403(B) PLANS

Now the Question Is: To 401(k) or to 403(b)?

By ILENE H. FERENCZY

Which plan is better? The answer will vary for different organizations and individuals depending upon each unique set of circumstances.

Now that the Small Business Job Protection Act of 1996 (SBJPA) has again made the popular 401(k) plan available to tax-exempt organizations, people are scrambling to assess which type of plan is better for their organization. In this case, one organization's meat is really another's poison. This column examines some of the issues that should be considered by a tax-exempt entity when choosing between the two kinds of retirement programs for its employees.

If your organization is neither a public school nor exempt under Code Section 501(c)(3), a 401(k) plan is your only option. Section 403(b) plans are available only to public schools and 501(c)(3) organizations. Therefore, any other exempt organization wanting a pretax salary deferral program for its employees must adopt a 401(k) plan.

Although having only one choice results in easy decision making, consultants should pause for a moment of reverence. SBJPA has produced one of those rare marketing opportunities—opening a new mine of clients that were previously out of reach. For nearly ten years, tax-exempt entities that were neither 501(c)(3) organizations nor public schools witnessed the expansion of 401(k) and 403(b) plans while being prohibited from offering the important benefit of pretax deferrals to their employees. Many of these organizations are now jumping on the bandwagon, and will be looking for consultants and service providers for assistance.

403(b) plans are the "no average deferral percentage (ADP) test" alternative for salary deferrals. Many 401(k) plan sponsors struggle annually with the balancing routine needed to pass ADP testing. Often, executives are required to take returned deferrals into income, or are severely limited each year in how much they can defer. Alternatively, the plan sponsor is forced to make qualified nonelective contributions (QNECs) to boost deferral percentages for non-highly compensated employees.

All this effort is avoided in a 403(b) plan, making the 403(b) approach hard to beat in that setting.

There is a trade-off, however, for nonchurch organizations that select a 403(b) arrangement over a 401(k) plan. Almost all employees must be given the opportunity to make salary deferrals to a 403(b) plan, essentially from their date of hire. Sponsors of 401(k) plans, on the other hand, can limit access to the plan by having eligibility requirements or by excluding groups of employees. Somewhat restrictive eligibility provisions eliminate the administrative costs involved in setting up payroll systems and plan accounts for short-term employees (assuming, of course, that they defer).

No nondiscrimination testing *at all* is required for a 403(b) plan sponsored by a church organization (even when contributions are made by the employer). Therefore, not only is ADP testing avoided for church plans, but so, too, are average contribution percentage (ACP) testing for matches and employee contributions and 401(a)(4) testing for profit-sharing-style contributions. Being able to avoid nondiscrimination testing altogether is a significant advantage 403(b) plans have over 401(k) plans for churches.

BENEFITS LIMITATIONS AND AGGREGATION

Section 401(k) plans are subject to the Section 415 limits and are aggregated with all other qualified plans that are sponsored by the employer. On the other hand, in most circumstances, 403(b) plans must meet Section 415 limits on their own, and are not aggregated with other qualified plans of the employer for this purpose. An exception to this exclusion—requiring aggregation—exists when the participant at issue controls the em-

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ployer. What "control" means exactly in a nonprofit setting is unclear, and is unlikely to be resolved until at least the year 2000, because the IRS has again delayed the timetable for issuing regulations on that subject. [Rev Proc 96-64, 1996-51 IRB 1 (12/16/96)]

The general rule that 403(b) arrangements and qualified plans of the employer are not aggregated for Section 415 purposes is a bit misleading, however, since these programs *are* aggregated for purposes of the maximum exclusion allowance. Also, participants making the "C" election under Code Section 415(c)(4) must aggregate qualified and 403(b) plans. (The "C" election enables an employee to limit contributions made to the 403(b) program to the lesser of 25 percent of pay or $30,000—the limit under Code Section 415—without regard to the limitations under the maximum exclusion allowance.) Therefore, 403(b) plan participants are not able to completely ignore benefits earned in qualified plans sponsored by the employer.

The exclusion allowance is retrospective, however, and may produce substantial opportunity for larger contributions when someone has not participated in a plan for several years of employment. Such an individual could receive an allocation of 25 percent of Section 415(c) compensation in the organization's qualified plan, and an additional 25 percent of such compensation in the 403(b) program, which would enable the participant—who is likely to be in his or her sunset years of employment—to aggressively accumulate retirement benefits. There are other catch-up elections available in 403(b) plans that allow long-term employees to contribute additional amounts to the plan. None of these catch-up provisions is available in a 401(k) setting.

Changes in the 415 limits under SBJPA create a different picture in the year 2000. Section 415(e) will be repealed at that time, allowing participants to ignore benefits earned in a defined benefit plan for purposes of determining allowable contributions to the 401(k) plan. On the other hand, contributions to defined benefit plans are still counted against a participant's maximum exclusion allowance in the 403(b) plan. So, although being able to ignore aggregation for Section 415 purposes may have been an attractive element of 403(b) plans in past years, being able to ignore defined benefit plans may weigh in favor of 401(k) plans in the new millennium.

FUNDING OPTIONS: STILL A CONCERN?

One of the main limitations on 403(b) flexibility is the limitation on allowable investment vehicles. 403(b) funds may be invested only in insurance company annuities or mutual funds in a custodial account. (Participant loans may be taken from either vehicle.) Section 401(k) monies, on the other hand, may be invested in many different vehicles.

The investment limitations of 403(b) arrangements may be an issue to some employers. However, as a result of the Department of Labor (DOL) regulations issued under ERISA Section 404(c), an increasing number of 401(k) plans invest exclusively in mutual funds and group variable annuity products. If plan assets will be placed in mutual funds, regardless of the type of plan, the fact that the 401(k) plan could have dumped money into that really terrific limited partnership is likely to be less important. On the other hand, an organization may want to hire an investment manager to maximize the investment returns earned for its participants. In that case, only a 401(k) plan offers the necessary breadth of investment options to allow the manager to weave his or her magic.

TITLE I COVERAGE: THAT REPORTING AND DISCLOSURE THING

The controversy surrounding some 403(b) plans' exemption from coverage under Title I of ERISA has been explored in previous columns. [Reish and Ferenczy, "The Overlooked ERISA Dilemma," 2 *J Pension Benefits* 4 (Summer 1995) 82] Only church plans and deferral-only plans can avoid Title I coverage, and—in the latter case—only if the employer plays an extremely limited role in plan operations. The DOL's Susan Lahne recently confirmed in a speech at the annual conference of the American Society of Pension Actuaries (ASPA) that this exception to Title I coverage is very narrowly drawn. This may mean that relatively few non-church plans are really exempt from Title I, regardless of popular opinion to the contrary.

403(b) plans that are exempt from Title I are not required to comply with many reporting and disclosure requirements. These requirements generally include: (1) filing the Form 5500 annual return/report; (2) providing summary plan descriptions to the participants and the DOL; and (3) giving participants a copy of

the summary annual report. In addition, it appears that non-Title I 403(b) arrangements are not subject to the qualified joint and survivor annuity rules. On the other hand, it is likely that non-Title I arrangements do not benefit from the ERISA protection from creditors.

Even if a 403(b) plan is covered by Title I, the reporting and disclosure requirements are less comprehensive than those required for a qualified plan. The annual return requirement is much easier to fulfill, because only a small portion of the Form 5500 needs to be completed. There has been considerable confusion about some of the other reporting requirements, and that confusion still exists if one refers only to written guidance provided by the DOL. Nevertheless, the DOL's Susan Lahne clarifed that the DOL's interpretation of the 403(b) Title I requirements is that (1) no independent CPA audit is required, even if the 403(b) plan covers more than 100 employees, (2) no Schedules A are required to be filed for 403(b) plans, even if the funds are invested in insurance contracts, and (3) no Schedules P are required, since there is no trustee. How this affects the running of the statute of limitations for purposes of the Form 5500—which is generally begun upon filing the Schedule P—is not clear.

Many 403(b) sponsors find it important not to be burdened with Title I requirements. Similarly, many sponsors may discover that avoiding the costs of a CPA audit of the plan is very attractive. If these are important elements, such sponsors should avoid the 401(k) route, since all 401(k) plans covering non-owners are covered by Title I.

PLAN DEFECTS: HOW DEADLY ARE THEY?

Both 401(k) and 403(b) plans owe their tax-sheltered status to their conformance with strict Internal Revenue Code requirements. Many of these requirements are the same or similar whether the plan is a 401(k) or 403(b) program. On the other hand, how those requirements are monitored and enforced by the IRS for each type of plan is very different.

A problem in the plan documentation is called a form defect. 401(k) plans must meet the strict IRS rules for plan documentation, and plan sponsors are advised to secure favorable determination letters (FDLs) to confirm that these rules are met. Conversely, 403(b) documentation requirements are much less rigid. Many 403(b)s are documented only by a loose confederation of company policies and annuity contracts. The only means by which a 403(b) sponsor can confirm that a 403(b) document meets all legal requirements is to apply to the IRS headquarters in Washington, DC, for a private letter ruling–a more costly (and surprisingly uncommon) process than the FDL procedures.

Although a form defect could cause the loss of tax-sheltered status to either plan type, the relative lack of strict documentation requirements for 403(b) programs makes this more likely to happen to a 401(k) plan. In addition, according to IRS representatives, a failure to follow the written terms of the 403(b) plan document does not create a defect, whereas this is a disqualifying defect for a 401(k) or other qualified plan.

Operational defects, on the other hand, can plague both 403(b) and 401(k) plans. These problems relate to actions taken (or omitted) during a plan's existence that cause it to fail the requirements for tax-sheltered status. An operational defect in a 401(k) or other qualified plan generally causes a loss of tax-sheltered status for the entire plan, even if the defect is relatively minor. Because of this potentially draconian result, the IRS has established several programs to assist sponsors in protecting the plan's qualified status, including the Voluntary Compliance Resolution (VCR) and Simplified VCR (SVP) programs managed by the IRS headquarters in Washington, DC, and the Voluntary Closing Agreement Program (Walk-in CAP), which is administered at the local IRS office level.

403(b) program defects are handled quite differently. The IRS has established three levels of 403(b) defects. Only a few types of operational defects—most of which are fairly severe violations of the law, such as discrimination in contributions—can cause the entire 403(b) program to lose its tax sheltered status. Other defects cause some individual participants to owe taxes on a part or all of their individual accounts. These types of defects are much more manageable than similar defects for qualified plans. Of course, if noncompliance is rampant throughout the plan, having all participants individually taxed is tantamount to plan disqualification.

The only programs under which a defective 403(b) plan can protect its tax-sheltered status are the Tax Sheltered Voluntary Correction program (TVC) and

the clsoing agreement procedures, both of which are administered out of the IRS headquarters. Therefore, very few (if any) problems may be resolved locally.

Much has been written about the fact that many 403(b) plans are not in full compliance with the tax code. The IRS has instituted a national audit initiative directed at 403(b) programs, and has made a review of the 403(b) plan part of its audit program for tax-exempt entities. It is not clear whether the audit risk for 403(b) plans is now the same as or higher than that for 401(k) plans. However, one can say unequivocally that defects discovered in an IRS audit will be treated seriously, whether they are in a 403(b) or a 401(k) plan.

PORTABILITY AND ACCESS: WHOSE PLAN IS IT, ANYWAY?

The IRS and many plan sponsors consider the 403(b) plan to belong to the individual employee. Therefore, there is often a much higher level of benefit portability under 403(b) programs than there is for 401(k) plans. In fact, many employers allow employees to choose their own 403(b) contract to receive deferral contributions, and these funds may be transferred from one 403(b) account to another at the employee's will.

Thus, it is easier for an employee to use the same 403(b) annuity contract or custodial account for 403(b) benefits from several employers. (For example, a teacher may use the same TIAA/CREF annuity contract for 403(b) benefits earned from a series of different schools during a working lifetime.) It also means that there is some ambiguity in the law about whether a plan can be truly terminated by action of the employer. After all, the employer cannot force a distribution of benefits from the 403(b) plan on termination, since the employee is the one who controls the account. Without a distribution of all benefits (that is, a balance sheet showing zero as the end-of-year assets), the plan is not considered to be terminated for purposes of the Form 5500 series filings.

Although employees enjoy more freedom to move their 403(b) funds from one vehicle to another, such amounts can only be transferred or rolled over to another 403(b) program or to an IRA. 401(k) funds are more flexible and can be rolled over to any other qualified plan, as well as to an IRA. This added flexibility may provide a greater range of portability between plans of successive employers, particularly when an individual moves between for-profit and not-for-profit organizations.

SO WHICH PLAN IS BETTER?

This question is akin to asking which type of qualified plan is better for a given employer. It depends on many factors, and the answer may be different for every employer. In all likelihood, educational institutions, which are heavily invested (both financially and procedurally) in 403(b) programs, will be slow to make a change to 401(k) programs. Nonprofit health institutions, on the other hand, are in a great state of flux in many respects these days, with an increasing number becoming owned or operated by for-profit organizations. For these entities, the ability to have one plan for all subsidiary companies (whether for-profit or nonprofit) will be attractive, and one more change in their currently volatile business environment will not be too much to handle.

TVC STATUS: AN ASIDE

The IRS has closed its fourth TVC case. What is significant in this case is what *didn't* happen. The IRS found that what the sponsor thought was a defect (the failure to follow the plan document's terms) was not, and that it could not result in the loss of tax-sheltered status—and issued a letter to this effect to the plan sponsor. While this letter does not guarantee that no other defect could exist that would create a loss of tax-sheltered status, it would be a powerful tool in the event of an audit.

This doesn't mean that every 403(b) plan sponsor should immediately trump up a possible defect and submit it to the IRS in the hopes of getting a "no defect" letter. However, if a sponsor is concerned about a situation that may or may not be a defect (particularly when the law is unclear, as is the case with so many of the 403(b) rules), it could be worthwhile to file under TVC. If there is a defect, it will be resolved under the program; if there isn't, the IRS will provide written assurance of that fact. All in all, not a bad deal.