403(b) Versus 401(k) Plans: Plan Design Options and Considerations

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Plan Design Options for Tax-Exempt Organizations

Today's focus:

- Key differences between 403(b) and 401(k) plans
- Advantages/disadvantages
- Which plan type may be the best option for the employer
- Plan design considerations

Plan Design Options for Tax-Exempt Organizations

Our discussion is associated with 501(c)(3) tax-exempt organizations.

- What types of plans can a 501(c)(3) tax-exempt organization sponsor?
  - 401(k)
  - 401(a) (Profit Sharing or Money Purchase)
  - 403(b)
  - 457(b) Top Hat
  - 457(f) Top Hat

Note: A number of tax-exempt organizations sponsor 403(b), 401(a), and 457(b) Top Hat plans.

403(b) Plans: ERISA Versus Non-ERISA

- 403(b) plans – ERISA or non-ERISA
  - "Subject to ERISA" means participants' benefits and rights are protected.
    - These include eligibility, participation, funding, reporting, disclosure, anti-alienation, anti-assignment, bonding and fiduciary duty
  - 403(b) plans may be exempt from ERISA requirements if certain conditions are met.
    - Regulatory exemption
      - ✓ Employer cannot exercise discretionary authority and decision-making.
      - ✓ Additional factors must be considered.
    - Statutory exemption
      - ✓ This applies to governmental plans and non-electing church plans.

403(b) Versus 401(k): Basic Differences

General requirements:

	ERISA 403(b) plan	401(k) plan
Who can sponsor?	Section 501(c)(3) tax-exempt organization, educational institution, or electing church employer	Any business entity, including tax-exempt organization, corporation, partnership, or sole proprietor Note: A governmental entity is ineligible from sponsoring a 401(k) plan unless the plan is grandfathered
Funding vehicle and investment options	Annuity contract that satisfies Section 403(b)(1) or mutual funds held in a Section 403(b)(7) custodial account	Group annuity contract or trust that may hold investments such as mutual funds, nonregistered separate accounts, stocks, bonds, or employer securities
Written plan document	Required	Required

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403(b) Versus 401(k): Basic Differences

Who can sponsor?

- Only certain tax-exempt and governmental entities may sponsor 403(b) plans:
  - 501(c)(3) – no other tax-exempt organizations
  - Public schools and certain governmental entities

Note: there are a number of organizations under 501(c); it <u>must be 501(c)(3)</u>.

<u>Governmental entities</u> are employers who have a "dual status" as both non-profit 501(c)(3) and governmental. These organizations may sponsor both 403(b) and 457(b) governmental plans.

403(b) Versus 401(k): Basic Differences

Funding vehicles:

- 403(b) – Annuity and/or Custodial Accounts
- 401(k) – Group Annuity or Trust
  - More flexibility and options for participants – stocks, bonds…brokerage account.

Plan design consideration – If an employer or key decision-maker wants flexibility and access to stocks and bonds, then a 401(k) plan is most likely the best option.

403(b) Versus 401(k): Basic Differences

Eligibility and entry requirements:

	ERISA 403(b) plan	401(k) plan
Eligible Employee	Salary deferrals: "universally available"; exclusions include: • Employees normally scheduled < 20 hours/week • Student employees • Nonresident aliens without U.S. source income • Employees covered under other 401(k), 403(b), or 457(b) governmental plans • Employees with deferrals < $200 Employer contributions: • Exclusions allowed provided Section 410(b) minimum coverage passed	All contributions available to all employees; exclusions include: Statutory exclusions: • Nonresident aliens without U.S. source income • Collectively bargained employees Non-statutory exclusions: • Exclusions allowed provided Section 410(b) minimum coverage test passed
Entry requirements	Salary deferrals: • Age and/or service requirement not permitted Employer contributions: • Age and/or service requirement permitted – Maximum age requirement of 21 years – Maximum requirement of 1 year of service; 2 years if full and immediate vesting	Salary deferrals: • Age and/or service requirement permitted – Maximum age requirement of 21 years – Maximum requirement of 1 year of service Employer contributions: • Age and/or service requirement permitted – Maximum age requirement of 21 years – Maximum requirement of 1 year of service; 2 years if full and immediate vesting

403(b) Versus 401(k): Basic Differences

- 403(b) – Universal availability

  What does that mean? Every employee (with limited exceptions) must be allowed to make salary deferrals to the plan.

  Note: Actual Deferral Percentage test (ADP) does not apply.

    - Exclusions allowed
        - Employees scheduled to work fewer than 20 hours/week
        - Student employees (for education organizations)
        - Employees covered under other plans
        - Employees with deferrals of less than $200/year

- Employer contributions (matching and non-elective) – the same rules and testing apply to both 403(b) and 401(k) plans.

- Plan design consideration – A 401(k) plan may be the "best" option if the employer intends to exclude employees from being able to make salary deferrals to the plan (410(b) minimum coverage applies). But why?

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403(b) Versus 401(k): Basic Differences

Plan design considerations:

	ERISA 403(b) plan	401(k) plan
Safe harbor design	Allowed – deemed to have passed the Actual Contribution Percentage test (ACP)	Allowed – deemed to have passed the ADP and/or the ACP test
Vesting	Salary deferrals: ○ Full and immediate Employer contributions: ○ Maximum 3-year cliff or 6-year graded vesting schedule	Salary deferrals: ○ Full and immediate Employer contributions: ○ Maximum 3-year cliff or 6-year graded vesting schedule
Plan-to-plan transfers	90-24 transfers replaced with contract exchanges and plan-to-plan transfers	Transfers allowed between 401(k) plans in certain circumstances

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403(b) Versus 401(k): Basic Differences

- ADP and ACP testing
  - 403(b) – ADP does not apply
  - 401(k) – ADP and ACP test applies

  Note: safe harbor plan option/rules apply to both.
- Exchanges and transfers
  - 403(b) – contract exchange versus 403(b) – plan-to-plan transfer
    - What's the difference? When do these occur?

Plan design considerations – A 403(b) offers an advantage in that HCEs may defer maximum each year (without fear of refunds for deferrals). The rules/requirements concerning exchanges and transfers are mostly for the initial setup (multiple vendors) and the day-to-day operation of a 403(b) plan.

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403(b) Versus 401(k): Basic Differences

Contribution limits:

Please note: Generally, the 415 limit applies individually to each plan ("control" exception). In 2016, an employee could receive $53,000 in each type of plan. The 402(g) limit requires aggregation of the deferrals made to all 403(b) and 401(k) plans for the calendar year. For 2016, an individual's limit to defer in both plans is $18,000 exclusive of catch-up contributions.

	ERISA 403(b) plan	401(k) plan
Contribution limits	415 limit – the lesser of 415 compensation or the 415 limit as indexed: 2016 limit is $53,000 Includes employee and employer contributions Excludes age 50 catch-up contributions Note: The 15-year special catch-up is included in the 415 limit.	415 limit – the lesser of 415 compensation or the 415 limit as indexed: 2016 limit is $53,000 Includes employee and employer contributions Excludes age 50 catch-up contributions
Roth	Permitted	Permitted
Catch-up contributions	Age 50 catch-up permitted 15-year special catch-up permitted for certain employers and specific service and contribution requirements Qualifying employees may contribute up to $3,000 more than the applicable 402(g) limit	Age 50 catch-up permitted

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403(b) Versus 401(k): Basic Differences

- Contribution limits and aggregation among plans:
  - 402(g) limit – individual calendar-year limit includes contributions to both 401(k) and 403(b)
  - 457(b) – NOT included in the 402(g) dollar limit (separate limit applies for 457 plans and 403(b)/401(k) plans
  - 415 limit – applies separately to 403(b) and 401(k) plans (with certain exceptions)

Plan design consideration – Employees may be able to maximize contributions if an employer sponsors both a 403(b) or 401(k) <u>and</u> a 457(b) Top Hat plan. It's possible to maximize employer contributions by using both a 403(b) and a 401(a)/(k) plan.

403(b) Versus 401(k): Basic Differences

403(b) 15-year special catch-up provision:

- Rules/requirements:
  - Service counted/employed by a "qualified organization"
  - Years of service – at least 15 years of service with the current employer. Part-time employees?
  - Eligibility to utilize – an employee must not have contributed on average more than $5,000 or more for each year of service to any elective deferral plan of the employer, including 401(k), SARSEP and SIMPLE.
  - Contribution limit – an eligible participant may be able to defer an additional $3,000 each year under this provision.
  - Lifetime catch-up limit – the total aggregate amount that may be contributed under this 15-year special catch up is $15,000.
  - Interaction with age 50 catch-up – the 15-year special catch-up provision is required to be used first.

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403(b) Versus 401(k): Basic Differences

403(b) 15-year special catch-up provision (continued):

- Should an employer offer this provision?
  - Advantage(s): May allow a participant to defer additional amounts to the plan. Note: $5,000 average deferral limit may prevent an employee from using it
  - Disadvantage(s): Requires calculation and maintenance of employee records for a period of at least 15 years. In addition, an auditor may focus on this provision in order to determine it's being calculated and handled correctly.
- Did the age 50 catch-up provision eliminate the need for a 15-year special catch-up?
- Trend: some employers are removing the 15-year catch-up from 403(b) plans.

  Note: Not considered a 411(d)(6) protected benefit

Plan design consideration – no longer considered a "significant" advantage for 403(b) plans due to changes in employee work history, age 50 catch-up option, the burden to employer, and more.

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403(b) Versus 401(k): Basic Differences

Testing requirements:

	ERISA 403(b) plan	401(k) plan
Nondiscrimination testing	<u>Salary deferrals</u> • Universal availability requirement • No formal test <u>Employer matching contributions</u> • ACP test • 410(b) minimum coverage test <u>Employer non-elective</u> • 401(a)(4) general test • 410(b) minimum coverage test Note: Benefit, right, or feature test may apply.	<u>Salary deferrals</u> • ADP test • 410(b) minimum coverage <u>Employer match</u> • ACP test • 410(b) minimum coverage test <u>Employer non-elective</u> • 401(a)(4) general test • 410(b) minimum coverage test Note: Benefit, right, or feature test may apply.
Top-heavy rules	Not applicable	Applicable unless plan meets exception available for 401(k) safe harbor plan design

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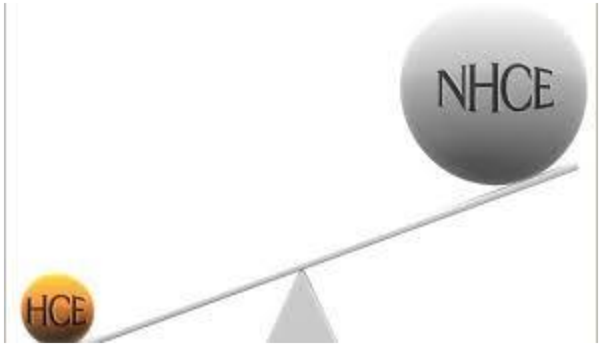
403(b) Versus 401(k): Basic Differences

- Testing requirements
  - 403(b) “advantage”
    - No ADP test
    - No top-heavy test

Plan design considerations – As noted earlier, 403(b) offers an advantage for HCEs since no test is applicable to salary deferrals. Top-heavy test doesn’t apply. (Consider the definition of key employees.)



403(b) Versus 401(k): Basic Differences

Reporting and disclosure requirements:

	ERISA 403(b) plan	401(k) plan
Form 5500	Required	Required
Audit requirement	Required if plan has more than 100 lives	Required if plan has more than 100 lives
Participant disclosure and notice requirements	○ Summary Plan Description (SPD)/ summary of material modification (SMM) ○ Summary annual report (SAR) ○ Benefit statements ○ Fee disclosure ○ Special tax notice ○ Universal availability notice The following <u>may</u> apply: ○ Safe harbor notice ○ Automatic enrollment ○ QDIA ○ Blackout/SOX notice	Same, except universal availability does not apply. In addition, employer stock diversification may apply.

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403(b) Versus 401(k): Basic Differences

- Reporting and disclosure
  - Main difference is universal availability
    - What does employer need to do to meet the universal availability requirement?
    - Is there an annual notice requirement?
    - What are best practices?
    - What does the auditor or agent look for or expect to see?

Plan design consideration – the primary consideration is how to communicate to employees their options/abilities to make salary deferrals to the 403(b) plan.

Additional Plan Design Considerations

- Additional plan design considerations:
  - Why would an eligible organization adopt a 401(k) plan rather than a 403(b) plan?
  - Can it be advantageous to sponsor both a 401(k) plan and a 403(b) plan?
  - Plan are design options and considerations for mergers and acquisitions?

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Adopt a 401(k) Rather Than a 403(b)?

- Why would an eligible organization adopt a 401(k) plan rather than a 403(b) plan?
  - Lack of understanding or possible assumption that a 401(k) is better
  - Eligibility or possible exclusion of certain employee classes/groups for salary deferral purposes
  - Universal availability requirement versus ADP testing
    - May be able to project results and determine which option is better
  - Different investment options or the ability to utilize certain types of investments

Maintain Multiple Plans

- Is it advantageous to maintain a 403(b) and a 401(k) or 401(a) plan?
  - May allow an employer to “double up” contributions for some groups

<u>Additional considerations</u>

  - A number of nonprofit employers still have more than one plan.
    - The 403(b) plan typically will accept salary deferrals and the 401(a) plan will accept employer non-elective contributions.
    - The 401(a) plan may accept the employer match associated with the deferrals to the 403(b) plan.
    - Employers can promote a “two-plan” approach with employees.

Mergers/Acquisitions

- 403(b) and 401(k) plans in organizational transactions/acquisitions
  - May acquire an entity that has a plan
  - 403(b) or 401(k) plan may be terminated, but these plans cannot be merged with an unlike plan (church exception)
  - Successor plan rules – terminate versus merge
  - Paternalistic retirement "leakage" concerns for terminated plans – how does the employer handle these?

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Questions?

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