletin 2010-01, confirming that many (some would argue most or all) nongovernment, nonchurch 403(b) plans using only a single investment vendor are indeed subject to Title I of ERISA. While all of these developments mean that 403(b)s look and feel more like 401(k) plans than ever, there are still a number of features unique to the 403(b) plan that should not be overlooked.

Eligibility and Nondiscrimination Testing

Elective Deferrals

One of the key differences between 401(k) and 403(b) plans is the requirement that 403(b) plans make salary deferrals universally available [Treas. Reg. § 1.403(b)-5(b)(1)]. In essence, that means that, with very few exceptions, anyone who is an employee of a not-for-profit ("NFP") sponsoring a 403(b) plan must be eligible to make elective deferrals. A 401(k) plan can, of course, impose eligibility requirements of up to one year of service and attainment of age 21, and can also exclude classes of employees assuming that the coverage rules of Code Section 410(b) are met.

In exchange for the inability to impose eligibility requirements, elective deferrals to a 403(b) plan are not subject to the actual deferral percentage ("ADP") test that applies to 401(k) plans. While this gives the 403(b) plan an edge in the great 401(k)/403(b) debate, there are several reasons it is not a slam-dunk. First, the inability to impose eligibility requirements increases the number of employees who are considered to be eligible participants for purposes of determining whether a plan is required to be audited each year (see Form 5500, below). Second, many small to mid-sized NFPs do not have the budget to pay higher salaries, and NFPs do not have shareholders. That makes it entirely possible there will be no highly compensated employees ("HCEs") covered by the plan, meaning there would be no ADP test in a 401(k) plan anyway—that is, 401(k) plans without HCEs do not need to test for nondiscrimination.

Employer Match and Nonelective Contributions

The 401(k) and 403(b) plans are on a level playing field when it comes to employer contributions. Both are subject to the minimum coverage requirements under I.R.C. § 410(b), the actual contribution percentage ("ACP") test under I.R.C. § 401(m) with respect to matching contributions, and the nondiscrimination requirements under I.R.C. § 401(a)(4) for nonelective contributions [Treas. Reg. § 1.403(b)-5(a)(1)]. It is this last test that is sometimes overlooked. It seems to be a somewhat common 403(b) plan design to provide tiered nonelective contributions based on length of service. When using such a design, each rate of contribution must be tested to ensure it is effectively available to participants on a nondiscriminatory basis. If the only participants with enough years of service to attain

the highest rate of contribution are HCEs, the tiered structure may need to be revisited. Furthermore, if the plan's allocation formula has failed the nondiscrimination requirements in previous years, corrective action should be taken.

Contribution Limits

Compensation, Elective Deferrals, and Annual Additions

Most of the contribution limits are the same for 403(b) plans as for 401(k) plans. Compensation is capped at the I.R.C. § 401(a)(17) limit of $245,000 [Treas. Reg. § 1.415(c)-2]; elective deferrals are capped at the I.R.C. § 402(g) limit of $16,500 [Treas. Reg. § 1.403(b)-4(c)(1)]; and annual additions are capped at the I.R.C. § 415 limit of the lesser of $49,000 or 100% of compensation [I.R.C. § 403(b)(1)], all as indexed.

Ketchup. . . er . . . Catch-Up Contributions

While 403(b) plans can allow participants who are age 50+ to make the same $5,500 in catch-up contributions as are available to 401(k) participants [Treas. Reg. § 1.403(b)-4(c)(2)(i)], certain types of NFPs can offer a second type of catch-up contribution in their 403(b) plan. Participants with at least 15 years of service who have made annual deferrals of less than $5,000 per year on average are entitled to make special catch-up contributions of up to $3,000 per year [Treas. Reg. § 1.403(b)-4(c)(3)]. The aggregate "15-year catch-up" cannot exceed $15,000 for any participant. Those employees who are eligible for both types of catch-up contributions may be able take advantage of both in the same year; however, the IRS requires that an employee maximize his or her 15-year catch-up prior to making any age 50+ catch-up contributions [Treas. Reg. § 1.403(b)-4(c)(3)(iv)].

This additional catch-up provision is only available to employers that are hospitals, educational institutions, home health services agencies, health and welfare agencies, and religious organizations. Furthermore, sponsors choosing to offer this additional catch-up must include the appropriate provisions in their plan documents.

Post-Severance Contributions

Similar to 401(k) plans, 403(b) plans have the option to permit elective deferrals from certain forms of compensation paid following severance from employment. The allowable forms of post-severance compensation generally include amounts earned but not yet paid, e.g., bonuses; unused paid leave (vacation or sick leave); and certain distributions from deferred compensation arrangements [Treas. Reg. § 1.415(c)-2(e)(3)].

NFPs have the unique option to provide additional benefits to terminated participants. A 403(b) sponsor can make post-severance nonelective contributions based on compensation earned during the participant's most recent one-year period of full-time service. These special contributions are subject to the regular annual additions limit and can be made for up to five years immediately following severance from employment [Treas. Reg. § 1.403(b)-4(d)(1) & (2)].

Investment Options

In the early days, the fixed annuity was pretty much the only investment product available to 403(b) plans. Although the options have expanded in the last 50 years, investment alternatives remain limited to annuities, mutual funds held, and certain life insurance contracts issued prior to September 23, 2007. Although there is a limited exception for certain church plans, individual stocks, bonds, and other alternative investments generally are not permitted.

Plan accounts can be established either at the plan or group level, such as a group annuity contract, or on the individual participant level. Since individual accounts are typically established pursuant to a contract between the participant and the investment vendor, the plan sponsor has virtually no control over such accounts and only limited access to account information. As a result, individual accounts make it nearly impossible for a plan sponsor to change vendors to take advantage of new features, better service, or lower fees because they cannot "force" the participants to move their individual accounts to the new provider's platform.

This limitation leads to potential fiduciary concerns, as 403(b) sponsors may find themselves "stuck" paying fees that are not reasonable in light of the services provided. For those sponsors that do make a change, there can be logistical challenges due to having to maintain accounts with a prior vendor for those individuals who do not elect to transfer to the new provider. The DOL provided some degree of transition relief for certain individual accounts of terminated participants to which no deposits were made after December 31, 2008 [DOL Field Assistance Bulletin 2009-02].

Form 5500 and Independent Audit

The requirement to file Form 5500 is not new for ERISA 403(b) plans; however, new rules have greatly expanded the amount of information that must be reported. In the past, 403(b) sponsors had to complete only the first page of Form 5500, which includes the sponsor's and plan's basic identifying information. Beginning with the 2009 plan year, 403(b) sponsors must now file a full Form 5500 to include participant counts, financial statements, and all other schedules and attachments required for 401(k) plans.

Plans with more than 100 participants as of the first day of the plan year are now subject to the requirement to engage an independent qualified public accountant ("IQPA") to audit the plan and to file the auditor's report along with Form 5500. Since participant count includes those who are eligible but not contributing plus terminated employees with remaining balances, the universal availability requirement (described above) means that any 403(b) sponsor with close to 100 employees may be required to have its plan audited. The cost of an audit can easily run into five figures, so NFPs should watch their participant counts carefully and budget accordingly.

Which One Is Better?

The short answer is that there is no definitive answer as to whether the 401(k) or the 403(b) outshines the other. A sliced beefsteak tomato is probably the better choice to go on that hot-off-the-grill hamburger, while plum tomatoes are most likely the way to go for pasta sauce. If your chili recipe calls for diced tomatoes, you're probably okay with either type. Similarly, the question of whether a 401(k) plan or 403(b) plan is better depends on the how the plan will be used.

The limitations on terminations and mergers between 401(k) and 403(b) plans generally dictate that an NFP maintaining a plan will continue with that same type of plan. If a new plan will cover HCEs who wish to defer significantly more than the NHCEs and/or the employer wishes to allow for added benefits for older workers, the 403(b) plan may be the way to go. If participants want to utilize "alternative" investment options or the employer is looking to control participant counts, the 401(k) plan may be the best option. For a plan that has no HCEs, invests exclusively in mutual funds, and is either well over or well under 100 participants, get out the crock pot…it might just be time for some chili. ■