RETIREMENT AND DEFERRED COMPENSATION PLANS FOR TAX EXEMPT ORGANIZATIONS

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The views expressed in this chapter are strictly those of the authors.

The authors would like to express their appreciation to Ron Merolli, Director of Advance Sales at National Life, and Katherine M. Glenn, for their efforts regarding this chapter.

SYNOPSIS

RETIREMENT AND DEFERRED COMPENSATION PLANS
FOR TAX EXEMPT ORGANIZATIONS

§1.01 INTRODUCTION

Tax exempt organizations[1] possess certain unique characteristics and are subject to specific Internal Revenue Code[2] provisions which need to be considered when designing and implementing qualified retirement plans and deferred compensation plans for these organizations. The 501(c)(3) organizations even enjoy a unique retirement plan vehicle - the 403(b) plan.[3] This chapter will explore what distinguishes the tax exempts from other business entities and discuss why retirement plans and deferred compensation plans are so important to these organizations. This chapter will also explain the significant features of 401(a), 403(b), SEPs, SIMPLEs, 457(b) and 457(f) plans and explore the relative advantages and disadvantages of each. Finally, this chapter will analyze who should serve as trustee of the qualified retirement plan and set forth how a tax exempt organization can establish these plans.

§ 1.02 UNIQUE CHARACTERISTICS OF TAX EXEMPTS

[1] Generous Benefits

Tax exempt organizations are often among the most generous providers of employee benefits as evidenced by their relatively high level of contributions on behalf of employees to retirement plans. In order to make up for lower salaries, tax exempt organizations often create

[1] In this chapter we use the term "tax exempt organizations" to mean those organizations that are exempt from income tax under I.R.C. §501(c). While certain other organizations are also exempt from income taxation under I.R.C. §501(d), our primary focus in this article is upon those organizations that are exempt from income tax under I.R.C. §501(c), including trade associations and charitable organizations, among others.

[2] The Internal Revenue Code of 1986, as amended, (hereinafter "Code@ or "IRC@).

[3] While the 403(b) plan is also available to public schools and universities, this article will focus on the use of 403(b) plans by 501(c)(3) organizations.

a benefits package which is more generous than that generally found in the for profit world. There is often pressure from the board members or outside donors (in the case of 501(c)(3) organizations) to keep the salaries of the staff and management employees low. Donors may focus on the salaries of the top management employees to evaluate overhead and administrative costs. Board members of a trade association often do not want to pay the CEO of the association more than they are paid themselves as head of their own companies. Employee benefits, however, are often not given the same amount of scrutiny. This generosity is at least partly a response to the employees' perception that their salaries are below market. Perhaps another reason for this generosity may be due to the absence of owners in the closely-held business world where every dollar given to staff employees for employee benefits is a dollar less profit/compensation for the owners and of stockholders in the publicly traded corporate arena where overhead costs for staff employees are kept low to keep profit high for the stockholders.

[2] Recruitment and Retention of Employees

Tax exempts, which seldom, if ever, have union employees, often use their retirement plan as an employee and management recruitment and retention tool. Tax exempt organizations frequently offer a fixed commitment plan with a fairly long vesting schedule, such as a defined benefit plan or a money-purchase pension plan, in order to reward their long term employees, and also offer a 401(k) plan with a very short vesting schedule to benefit their transient and younger employees. CEOs, COOs or CFOs, concerned about retaining their most valuable employees, often spend time analyzing what type of plans best meet these employees' needs. Because the benefits are often quite substantial, these plans become an important piece of the overall compensation structure for these employees. When the plans are properly designed, implemented and communicated, they are appreciated by management and staff alike.

[3] Top-Heavy Rules Generally Do Not Apply

Even though many tax exempt organizations are more similar in size to closely held businesses than to publicly traded businesses, the majority of plans offered by tax exempt organizations, unlike the plans of for-profit small to mid-size enterprises, are not subject to the top-heavy rules.[4] Because there are no stockholders in a tax exempt organization, the only way an employee can be deemed a key employee[5] for top-heavy purposes is to be an officer making more than $130,000 a year (indexed for inflation). Factors taken into account in determining who is an "officer" are the source of a person's authority, the term for which he or she is elected or appointed, and the nature and extent of the individual's responsibilities.[6] Based on the governance structure of many tax exempts, one could argue there are no key employees; none of the officers of the organization are employees, and senior management, even those with a title such as CEO or executive director, often do not have independent decision-making responsibility and are charged only with implementing the decisions of the board. Even with associations with this governance structure, it is probably prudent to consider the top staff positions in the tax exempt organization as key employees when determining if the plan is top-

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[4] A "top-heavy@ plan is defined in I.R.C. §416 as a plan in which the present value of accrued benefits for key employees is more than 60% of the present value of accrued benefits of all employees.

[5] A "key employee@ is defined under I.R.C. §416 as an officer having annual compensation greater than $130,000 (indexed for inflation), a more than 5% owner, or a more than 1% owner having annual compensation of more than $150,000 (not indexed).

[6] I.R.C. §416.

heavy.[7] It is not unusual, however, to find that only the CEO or the Executive Director can be considered a key employee under IRC § 416. Unless the association employs very few staff members, it is unlikely that the tax exempt's plan will be top-heavy.

[4] Unique Plans Available Only to Tax Exempts

[a] *457(b) and 457(f) Plans*

[7] The authors have encountered very few top-heavy association plans.

Only tax exempts, along with governmental or state organizations,[8] are allowed to sponsor 457(b) and 457(f) plans.[9] Tax exempts generally offer the 457(b) plan only to the top-hat employees, a select group of management, or highly compensated employees.[10] Prior to EGTRRA, however, employees could not double up on cash or deferred contributions made to a 401(k) or 403(b) and a 457(b) plan. Beginning in 2002, the cash or deferred contribution limitation was decoupled, and those employees who are covered by a 457(b) plan are now able to make a full 401(k) contribution and a full 457(b) contribution.

[b] *403(b) Plans*

Only 501(c)(3) organizations and public and private school systems are allowed to sponsor 403(b) plans. Historically, tax exempt entities were less likely than taxable entities to establish qualified retirement plans for their employees under I.R.C. §401(a) since the tax deductions available to employers under 401(a) plans were not meaningful to entities that were already exempt from income taxes. If tax exempt organizations offered their employees

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[8] For these purposes, a state governmental organization includes a state, its political subdivisions, and an agency or instrumentality of either. I.R.C. §457(e)(i)(A).

[9] Except for 401(k) plans established by tax exempts before July 2, 1986, tax exempt organizations were not allowed to sponsor 401(k) plans. The congressional rationale was that tax exempt organizations did not need 401(k) plans since they had 457(b) plans. This was a rather bizarre rationale since 457(b) plans could only be offered to top-hat employees, whereas 401(k) plans are required to satisfy the coverage rules of IRC §410(b). Thus, staff employees were precluded from making cash or deferred contributions into a retirement plan unless the tax exempt had a grandfathered 401(k) plan (one established before July 2, 1986) or was a 501(c)(3) organization. 401(k) plans were reinstated for tax exempt organizations by the Small Business Job Protection Act of 1996 (SBJPA).

[10] ERISA §201(2). See §1.10, §457(b) eligible plans. Highly compensated employees include any employee (i) who was a 5% owner at any time during the year at issue or the preceding year, or (ii) who, for the preceding year, had compensation in excess of $80,000, adjusted for inflation and, if the employer elects, was in the top paid group of employees for the preceding year. The compensation amount for determining highly compensated employees is increased in increments of $5,000, and it was increased to $90,000 in 2002. Notice 2001-84, 2001-53 I.R.B. 642. The top paid group of employees includes the top 20% of employees in terms of compensation. I.R.C. §414(q).

retirement accounts or annuities at all, the plans usually were not qualified plans. Accordingly, the employees could not defer taking the contributions to the plan into current income.

Initially, Congress responded to this perceived problem by allowing employees of tax exempt organizations to defer from income tax the employer's contributions to retirement plans. Some nonprofit organizations, particularly hospitals, began to "abuse" this power, however, and started paying staff physicians significant portions of their income in this tax deferred form. To restrict this "abuse," Congress created 403(b) tax sheltered annuities (TSAs) in 1958, limiting the amount of income that could be contributed each year to the plan. In 1961, TSAs were extended to employees of public and private schools, and in 1974, they were extended to mutual fund shares held in custodial accounts.

§ 1.03 403(b) TAX SHELTERED ANNUITIES

Employers that are exempt from income taxation under I.R.C. §501(c)(3) may purchase annuity contracts[11] on behalf of their employees on an income tax deferred basis. The employee's rights under the contract must be non-forfeitable, except for the failure to pay future premiums.[12] Subject to certain limitations, the employer's contributions (including employer contributions under a salary reduction agreement) and other additions will be excluded from the employee's gross income in the year contributed, and annuity values will be

[11] Custodial accounts that are invested in regulated investment company stock and from which distributions may not be paid or made available to the employee or beneficiary before the employee dies, attains age 59½, has a severance from employment, becomes disabled, or, with respect to contributions under a salary reduction agreement, encounters financial hardship, are also treated as annuity contracts under I.R.C. §403(b). I.R.C. §403(b)(7). In addition, retirement income accounts that are defined contribution programs established or maintained by a church or a convention or association of churches for the benefit of qualified employee also are treated as annuity contracts under I.R.C. §403(b). I.R.C. §403(b)(9). Herein, annuity contracts, custodial accounts and retirement income accounts will all be referred to as tax sheltered annuities or 403(b) plans.

subject to income tax only when amounts are actually distributed to the employee or beneficiary.[13]

[1] Cash or Deferred Contributions

Depending on the plan design, employees may be able to make a variety of contributions to a 403(b) plan on a tax-deferred basis, including elective deferrals,[14] special I.R.C. §403(b) catch-up contributions,[15] and age 50 catch-up contributions.[16] Employers may make additional employer contributions.[17] Each of these contributions is subject to separate limitations, and the total amount of annual additions[18] that may be excluded from current income also is limited.

[a] *Elective Deferrals*

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[12] I.R.C. §403(b)(1)(C).

[13] I.R.C. §403(b)(1).

[14] Elective deferrals include employer contributions (i) under a qualified cash or deferred arrangement under I.R.C. §401(k), (ii) to a Simplified Employer Pension ("SEP@) under I.R.C. §§ 402(h)(1)(B) and 408(k), (iii) to a 403(b) plan, or (iv) to a savings incentive match plan for employees ("SIMPLE@) under I.R.C. §408(p). They do not, however, include salary reductions under an employee's one-time, irrevocable election made when the employee first becomes eligible to participate in the salary reduction or elective deferral arrangement. I.R.C. §402(g)(3).

[15] I.R.C. §402(g)(7).

[16] I.R.C. §414(v).

[17] I.R.C. §415(c).

[18] I.R.C. §415(c)(2) defines "annual additions@ to include employer contributions, employee contributions and forfeitures.

Elective deferrals, if permitted by the plan, are limited to $12,000 in 2003, increasing to $15,000 in 2006.[19] This limitation is applied to all elective deferrals by the employee, not simply to elective deferrals made by the employee to a particular employer's 403(b) plans.[20] Accordingly, any elective deferrals by the employee to a 401(k), SEP or SIMPLE plan in the same year reduce the amount of elective deferrals to 403(b) plans that the employee may exclude from income in the same year.[21]

[b] *Special 403(b) Catch-Up Contributions*

Employees of educational organizations, hospitals, home health service agencies, health and welfare service agencies, and churches (including a convention or association of churches), if the employee has completed 15 years of service with the employer, may increase elective deferrals to a tax sheltered annuity by up to $3,000 per year. The total amount of these catch-up contributions, however, are subject to two lifetime limits, both of which must be satisfied. Total special catch-up contributions may not exceed the lesser of (i) $15,000 and (ii) the aggregate of the amount per year of employment by which the employee's average elective deferrals during employment with the employer are less than $5,000 per year.[22]

[c] *Age 50 Catch-Up Contributions*

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[19] I.R.C. §402(g)(1). These limitations are increased after 2006 for inflation in $500 increments, but are subject to the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGGTRA"), P. L. 107-16, 115 Stat. 38 (May 26, 2001).

[20] I.R.C. §§402(g)(1), 402(g)(3)(C) and 402(g)(4).

[21] Note that contributions to an eligible 457(b) deferred compensation plan ("457(b) plan@) are not treated as elective deferrals for this purpose. Thus, contributions to a 457(b) plan do not reduce the maximum elective deferrals that an employee may make, and similarly, elective deferrals do not reduce the amounts that may be contributed to a 457(b) plan. I.R.C. §§457(b)(2)(A) and (b)(15).

[22] I.R.C. §402(g)(7).

403(b) plans may also offer age 50 catch-up contributions ($2,000 in 2003 increasing to $5,000 in 2006).[23] Age 50 catch-up contributions to 401(k), 403(b), 408(k) and 408(p) plans are coordinated, so that a contribution to one plan reduces the allowable catch-up contributions to the others, but separate, additional age 50 catch-up contributions may be made to 457(b) governmental plans.[24]

[d] *Total Annual Additions*

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[23] I.R.C. §414(v).

[24] I.R.C. §414(v)(2)(D).

Subject to certain non-discrimination requirements, 403(b) plans may permit nonelective employer contributions and employer matching contributions in addition to elective deferrals. The total amount of annual additions on behalf of an employee, however, is limited to the lesser of $40,000 (for 2002) or 100% of includable compensation.[25]

Note that all defined contribution plans "maintained by an employer" are treated as a single plan for purposes of applying the I.R.C. §415 limitations. Thus, the limitation applies to the aggregate of contributions on behalf of an employee to all plans operated by the same employer (with all employers within a controlled group or affiliated group being treated as a single employer).[26]

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[25] I.R.C. §415(c). Includable compensation consists of compensation received from the employer during the most recent year of service, excluding nonelective employer contributions or matching contributions to the 403(b) plan, but including (1) amounts that are received by the employee within 5 years of termination from service and that are based upon the employee's includible compensation during the last 12 months of employment (e.g., payments for disability, sick leave, or vacation leave), (2) elective deferrals to a 401(k), 403(b), SEP or SIMPLE, (4) contributions to a 457(b) plan, and (4) income deferred under a §125 cafeteria plan or a §132(f)(4) transportation fringe benefit program.

[26] At least one commentator appears to indicate that under certain circumstances, the 415(c) limitation applies separately to 403(b) plans and to 401(a) qualified pension, profit sharing, stock bonus or annuity plans maintained by the same employer, so that the employer could contribute up to $40,000 to each plan (total of $80,000) reduced by the employee's elective deferrals. Harvey B. Wallace II, "Retirement Benefits Planning Update,@ Probate & Property (January/February 2003).

The commentator appears to be relying on Treas. Reg. §1.415-8(d). Under this regulation, unless the employee is in control of the employer, then only the employee is treated as maintaining the 403(b) annuity, and the employer is not treated as also maintaining the annuity. If the employee is treated as maintaining the 403(b) annuity, and if the employer is treated as maintaining the 401(k) plan, the $40,000 limitation arguably would apply separately to the employee (with respect to the 403(b) plan) and the employer (with respect to the 401(k) plan). In essence, the employee functions as a separate "employer@ with respect to the 403(b) plan, at least for the purposes of the §415(c) limitations.

The authors note that this interpretation is not inconsistent with the usual understanding of these regulations.

The fact pattern in the regulations involves two separate employers, each of which offers a plan that covers a single employee. This is quite different from the situation in which a single employer (e.g., the medical school) offers a 401(k) plan and a 403(b) plan to its employees. In this second fact pattern, most commentators would agree that the 415(c) limitation applies in the aggregate to both plans rather than individually to each plan. Most commentators appear reluctant to rely on I.R.C. §415(k)(4), which states that a 403(b) plan is treated as a plan maintained by the employer if the participant in the TSA owns more than a 50% interest in the employer, to conclude that a 403(b) plan in which the employee does not have a control relationship with the employer is owned by the employee for purposes of applying the 415(c) limitation. Yet this appears to be the required predicate for concluding that the 415(c) limitation applies separate to a 401(k) plan and a 403(b) run by the same "economic@ employer. Only with this predicate can one argue that the "employer@ offering the 403(b) plan, with respect to the 415(c) limitation, is the employee.

[e] *Discrimination Requirements*

Separate non-discrimination rules apply to elective deferrals, on the one hand, and employer nonelective contributions, matching contributions and employee after-tax contributions on the other.[27] Currently, the non-discrimination requirements for all of these types of contributions are satisfied if the employer operates the 403(b) annuity plan under a good faith, reasonable interpretation of the requirements. Although the regulations do not define what constitutes a good faith, reasonable interpretation of the regulations, they do, provide for certain safe harbors.[28] The non-discrimination and coverage rules do not apply to tax sheltered annuities maintained for church employees,[29] and except for the compensation limits of I.R.C. §401(a)(17),[30] do not apply to governmental plans.[31]

[f] *Elective Deferrals*

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[27] I.R.C. §403(b)(12).

[28] Notice 89-23, 1989-1 I.R.B. 654.

[29] I.R.C. §403(b)(1)(D).

[30] Compensation taken into account may not exceed $200,000 adjusted for increases in the cost of living.

[31] I.R.C. §403(b)(12)(C).

With limited exceptions, all employees must be eligible to defer annually more than $200 under the salary reduction agreement, and the opportunity to make elective deferrals must be available to all employees on the same basis. Employees who participate in the employer's 457(b) plan,[32] 401(k) plan or another 403(b) plan may be excluded from a particular 403(b) plan. Non-resident aliens earning no U.S. source income[33] and employees working fewer than 20 hours per week may also be excluded.[34] In contrast with 401(k) plans, however, exclusion based upon age, years of service or collective bargaining arrangements is not permitted.

[g] *Contributions Other Than Elective Deferrals*

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[32] This exception allows for creative planning opportunities. In order to facilitate satisfying the discrimination rules applicable to a 403(b) plan, a top-hat employee who is eligible to participate in a 457(b) plan could be excluded entirely from the 403(b) plan.

[33] Student employees providing services for a school, college or university while enrolled at such institution may also be excluded. Exclusion of student employees, however, is subject to the minimum coverage requirements of I.R.C. §410(b)(4).

[34] I.R.C. §403(b)(12).

Contributions other than those made under a salary reduction agreement must satisfy the requirements of I.R.C. §§401(a)(4),[35] 401(a)(5),[36] 401(a)(17), 401(m),[37] and 410(b).[38] Notice 89-23 establishes three safe harbors for satisfying these requirements. Depending upon the degree of disparity between the highest percentage of compensation contributed by a highly compensated employee and the lowest percentage of compensation contributed by a non-highly compensated employee, the safe harbors create (i) standards for participation rates among non-highly compensated employees and (ii) representation rates of non-highly compensated employees among all employees accruing benefits under the plan. Under the maximum disparity safe harbor, the contribution percentage of a highly compensated employee may reach 180% of the lowest contribution percentage of a non-highly compensated employee.

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[35] Plans cannot discriminate in favor of highly compensated employees, excluding collectively bargained employees and non-resident aliens receiving no U.S. source earned income. There are two safe harbors for satisfying these nondiscrimination requirements. A plan that allocates contributions using the same percentage of compensation or same dollar amount for each employee satisfies the "uniform formula@ safe harbor. A plan that allocates contributions based on "points@ credited to a participant can satisfy the "age or service weighting formula@ safe harbor. Points must be provided on a uniform basis for compensation, age or years of service. If the safe harbors are not met, the plan must use cross testing, under which nondiscrimination testing is done in terms of benefits rather than contributions. Allocations are converted into equivalent accrual rates to satisfy the defined benefit general test under Treas. Reg. §1.401(a)(4)-8(c)(2). See, Califmade and Cohn, "401(k) Safe Harbors Work for Small Business,@ New York University Fifty-Eighth Institute on Federal Taxation: Employee Benefits and Executive Compensation (2000), (hereafter, "Safe Harbors Work for Small Business@), at 2.05[3].

[36] A classification under the plan may be limited to salaried or clerical employees; contributions and benefits may bear a uniform relationship to compensation; disparity in contributions or benefits between highly compensated employees and non-highly compensated employees must satisfy the permitted disparity limitations of I.R.C. §401(l).

[37] I.R.C. §401(m) includes non-discrimination rules for matching contributions and employee contributions. If this requirement is not satisfied through meeting safe harbor standards, then the plan must be tested annually under the actual contribution percentage test ("ACP@ test). If the test is not satisfied, the plan must either return "excess@ deferrals to highly compensated employees or increase employer contributions on behalf of non-highly compensated employees. See, "Safe Harbors Work for Small Business,@ at 2.05[4].

[38] I.R.C. §410(b) imposes minimum coverage requirements and includes an average benefits percentage test.

[h] *Distributions*

The minimum distribution requirements[39] apply to all amounts accruing in a 403(b) plan after December 31, 1986.[40]

[i] *Restrictions on Withdrawals*

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[39] I.R.C. §401(a)(9).

[40] I.R.C. §403(b)(10); Treas. Reg. §1.403(b)-3, Q&A 2. Note that earnings after December 31, 1986 on the pre-1987 account balance are subject to the minimum distribution requirements. The required minimum distribution for a year is therefore calculated based upon the post-1986 account balance (including earnings upon pre-1987 assets), and any distribution in a year in excess of the required minimum distribution is attributed first to the pre-1987 balance. Treas. Reg. §1.403(b)-3, A-2(c). The pre-1987 account balance must, however, be distributed in accordance with the incidental benefit requirements, and commencement of distributions from this portion of a 403(b) account cannot be delayed once the employee reaches age 75. Treas. Reg. §1.403(b)-3,Q&A 3. A complete discussion of the minimum distributions requirements is beyond the scope of this paper. See, Calimafde and Cohn, "Taking Maximum Advantage of Retirement Plan Assets,@ Maryland Bar Journal, (March/April 2003).

Certain restrictions on withdrawals apply, depending upon the type of contribution to the plan. With respect to 403(b) annuity contracts, amounts attributable to elective deferrals may be withdrawn without penalty only when the employee attains age 59½, has a severance from employment,[41] dies, or becomes disabled, or in the case of hardship.[42] Hardship distributions are limited to elective deferrals, excluding any income attributable to the deferral.[43] The withdrawal restrictions apply only to post-1986 contributions. Moreover, they do not apply to contributions that are not elective deferrals, such as mandatory employee salary reduction contributions, contributions under a one-time irrevocable election by the employee made when the employee initially becomes eligible to participate in the plan, after-tax contributions and employer contributions.

Restrictions on withdrawals from 403(b)(7) custodial accounts apply to all amounts in the account, not only to amounts attributable to elective deferrals. Account balances may not be withdrawn until the employee attains age 59½, has a severance from employment, becomes disabled or dies.[44] In addition, amounts attributable to elective deferrals, including earnings on

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[41] For distributions before 2002, the standard was "separation from service.@ This standard was changed in the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA@). Under the "separation from service@ standard, the "same desk rule@ applied: no separation from service is deemed to occur if the employee continues the same job responsibilities under a new employer as a result of a liquidation, merger, consolidation or similar corporation reorganization. In contrast, an employee would have a severance from employment under that factual situation.

[42] I.R.C. §403(b)(11). Amounts in the annuity contract as of December 31, 1988 are grand-fathered and withdrawal restrictions do not apply.

[43] I.R.C. §403(b)(11)(B).

[44] I.R.C. §403(b)(7)(A)(ii). Not only do these restrictions apply to all amounts in the 403(b)(7) custodial account, not merely elective deferrals, but the grandfather provisions that apply to pre-1989 amounts in 403(b) annuity accounts apply to 403(b)(7) accounts only with respect to the hardship exception applicable to elective deferrals.

elective deferrals, may be withdrawn if the employee encounters financial hardship.[45]

Custodial account funds that are transferred to an annuity account remain subject to the broader withdrawal restrictions applicable to custodial accounts.[46] Amounts transferred from an annuity contract to a custodial account become subject to the custodial account restrictions and appear to lose any grandfather protections.

§1.04 401(k) PLAN DESIGNS FOR TAX EXEMPT ORGANIZATIONS

[1] 401(k) Plans

A 401(k) plan is a type of retirement plan which allows employees to make pre-tax deferrals of their salary. In order to encourage participation, tax exempt organizations can match up to 100% of all or a portion of each employee's 401(k) contribution. In addition, the tax exempt organization can continue to choose, on an annual basis and in its discretion, to make profit sharing contributions to the plan.

A 401(k) plan can allow employees to save up to $12,000 in 2003, with this limit increasing in $1,000 increments over the next three years. Starting in 2007, the $15,000 401(k) limitation will be indexed for inflation. When employees make a 401(k) contribution, they are in effect contributing a portion of their salary directly into a 401(k) account in the plan instead of receiving the money in a paycheck. The money saved in the 401(k) plan, as well as the earnings on that money, are not taxed while in the plan. The 401(k) portion of the plan can therefore be considered similar to a jumbo IRA for employees.

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[45] The Department of Labor, in Advisory Opinion 94-30A, has indicated that an employer's involvement in verifying hardship may cause the plan to lose its exemption from ERISA, the Employee Retirement Income Security Act of 1974, 29 USC §1001, et seq.

[46] Rev. Rul. 90-24, 1990-1 C.B. 97. See §1.11, §457(b) Eligible Plans.

In addition, employees who are age 50 or older by the end of the calendar year can make "catch-up" contributions over and above the $12,000 limit. Catch-up contributions allow employees who are approaching retirement age to "catch up" to younger employees who have longer to save for retirement. Employees age 50 and older can contribute an additional $1,000 each year in catch-up 401(k) contributions, up to an additional $5,000 in 2006. For 2003, the allowable catch-up contribution is $2,000. Beginning in 2007, the catch-up contribution is indexed to the cost of living. These catch-up contributions are **not** included in the IRC §415(c) 100% of compensation or $40,000 contribution limit imposed on each plan participant.

A 401(k) plan is subject to anti-discrimination tests because Congress and IRS are concerned that key employees are likely to have the ability to decrease their current income by a greater amount than the non-highly compensated employees. In an attempt to equalize this perceived problem or inequity, Congress has required the employer to perform complex testing known as the "ADP" tests so that the amount the highly compensated employees can contribute to the plan is limited by what the non-highly compensated employees contribute plus any employer contributions which are immediately 100% vested and non-forfeitable. (The 100% vested employer contributions that can be taken into account are profit sharing contributions and matching contributions.) In the event (which is a likely occurrence) that the non-highly compensated employees do not make sufficient 401(k) contributions to allow the highly compensated employees to maximize their contributions and still pass the ADP tests, then either the highly compensated employees§ 401(k) deferrals have to be lowered, or an additional 100% vested profit sharing contribution or 100% vested match must be made for the non-highly compensated employees in an amount which will allow the plan to pass the ADP tests.

The adjusted deferral percentage for an employee is determined by dividing (I) the employee's 401(k) contributions plus any 100% vested employer contributions made on behalf of the employee by (ii) the employee's compensation. All of the ADPs for the non-highly compensated employees are averaged, as are the ADPs for the highly c ompensated employees. Then the tests below are applied to make sure the ADP for highly compensated employees is not too high. There are currently two alternative ADP tests: The average ADP for the highly compensated employees cannot exceed 1.25 times the average ADP for the non-highly compensated employees, or the average ADP for the highly compensated employees cannot exceed twice the average ADP for the non-highly compensated employees with no more than a 2 percentage point spread.

The 401(k) testing can be made easier by using prior year's results for non-highly compensated employees. By doing this, the tax exempt organization will know early in the year how much the highly compensated employees will be able to contribute to the 401(k) plan. This allows the highly compensated employees to plan accordingly.

[a] *401(k) Safe Harbor Plan Design*

Alternatively, a tax exempt organization can "safe harbor" its 401(k) plan. Congress added the safe harbor 401(k) plan designs to allow companies to forgo the complex 401(k) ADP tests in exchange for making safe harbor contributions on behalf of their non-highly compensated employees. There are two ways to safe harbor a 401(k) plan. First, the tax exempt organization can contribute 3% of compensation for every eligible non-highly compensated employee. If the association makes this 3% safe harbor contribution, referred to as a non-elective safe harbor contribution, then the plan is not required to do any ADP testing, and every eligible employee, key or non-key, highly compensated or non-highly compensated, can contribute as much as he or she wants up to the maximum 401(k) amount (currently $12,000). The 401(k) contributions for the highly compensated employees are no longer limited by the 401(k) contributions made by the non-highly compensated employees; because of the safe harboring of the plan, it no longer matters what 401(k) contributions are made by the staff employees.

The employer can also "safe harbor" the plan and avoid ADP testing by matching every non-highly compensated employee's 401(k) contribution in one of the following ways:

(i) *Basic matching formula*

The basic matching formula is a 100% match on 401(k) contributions that do not exceed 3% of the employee's compensation, and a 50% match on the employee's 401(k) contributions that exceed 3% but do not exceed 5% of the employee's compensation.[47]

(ii) *Enhanced matching formula*

[47] I.R.C. §401(k)(12)(E)(ii) and 401(m)(11)(i).

The enhanced matching formula is a formula under which (A) the total rate of match at each and every level of elective contributions is at least as high as that under the basic matching formula, (B) the matching rate does not increase with increases in the rate of elective contributions, and (C) the rate of match for any highly compensated employee does not exceed the rate of match for any non-highly compensated employee at the same level of elective contribution.[48] For example, a plan that matches 100% of an employee's elective deferrals up to 4% of compensation will qualify as an enhanced matching formula. Similarly, a plan that matches 125% of employee elective deferrals up to the first 3% of employee deferrals and matches 25% of elective deferrals from 3%-4% of compensation, with no additional match thereafter, also satisfies the criteria.[49]

[48] I.R.C. §§401(k)(12)(B)(iii) and 401(m)(11)(i); I.R.S. Notice 98-52, 1998-46 I.R.B. 16.

[49] A plan that provides the basic matching formula for one group of employees (consisting of non-highly compensated employees) and a 100% match for elective deferrals up to 5% of compensation for a second group of employees (consisting of highly compensated employees) does not satisfy the safe harbor since matches provided to the highly compensated employees who elect to defer amounts in excess of 3% of compensation exceed the matches available to the non-highly compensated employees in the first group electing to defer the same percent of compensation. Similarly, a plan that matches 100% of elective deferrals up to 2% of compensation but only 25% of additional elective deferrals up to 5% of compensation does not satisfy the enhanced formula matching contribution safe harbor since the rate of match for elective deferrals in excess of 2% of compensation is less than the rate of match under the basic formula. Finally, a plan that matches 100% of elective deferrals up to 3% of compensation and 150% of elective deferrals of the next 2% of compensation does not qualify since the rate of match increases as the rate of deferral increases. For an excellent outline of 401(k) safe harbors, see Merl, Safe Harbor 401(k) Plans. Although written prior to I.R.S. Notice 2000-3, this article, which was presented by Elinor R. Merl at the 1999 ASPA Conference (Oct. 25, 1999), includes several of the examples discussed in this text.

Prior to the beginning to the plan year, each employee must be given notice that the plan intends to rely upon a safe harbor formula.[50] The notice must inform the employee of his or her rights and obligations under the plan, describe the safe harbor matching or nonelective contribution formula that will be used, and indicate whether other contributions may be made under the plan.[51] All matching contributions and nonelective contributions used to satisfy the safe harbor must be non-forfeitable and subject to the withdrawal restrictions of I.R.C. §401(k)(2)(B): they must be fully vested and may not be distributable earlier than the employee's attainment of age 59½, separation from service, death or disability, termination of the plan without creation of a successor plan, disposition of a subsidiary or hardship.

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[50] This notice must be given within a "reasonable period@ prior to the beginning of the plan year. "Reasonable period@ is generally deemed to be at least 30 days and no more than 90 days before the beginning of each plan year. Special guidelines apply for a newly eligible employee and for new employees who are immediately eligible to participate. See, Calimafde and Cohn, "401(k) Safe Harbors Work For Small Business,@ The New York University 58th Institute on Federal Taxation, Employee Benefits and Executive Compensation (2000).

[51] The notice must include additional information as well. For details, see Calimafde and Cohn, "401(k) Safe Harbors Work for Small Business,@ supra at §2.09.

401(k) plans are also subject to certain coverage requirements designed to ensure that the plan extends benefits to a significant percentage of non-highly compensated employees as well as highly compensated employees.[52] To meet this requirement, a 401(k) plan must satisfy one of three tests: (1) the plan must benefit at least 70% of non-highly compensated employees,[53] (2) the percentage of non-highly compensated employees covered by the plan must be at least 70% of the percentage of highly compensated employees covered by the plan,[54] or (3) the plan must either benefit a nondiscriminatory classification of employees or must provide an average benefit percentage for the group of all non-highly compensated employees that is at least 70% of the average benefit percentage provided for the group of all highly compensated employees.[55] Contributions may not be subject to a "year of service" requirement, nor may they be conditioned upon the employee's being employed on the last day of the plan year. The plan, however, can require, as conditions of eligibility to participate in the plan, that the employee attain at least age 21 and that the employee satisfy a "year of service" requirement. Additional employer profit sharing contributions under the plan may be subject to a vesting schedule, to a 1,000 hour of service requirement, and to a requirement that the employee be employed on the last day of the plan year. Vesting and withdrawal restrictions may also be imposed on matching contributions not needed to satisfy the safe harbor test. For example, if an employer elects under I.R.C. § 410(b)(4) to treat employees who have not yet

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[52] I.R.C. §410(b) applies to all I.R.C. §401 qualified plans, not only to 401(k) plans.

[53] I.R.C. §410(b)(1)(A).

[54] I.R.C. §410(b)(1)(B).

[55] I.R.C. §§410(b)(2)(A)(i) and 410(b)(2)(A)(iii).

attained age 21 or completed a year of service separately for Section 410 coverage purposes, and if the plan is accordingly treated as two separate plans (with one plan benefiting only employees who do not satisfy these requirements), then either plan can satisfy the ADP test safe harbor independently of the other. In essence, the employees who do not satisfy either the age 21 or year of service requirement are treated as not being eligible employees so long as the employer has elected to treat them separately for coverage purposes under Section 410(b). However, the plan must then specifically provide that elective contributions (and, if applicable, matching contributions) on behalf of the employees who are not "eligible" employees, will satisfy the traditional ADP test (and, if applicable, the traditional Actual Contribution Percentage ["ACP"] test.).[56]

[56] I.R.S. Notice 98-52, 1998-46 I.R.B. 16, at Part IX.B.1; I.R.S. Notice 2000-3, 2000-4 I.R.B. 413., at Q&A #10.

Tax exempt organizations should carefully consider taking advantage of the 401(k) safe harbor plan design, particularly if the organization is already contributing 3% for the non-highly compensated employees or making a match similar to one described above. Unfortunately, as the law stands today, a tax exempt organization that already sponsors a 401(k) plan will only be allowed to safe harbor the plan for the next succeeding plan year since, as previously mentioned, the employer must provide notice of the safe harbor at least 30 days, but not more than 90 days, prior to the beginning of the plan year. A tax exempt organization that does not yet have a 401(k) plan, or that would like to add a 401(k) option to its existing profit sharing plan, may safe harbor the plan in conjunction with adding the 401(k) feature.[57]

[b] *Designing 401(k) Plans to Achieve Maximum Employee Appreciation*

Prior to the collapse of the stock market, 401(k) plans were the most popular plans among employees. (Since the decline in the stock market, employees are beginning to understand the advantages of the defined benefit plan.) A tax exempt organization which sponsors a 401(k) plan that is not appreciated by its employees should consider making, increasing, or perhaps changing the composition of employer contributions to the plan. The company can either make a profit sharing contribution that all eligible employees will receive, or add a matching contribution that only those employees who are making 401(k) contributions will receive.

Tax exempt organizations are sometimes surprised to find that many staff employees do not particularly value matching contributions. Employees who need all of their cash flow for

[57] If a tax exempt organization is considering adding a 401(k) feature to an existing profit sharing plan or making an existing 401(k) plan a safe harbor plan, the tax exempt organization should seek out a qualified plan

monthly expenses can not make significant 401(k) contributions and therefore perceive the matching contribution as an unfair benefit geared to employees who are more well off. The single mother who needs every dollar to support her family is understandably not particularly pleased that her single male co-worker is getting a significant match on his 401(k) contributions. Employers with these employee demographics should consider adding a profit sharing component to their 401(k) plan. The profit sharing component will benefit all eligible employees regardless of a particular employee's economic situation. The tax exempt organization can do this by either reducing the existing match and converting those dollars into a profit sharing contribution or by simply increasing the company's overall contribution to the plan.

A tax exempt organization that is changing its plan to add a profit sharing component should meet with all of the employees to explain how all of the employees will share in the profit sharing contribution. By doing so, the tax exempt organization will receive credit for being sensitive to the employees' discontent with the existing plan and for changing the plan to better suit the employees' needs. Changing the plan without communicating and explaining to employees the reasons for the change is a common error. The tax exempt organization should have one or more of its advisors explain the change to the employees, using the occasion also to go over available investment choices and review other pertinent provisions of the plan.

[c] *Additional Matches for Particular Groups of Employees*

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attorney or advisor since this transition is fraught with rules that confound many providers.

Most tax exempt organizations believe that a match has to benefit all employees who are making 401(k) contributions across the board and, as a general rule, this is true. Some tax exempt organizations that are trying to reward a particular group of employees, for instance, older employees or those with greater longevity, have adopted more creative matching contribution provisions. For example, a tax exempt 401(k) plan may have a double layer of matches. The first match would be designed to benefit all employees who make 401(k) contributions - the company, for example, could provide a dollar for dollar match up to the first 4% of an employee's compensation. The second match would benefit only those employees who make a 401(k) contribution and have worked with the tax exempt organization for, say, three years.[58] Alternatively, the plan could have several levels of matches based on years of service and/or age. For example, the plan could match 401(k) contributions for all employees with fewer than three years of service at 25 cents on the dollar, match all 401(k) contributions for employees with more than three and fewer than 10 years of service at 50 cents on the dollar, and match all 401(k) contributions for employees with more than 10 years of service at $2.00 for every dollar contributed. This type of creative match would be combined with the general match and would have to pass the "ACP" rules.[59]

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[58] For plan document purposes, the language for the additional match would most likely be expressed in terms of years of service.

[59] This type of plan design cannot be accommodated under a prototype plan and would require the plan to be individually designed. Many tax exempt organizations prefer their plans to be individually designed in any event. Not only can the design be more carefully tailored to the needs of the tax exempt organization, but the plan document itself is easier to understand because the plan provisions are actually inserted into the plan document. By inserting the plan provisions in the plan document, one can read one document rather than reading both the adoptive agreement and the prototype plan document to understand a particular provision. In some cases, this approach results in an additional IRS user fee to receive the IRS determination letter. Employers with no more than 100 employees and with at least one non-highly compensated employee participating in_the plan do

The ACP tests apply to matching contributions and employee after-tax contributions. The actual contribution percentage compares the sum of the matching contributions and employee after-tax contributions[60] paid under a plan on behalf of a participant during a plan year with the participant's compensation. The test may be satisfied in one of two ways:

the ACP for all highly compensated employees may not be more than 1.25 times the ACP for all non-highly compensated employees, or the ACP for highly compensated employees may not be more than 2 percentage points greater than the ACP for non-highly compensated employees and may not be more than double the ACP for non-highly compensated employees.[61]

[d] *Combining a Cross-Tested Profit Sharing Allocation with a 401(k) Plan Design*

Tax exempt organizations can add a "cross-tested" profit sharing plan allocation (described in detail in §1.07 below) to the 401(k) plan. This provides flexibility for the staff employees with respect to deciding how much money they want to defer into the plan (i.e., 401(k) contributions), while allowing the tax exempt organization to provide greater benefits for its most valuable employees under the cross-tested portion of the plan. This feature, if properly designed and effectively communicated, will encourage all employees to perceive the plan as providing valuable benefits, while at the same time providing the more valued

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not need to pay the IRS user fee for a determination letter for requests made after December 31, 2001 and within the first five years the plan was established.

[60] Few plans allow employees to make after-tax contributions.

[61] For a more detailed discussion of ACP testing and safe harbors, see Calimafde and Cohn, "401(k) Safe Harbors Work For Small Business,@ supra., §§2.05[6], 2.06 and 2.07.

employees with additional contributions. The more that the key employees view the plan as providing meaningful benefits, the more they will become interested in and involved with the plan. Having employees interested and invested in the plan is perhaps the key to a successful retirement plan program.

[e] *Investment Choices*

The tax exempt organization should make sure that plan participants consider the investment choices offered under its 401(k), 403(b) or any other plan to be good choices.[62] If a tax exempt organization has taken the time and effort to design its plan carefully in order to benefit its employees, particularly the most valuable employees, and then offers investment choices that the employees consider poor investments, the tax exempt organization will lose a great deal of the benefit that can be obtained by providing the plan to its employees. The topic of investment choices is beyond the scope of this article, but it is an important consideration that tax exempt organizations often overlook when designing a retirement plan program. The tax exempt organization may be well served to hire an outside investment expert who can review the fund selections with the plan participants and provide meaningful employee education with respect to the types of funds offered and asset allocation models. These meetings should take place at least twice a year and, if possible, every quarter. Not only does this enhance employee understanding of the plan, but it also protects the tax exempt organization from fiduciary

[62] Not all 401(k) plans have individually directed accounts in which the employees can select from a variety of mutual funds or from mutual funds and individual marketable securities. Some 401(k) have so-called "pooled accounts.@ Plans using pooled accounts can have either all or some of the employer contributions (for instance, the profit sharing portion), or all of the plan funds, including the employee 401(k) contributions, in the pooled fund. The pooled accounts are most often professionally managed, and many experts believe that they generate a better return for the average 401(k) participant than that generated by individually directed accounts.

liability in that an independent outside expert has selected the funds and monitors the funds on an on-going basis.

§1.05 COMPARISON OF 401(k) PLANS AND 403(b) ANNUITIES

Starting in 1997, non-governmental tax exempt organizations have been permitted to sponsor both 401(k) plans and 403(b) plans. Accordingly, a comparison of the benefits and limitations of each type of plan is useful in assisting employers in determining which type of plan to offer or whether to offer both plans.

[1] Advantages of 401(k) Plan

[a] *Coverage Requirements for Elective Deferrals*

Under a 403(b) plan that includes elective deferrals, virtually all employees must be eligible to defer more than $200 annually. The participation and coverage requirements applicable to 401(k) plans,[63] however, permit the use of age and service requirements. Moreover, failure to satisfy the universal availability requirements of a 403(b) plan can disqualify the entire plan, whereas failure to satisfy the I.R.C. §410(b) coverage requirements in a 401(k) plan results in penalties to highly compensated employees under I.R.C. §402(b)(4), but does not disqualify the plan.

[b] *More Flexible Investment Options*

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[63] I.R.C. §§410(a) and 410(b).

Apart from the employer's need to satisfy fiduciary requirements, there are no limits on the types of investments that can be made to a 401(k) plan.[64] Investments in tangible assets such as real estate, art, precious metals or gems, stamps, coins, antiques and rugs are permitted (as long as they are permitted by the plan itself) even though these may not generate current income and clearly lack liquidity. Generally, in self-directed 401(k) accounts, employees are permitted to select from a wide range of mutual funds and blue chip securities. Investment options in 403(b) plans, in contrast, are restricted to annuities offered by insurance companies and, in 403(b)(7) custodial accounts, to mutual funds offered by regulated investment companies.

[c] *Protection in Bankruptcy Proceedings*

The anti-alienation provisions of ERISA[65] protect a bankrupt employee's 401(k) account by excluding the 401(k) account from the bankruptcy estate.[66] If a 403(b) plan is not ERISA-qualified, the participant's account will become property of the bankruptcy estate, but may nonetheless be exempt from creditors under state law.

[d] *Calculating Disqualifying Contributions*

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[64] There are limits, however, on the amount that a qualified retirement plan can invest in employer securities and qualifying employer real property.

[65] The Employee Retirement Income Security Act of 1974, 29 USC §1001, et seq.

[66] Patterson v. Shumate, 504 U.S. 753 (1992).

For purposes of the §415 limitations on contributions, the sponsor of a 401(k) plan does not need to aggregate employer contributions to the 401(k) plan with contributions to a Keogh plan sponsored by another entity controlled by the employee if no controlled group relationship exists. In contrast, 403(b) employer contributions must be aggregated with contributions to a plan sponsored by another entity if the employee controls the outside business (even if no controlled group exists).[67] This distinction is particularly important in the case of physicians or professors who, in addition to being employees of a tax exempt hospital or university, may also control and be employed by a medical practice or consulting firm. For purposes of determining whether a business and a tax exempt organization are part of a controlled group for purposes of 414(c), an entity has a controlling interest in a nonstock nonprofit corporation if at least 80% of the directors or trustees of such organization are either representatives of or directly or indirectly controlled by such entity. A trustee or director is a representative of the controlling entity if he is a trustee, director, agent, or employee of such entity.

[e] *Anti-Conditioning Rules*

Other than matching contributions, benefits under a 401(k) plan may not be contingent, directly or indirectly, on an employee's agreement to defer salary.[68] No comparable rule applies to 403(b) plans.

[f] *Administrative Control*

Sometimes a single or small number of vendors can provide a wide range of suitable

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[67] I.R.C. §415(k)(4); Treas. Reg. §1.415-8(d).

investment choices for participants in a 401(k) plan, whereas a larger number of insurance companies may be required to provide employers a suitable selection of annuity products. By minimizing the number of suppliers involved, the employer can maintain better control over compliance and administrative issues.

[2] Advantages of 403(b) Plan

[a] *Ability to Avoid ERISA Requirements*

[68] I.R.C. §401(k)(4)(A).

401(k) plans are subject to the fiduciary, reporting and administrative requirements of ERISA.[69] 403(b) plans, however, can be designed so as not to be covered by ERISA, as long as the plan does not include employer nonelective or matching contributions.[70] To eliminate the fiduciary liability and reporting requirements of ERISA, the 403(b) plan must be structured so that (1) participation is voluntary; (2) all rights under the annuity contract or custodial accounts are enforceable solely by the employee or beneficiary or his or her authorized representative; (3) there are no matching or nonelective employer contributions; (4) the employer's involvement is limited to (i) permitting agents or brokers to publicize their investment products to employees, (ii) requesting information concerning investment products, (iii) summarizing or compiling information to facilitate review and analysis by employees, (iv) holding a group annuity contract in the employer's name, and (v) limiting investment options to a number and selection that is designed to afford employees a reasonable choice while easing administrative burdens and costs, and minimizing the interference with employee performance that could result from direct solicitations by carriers, and (5) the employer receives no direct or indirect consideration or compensation except to cover proper expenses incurred in performing its responsibilities in administrating the salary reduction agreements. If these requirements are not satisfied, then the plan will be an ERISA plan.

[b] *Additional Contributions Available*

The special 403(b) special catch-up contribution permits additional contributions

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[69] Employee Retirement Income Security Act of 1974, 29 U.S.C. §1001, et seq.

[70] 29 CFR §2510.3-2(f). Indeed, the overwhelming majority of 403(b) plans are designed not to be ERISA plans.

beyond what is available in a 401(k) plan.

[c] *Simplified Discrimination Rules*

403(b) plans are subject to many of the discrimination tests applicable to 401(k) plans, including the ACP tests, but the ADP tests[71] and the top-heavy rules[72] do not apply. While an employer can avoid expensive annual 401(k) testing through design based safe harbors,[73] the minimum matching or nonelective contributions required to satisfy these safe harbors may be too expensive for some employers, leading them to choose to sponsor a 403(b) plan rather than a 401(k) plan.

[3] Converting From 403(b) to 401(k) Plans

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[71] I.R.C. §401(k)(3)(A).

[72] I.R.C. §416.

[73] See, Calimafde and Cohn, supra.

EGGTRA permits rollovers of accounts between 401(k) and 403(b) plans in either direction. It is not clear, however, that an organization that sponsors a 403(b) plan can terminate the plan and roll over all of the accounts (or even a group annuity) to a 401(k) plan.[74]

§1.06 MONEY-PURCHASE PENSION PLANS

[74] Rev. Rul. 90-24, 1990-1, C.B. 97, which was issued before EGGTRA, held that direct transfers from one 403(b) investment vehic le to another were not taxable if the funds continued to be subject to the 403(b)(11) distribution restrictions after transfer. In a transfer of accounts from a 403(b) plan to a 401(k) plan, the funds would continue to be subject to distribution restrictions that are the same as those governing distributions from 403(b) accounts. Arguably, the reasoning in Rev. Rul 90-24 would permit termination of the 403(b) plan through transfers of the individual accounts to a 401(k) plan.

Most commentators, however, believe that EGGTRA only permits rollovers upon a distribution event. Termination of a 403(b) plan is not a distribution event. The Portman - Cardin III bill would permit (1) transfers between qualified defined contribution plans and 403(b) plans, and (2) mergers of qualified defined contribution plans with 403(b) plans, provided that there is no reduction in the vested benefit or total benefit of any participant or beneficiary, and provided that participant or beneficiary consent is obtained (if applicable under the terms of the 403(b) contract or applicable law). After the transfer or merger, the transferor plan's QJSA/QPSA (or the "profit-sharing" exception) requirements and the anti-cutback rule provisions must be maintained. Distributions are made in accordance with the terms of the transferee or merged plan, but any grandfather treatment is retained (e.g., 10-year lump sum averaging, capital gain treatment). The very presence of these provisions in the bill indicates that the law does not allow such transfers or mergers.

Indeed, in an address to a conference of tax-exempt and governmental employers in Washington, D.C. on September 12, 2002, Robert J. Architect, a tax law specialist in the IRS Employee Plans Division, announced that the IRS would be releasing an adverse private letter ruling regarding mergers of 403(b) plans into 401(k) plans. The authors have not yet seen this PLR.

Prior to EGTRRA, it was not unusual for a tax exempt organization to sponsor two plans - a money-purchase pension plan with a contribution generally in the 8% to 10% range which was integrated with Social Security[75], and a profit sharing plan with a discretionary formula between zero and 15% of compensation. The money-purchase pension plan design is now almost obsolete due to changes in EGTRRA that allow employers to contribute to a profit sharing plan up to 25% of the aggregate compensation of all employees. Further, the pre-EGTRRA A25% or $35,000" aggregate contribution limit included 401(k) contributions. The new A100% or $40,000" contribution limit under EGTRRA no longer includes 401(k) contributions. Because of the favorable changes under EGTRRA, however, a tax exempt organization which in the past required both a money-purchase pension plan and a profit sharing plan to meet its retirement goals can now do so with only a profit sharing plan. The money-purchase plan can be merged into the profit sharing plan, eliminating the administrative costs associated with two plans, not to mention the mandatory, fixed contributions of a money-purchase pension plan.[76] This merger does not require an acceleration of vesting of the benefits in the money-purchase pension plan.

The money-purchase pension plan is a "fixed commitment" plan, and unlike the profit sharing plan, the money purchase pension plan does not afford the tax exempt organization the discretion to change the amount of the employer contribution annually. Because the money

[75] The technical term for a plan integrated with Social Security is now a plan designed with permitted disparity under I.R.C. §401(l).

[76] A plan merger should be handled by a qualified retirement plan attorney or advisor to ensure that all required pre-merger amendments to the money-purchase pension plan are adopted and that all statutory requirements are satisfied.

purchase plan requires the employer to contribute to the plan annually at a fixed rate, many tax exempt employees prefer a money-purchase pension plan over a profit sharing plan. As a result, some tax exempt employers have decided to retain their money-purchase pension plans rather than merge them into their profit sharing plans. Sometimes money-purchase pension plans have longer vesting schedules than the companion profit sharing plan, so that the money-purchase pension plan will be of greater benefit to the longer term employees.

§1.07 COMPARABILITY PLANS

Comparability plans (sometimes called "cross-tested" or “group based” plans), designed under IRC 401(a)(4) regulations, can often provide maximum contributions for the key or high-level management employees while keeping contributions for the non-key employees in balance. A comparability plan is a very creative plan design which allows the tax exempt organization to group employees in whatever manner it deems appropriate. A plan could group employees by job description and years of service. For instance, the plan could call for contributions for the CEO and/or Executive Director and/or CFO to be made at 20% of compensation level, 15% for other management employees, 10% for staff employees who have been with the tax exempt organization for five or more years, and 7% for all other employees. Another option would be for the plan to group employees by age. For example, a plan could provide that all employees who are 50 years or older would get an 18% of compensation contribution, all employees who are between 40 and 50 would get 12%, and all employees younger than 40 would receive, say, a 10% contribution. Groupings can be based on service with the tax exempt organization, or age and service, or just age. Alternatively, groupings can be based on type of job or position with the tax exempt organization. Generally, these plans are designed so that the level of contributions with respect to staff is kept the same as under the existing plan offered by the tax exempt organization, but contributions for key employees and other designated employees are increased. Comparability plans are usually designed as flexible profit sharing plans, often with a 401(k) component.

A comparability plan is tested under the 401(a)(4) regulations to ensure that benefits at normal retirement age for non-highly compensated employees are comparable to benefits at such time for highly compensated employees. To test under 401(a)(4), allocations must first be converted into equivalent accrual rates.[77] Then the employees are placed into rate groups. A rate group exists for every highly compensated employee, consisting of that employee and all other employees who have an equivalent benefit accrual rate that is greater than or equal to the highly compensated employee's equivalent benefit accrual rate. Each rate group must then satisfy the 410(b) coverage rules by passing either the Ratio Percentage Test[78] or the Average Benefit Test.[79] Because this testing takes age into account, discrimination testing for

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[77] One of two methods can be used to convert the allocations into equivalent accrual rates - the annual method or the accrued to date method. Under the annual method, one must (1) determine the dollar allocation for the plan year for each employee (*i.e.*, all employer contributions and forfeitures); (2) Anormalize" the allocation; (3) pick a "testing age" in the future (*i.e.*, normal retirement age); (4) credit the allocation with interest (7.5% to 8.5%), until the testing age is reached, to determine a projected value; (5) convert the projected value to a single life annuity commencing at the testing age; (Note that standard interest rates and annuity factors used in this calculation are: 1983 GAN, 1983 IAM, UP 84, 1971 GAM, and 1971 IAM for mortality and 7.5% to 8.5% for interest; different interest rates may be used for computing the annuity factor and making the interest adjustment to the testing age, but interest rates and factors must be applied consistently to all employees.); (6) divide the annuity by the employee's compensation for the plan year to obtain the equivalent accrual rate for the employee; and (7) adjust for permitted disparity. (Note that this last step is optional. See Treas. Reg. §1.401(a)(4)-7.) Under the accrued to date method, one uses the total account balance for the participant at any time rather than just the annual allocation.

[78] The ratio percentage test is a test that requires the percentage of non-highly compensated employees benefitting under the plan to be at least 70 percent of the percentage of highly compensated employees benefitting under the plan. Treas Reg § 1.410(b)-2(b)(2).

[79] The average benefits test consists of two separate tests, both of which must be satisfied. First, the

comparability plans is closer to that of a defined benefit plan than to that of a defined contribution plan. Each year this plan design requires testing under the 401(a)(4) regulations, and if the makeup of the employees changes significantly (which is often the case if there is a small group of employees), then the plan design may need to be changed.

In addition, a comparability plan must pass the allocation gateway test. Under this gateway test, each non-highly compensated employee must have an allocation rate that is the lesser of one-third of the allocation rate of the highly compensated employee with the highest allocation rate or 5% of compensation.[80]

A comparability plan requires the oversight of a sophisticated benefits plan attorney or advisor. The plan must be properly designed and tested annually to ensure continued compliance. While these requirements increase plan costs, many tax exempt organizations appreciate the plan's flexibility and the ability to provide increased contributions to the tax

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nondiscriminatory classification test requires the plan to benefit a class of employees established by the employer that is both reasonable and nondiscriminatory. Second, the average benefit percentage test requires the average benefit percentage for non-highly compensated employees to be at least 70 percent of the average benefit percentage for highly compensated employees. Treas Reg § 1.410(b)-2(b)(3).

[80] There is a different compensation rule for the one-third test than for the 5% test. The one-third test is based on the allocation rate. An employee's allocation rate is the percentage obtained by dividing the employee's allocation for the plan year derived from employer contributions (other than matching contributions, if the plan also includes a 401(k) arrangement) and forfeitures, divided by his or her plan year compensation. Imputed permitted disparity cannot be taken into account for this purpose. Treas. Reg. §1.401(a)(4)-2(c)(2). Plan year compensation, in turn, is defined in Treas. Reg. §1.401(a)(4)-12 as compensation determined under Code Section 414(s) (generally measured for the plan year, or the portion of the plan year that the employee is eligible for the plan). The 5% test is based on Code Section 415(c)(3) compensation, which is the same definition of "compensation@ used to determine top heavy minimum contributions. However, the final regulations provide that the 5% test is to be applied to Section 415(c)(3) compensation measured over a period of time permitted under the definition of plan year compensation. This means that if the plan document so provides, the final regulations now allow the 5% contribution to be limited to compensation earned while a participant in the plan. Treas. Reg. §1.401(a)(4)-8(b)(1)(vi).

exempt organization's most valued employees.

[1] Conversion of Contributions from a 457(f) Plan into a Comparability Plan

Tax exempt organizations that change to a comparability plan design often stop making employer payments to a 457(f) plan on behalf of the organization's key employees and instead make payments into the new comparability plan. This is a win-win situation for the organization's most valuable key employees and the tax exempt organization. For key employees there are several advantages. Unlike funds in the 457(f) plan, funds in the comparability plan: (1) do not have to be subject to a substantial risk of forfeiture and are not vulnerable to claims of the employer's creditors; (2) are protected by ERISA, which, among other things, safeguards against inadequate funding of the plan; and (3) can be rolled over to an IRA, which provides significant investment and pay-out flexibility.

§1.08 DEFINED BENEFIT PLANS

For at least a decade, defined benefit plans have fallen out of favor with tax exempt organizations (and most other employers). When the stock market was going up, employees were not very excited about a plan that guaranteed only a 6% or 7% return with no ability to reap the benefits of a higher yield. Of course, today that sounds like a great deal. Employees often do not appreciate defined benefit plans because there are no individual account balances, and it is almost impossible for employees to figure out what they have really accrued under the plan. Many younger employees with few years of service do understand, however, that defined benefit plans do not offer them as much benefit as a defined contribution plan. Similarly situated employees are often disturbed to find that they will receive different contributions because of differences in their age. Nevertheless, today this type of plan provides certain advantages that cannot be obtained in the defined contribution world (including 401(k), profit sharing or money-purchase pension plans).

The defined benefit plan can provide older executives as well as other key and valued employees greater benefits than a defined contribution plan. A defined benefit plan promises the employee a certain benefit at retirement age. For example, a defined benefit plan could promise to pay 50% of an employee's salary (based on the average of the employee's highest three years of compensation) each year that the employee or his or her spouse lives past the employee's retirement. Or, it could promise a benefit which builds up year by year; e.g., 1.5% of compensation for each year of service up to 25 years of service. Employees who work for the tax exempt organization for a long period of time and stay until retirement will receive a valuable pension which they cannot outlive.

Many defined benefit plans also provide an alternative lump sum payout option which the participant can elect to roll over (or directly transfer) to an IRA so that the employee, rather than an insurance company, controls the flow of income. Of course, if an employee elects to take his or her benefit in the defined benefit plan and roll it over to an IRA, the employee will be able to retain the interest earnings on the funds in the tax free environment, but can run out of money if the funds are not invested wisely or are spent too quickly.

The defined benefit plan does not have separate account balances; instead there is one common trust fund which pays all of the benefits. Employees understandably prefer to receive reports on the status of "their" account in a defined contribution plan. This is why many associations sponsor both a defined benefit plan and a 401(k) or 403(b) plan. Today, employees are beginning to understand that with a defined benefit plan, even though they do not have an individual account balance or the ability to invest the funds, they do not assume any investment risk and are, in effect, guaranteed a lifetime retirement benefit. Prior to the stock market collapse, a guaranteed return of 6% was not considered to be particularly valuable, but with many workers having to postpone retirement because of the collapse of their 401(k) plans, a guaranteed 6% return is now truly appreciated.

Companies have been reluctant to offer new defined benefit plans because of the inherent fixed commitment to making annual contributions, the high administrative costs (since an actuary must be employed to determine the correct funding and annually certify to the Department of Labor that the plan has been properly funded in accordance with sound actuarial principles), and the company’s obligation to ensure that promised benefits will be available. Congress is now aware that many of the protections for non-key and non-highly compensated employees added to defined benefit plans in the 1980's actually caused the demise of those plans. The authors hope that Congress will alleviate some of the statutorily imposed unnecessary burdens so that defined benefit plans will again become attractive to employers. Nevertheless, even today, a defined benefit plan can be a very valuable plan design, and a tax exempt organization should consider this type of plan when analyzing its retirement plan program and determining whether it is providing well appreciated retirement benefits. Any new defined benefit plan should be individually tailored to the needs and characteristics of the tax exempt organization. Because it is a complex plan to design and administer properly, the defined benefit plan should only be adopted with the advice of a skilled benefits attorney or other highly qualified professional.[81]

[1] Cash Balance Cross-Tested Defined Benefit Plans

The cash balance cross-tested plan is the "new kid on the block." This plan provides the higher contribution levels found in a defined benefit plan, coupled with individual account balances found in defined contribution plans. Even though there are individual account balances, participants are not able to invest the funds in their account balance individually. Moreover, employees do not participate in the upside advantage if actual returns on pooled funds exceed the plan's guaranteed returns (usually in the 5% - 6% range).

[81] Some tax exempt organizations place their defined benefit plans on auto-pilot rather than having them reviewed by qualified plan advisors on a regular basis. This can be a costly mistake. One plan that the authors analyzed was over-funded by over $1,000,000, while at the same time the brokerage house that established the plan was requesting almost $300,000 of additional funding. When questioned, the plan advisor from the brokerage house responded that the association had at one point indicated that they wanted to fund the plan in an amount equal to $300,000 a year in order to ensure adequate funding. The brokerage firm was simply carrying out this initial game plan without reevaluating whether it was still appropriate given the company's actual obligations under the plan. The tax exempt organization was delighted to find out about the over-funding. They decided that they would forgo further contributions to the plan until additional contributions were actually required. The tax exempt organization also learned that it needed an outside expert in the design and administration of defined benefits plans to interface with the brokerage house.

Employees can be grouped under this plan design in the same manner as under a traditional comparability plan design so that contribution amounts are not necessarily dependent upon the age of the participant.[82] Regardless of the employee's age, however, contributions for highly compensated employees under a cash balance cross-tested plan design can be quite significant. For example, a 35 year old highly compensated employee could receive a contribution as high as $85,000, a 50 year old as high as $145,000, a 55 year old as high as $175,000, and a 60 year old as high as $215,000. On the other hand, staff costs may not be much higher than 10% of pay. Not surprisingly, this high contribution plan is much more complicated than a defined contribution plan and requires the use of an actuary. Only a tax exempt organization that is interested in making annual contributions for its most valued employees in excess of the maximum $40,000 (the current maximum for contributions to a defined contribution plan) should consider a cash balance cross-tested defined benefit plan.

Like a regular defined benefit plan, a cash balance cross-tested defined benefit plan requires the highest skilled benefits professionals; associations should be prepared to deal with very high administrative and legal fees to establish the plan and to keep it running in accordance with the IRS regulations.

§1.09 SEP: THE SIMPLIFIED EMPLOYEE PENSION

[82] See Section 1.07, supra. for a discussion of appropriate grouping of employees in a cross tested plan.

Both SEPs[83] and SIMPLEs[84] are IRA based plans that require minimal administration by the employer. The employer simply goes to a bank or brokerage house and sets up separate IRAs for each eligible employee. The company makes the correct contribution into each separate IRA and, without much further responsibility, walks away.[85] Because the funds need not be held in a trust,[86] but are owned by the employees, employees can remove their funds at any time, in any amount and for any reason,[87] although amounts withdrawn before the employee reaches age 59½ will be subject to the 10% early withdrawal penalty.[88]

[1] Contributions

A SEP is an arrangement under which an employer contributes to individual retirement accounts or individual retirement annuities under the plan on behalf of employees. Within certain limitations, the employer may deduct its contributions and the employee may exclude

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[83] The Simplified Employee Pension was created by the Revenue Act of 1978 for years beginning after December 31, 1979. It has largely been supplanted by the SIMPLE.

[84] The Simplified Incentive Match Plan for Employees, created by the Small Business Job Protection Act of 1996, effective January 1, 1997.

[85] For example, annual reporting requirements are limited. I.R.C. §408(l)(1). In the SEP, there is no need to file Form 5500; the employer instead files Form 5498 which sets out contributions to the SEP and the fair market value of the assets in the SEP. The SEP imposes certain simple notification requirements on the employer, whereas under a SIMPLE plan, the employer must provide the employee a basic summary plan description. I.R.C. §408(l)(2). The assets contributed to a SEP or SIMPLE are managed by a financial institution. Although the employee may be permitted to direct investments of his or her account, assets may not be invested in life insurance contracts, collectibles or other assets which are not permitted for IRAs. I.R.C. §§408(a)(3) and 408(m). In addition, assets may not be lent to the employee. I.R.C. §408(e)(4). The SEP may be established with a bank, thrift institution, insurance company, brokerage firm or any other entity that is eligible to be an IRA custodian. I.R.C. §§408(a)(2) and 408(n).

[86] I.R.C. §408(h).

[87] Indeed, I.R.C. §408(k)(4) requires that employees be permitted at all times to withdraw their entire IRA balance, and employer contributions may not be conditioned on the employee's agreeing to retain the contributions in the IRA account.

[88] I.R.C. §72(t).

these contributions from current income. For SEPs, the employer contribution cannot exceed the lesser of (i) 25% of compensation[89] or (ii) $40,000.[90] Any excess contribution is includible in the employee's income and is subject to a 6% excise tax.[91] Moreover, if the SEP account or annuity is part of a top-heavy plan, the top-heavy requirements must be satisfied.[92] Employer contributions on behalf of each eligible non-key employee must generally be at least 3% of compensation.[93]

[89] For this purpose, the definition of "compensation@ in I.R.C. §414(s) is used. The employer may elect to exclude employer contributions to the SEP, elective deferrals and deferrals to a cafeteria plan (I.R.C. §125) or transportation fringe contributions (I.R.C. §132(f)(4)) from compensation when determining the contribution limitation. I.R.C. §402(h)(2).

[90] The $40,000 represents the I.R.C. §415(c)(1)(A) limitation.

[91] I.R.C. §4973. The employee may contribute an additional $2,000 to a personal IRA even if participating in the SEP, but in determining the deductibility of the $2,000 contribution to the personal IRA, the participant will be treated as an active participant in the SEP.

[92] I.R.C. §408(k)(1)(B).

[93] See I.R.C. §§416(c)(2) and 416(e) for the top-heavy requirements.

Age 50 catch-up contributions are also permitted, but contributions to a SEP are aggregated with those to a SIMPLE, 401(a) plan or 403(b) annuity.[94] The catch-up contribution limits increase from $1,000 in 2002 to $5,000 in 2006.[95]

[2] Participation Requirements

[94] I.R.C. §414(v)(3)(D).

[95] I.R.C. §414(v)(2)(B).

The employer must make contributions on behalf of all eligible employees,[96] whether or not they are employed as of a particular date.[97] Eligible employees include employees who have attained age 21, have worked for the employer for at least three of the preceding 5 years, and have earned at least $450[98] in compensation[99] from the employer during the year. Thus, part time employees must be participants in the plan unless they are otherwise excluded by statute.[100] As with the 401(a) plans described above (401(k), money-purchase, profit sharing, and defined benefit), employees subject to collective bargaining agreements and nonresident aliens with no U.S. source income are excluded by statute. Contributions also must be made for eligible employees over age 70½ even though they could not contribute to their own IRA and may already be receiving distributions from their SEP.[101] Employer contributions must be determined under a written allocation formula that specifies the requirements which the employee must satisfy to share in the allocation and the manner in which the amount allocated is computed.[102]

[3] Discrimination Rules

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[96] I.R.C. §408(k)(2).

[97] Prop. Treas. Reg. §1.408-7(d)(3). Thus, a contribution may be required with respect to a terminated employee if that employee met the qualifications for participation during the plan year.

[98] This amount is increased periodically for inflation. I.R.C. §408(k)(8).

[99] For this purpose, the I.R.C. §414(q)(4) definition of "compensation@ is used so that contributions to the SEP or SIMPLE, elective deferrals, and deferrals to a 457(b) plan, cafeteria plan or transportation fringe are included in "compensation.@ This is a broader definition of "compensation@ than in a SIMPLE since the definition includes I.R.C. §125 cafeteria plans and I.R.C. §132(f)(4) transportation fringe.

[100] Nonresident aliens and collectively bargained employees are excluded under I.R.C. §408(k)(2).

[101] I.R.C. §219(b)(2).

[102] I.R.C. §408(k)(5).

Employer contributions may not discriminate in favor of eligible highly compensated employees. A plan under which employer contributions (other than salary contributions) do not bear a uniform relationship to the compensation[103] of each employee, except for the disparity permitted under I.R.C. §401(l)(2), will be treated as discriminating in favor of highly compensated employees.[104] A model SEP agreement can be used by companies by completing Form 5305-SEP. By distributing the form to the participating employees, the company will meet all of its reporting and notice obligations. A model SEP cannot be used by a company that is maintaining a qualified retirement plan or by a company that has ever sponsored a defined benefit plan. Also, if the formula under the SEP takes into account permitted disparity, the company cannot use the model SEP agreement, and additional information must be furnished to the employees with respect to the plan. This is why the vast majority of SEPs are model SEPs and provide contributions for all employees based on the same percentage of compensation.

[4] Taxation

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[103] Only compensation up to $200,000, adjusted for inflation, is taken into account. I.R.C. §§408(k)(3)(C) and 408(k)(8).

[104] I.R.C. §§408(k)(3)(C) and (D).

Subject to the $40,000 annual addition limitation for each employee,[105] the employer can deduct up to 25% of the total compensation paid to all participating employees during the calendar year ending with or within the employer's taxable year. An excess contribution is deductible in succeeding taxable years in order of time, subject to the 25% of compensation limitation. If the employer maintains both a SEP and a defined contribution plan, the deduction limitation for the contribution to the defined contribution plan is reduced by the amount of the allowable deduction for the SEP contribution.[106]

Distributions from a SEP are taxed to the employee like distributions from an IRA. The I.R.C. §72(t) 10% penalty for early distributions also applies. In addition, a non-refundable tax credit is available for elective contributions to a SARSEP[107] through 2006.[108]

[5] Advantages and Disadvantages of a Simplified Employee Pension

The primary advantage of a SEP is the minimal paperwork and bookkeeping required to establish and administer the plan. Once the SEP is established with an eligible IRA custodian, the plan assets are managed by the financial institution. Annual reporting requirements are limited, and the employer does not need to file Form 5500.

The employer also retains considerable flexibility regarding contributions to the SEP. As long as non-discrimination requirements are satisfied, the employer may contribute any amount it wants up to the maximum set by law, or can choose not to make any contribution at

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[105] I.R.C. §414(c)(1)(A).

[106] I.R.C. §404(h).

[107] SARSEP refers to a salary reduction simplified employee plan.

[108] I.R.C. §25B.

all (like a profit sharing plan).

Finally, the employer's fiduciary duty is reduced because the plan is not a trust-based plan and employees choose their own investments.

One disadvantage of the SEP is that the eligibility rules are less restrictive than for qualified plans.[109] This can increase the employer's costs, since even part-time employees must be covered if they meet the eligibility criteria. Also, contributions to a SEP vest immediately: in contrast to a qualified plan, the employer cannot impose a vesting schedule.[110] Some administrative complexity is retained in order to enforce the non-discrimination requirements. The employer must still identify highly compensated and key employees and satisfy the top heavy tests.[111] Finally, under state law, assets may not be as well protected from creditors as assets in a qualified retirement plan.[112]

§1.10 SIMPLE: THE SIMPLIFIED INCENTIVE MATCH PLAN FOR EMPLOYEES

[109] I.R.C. §408(k)(2).

[110] I.R.C. §408(k)(4).

[111] I.R.C. §§408(k)(3) and 408(k)(1)(B).

[112] See, European American Bank v. H. Frenkel, Ltd., 555 NYS 2d 1016 (1990); In re Taft, No. 190-13220-352 (Bankr ED NY 1994); In re CRS Steam, Inc., Nos. 97-44296, 97-44297 (Bankr D Ma 1998); In re Bissell, 2000 WL 1733281 (Bankr Va 2000).

Like the SEP, the SIMPLE is an IRA based plan that imposes minimal administrative burdens on the employer.[113] Employers[114] with 100 or fewer employees who receive at least $5,000 in compensation[115] from the employer during the preceding year may adopt a SIMPLE plan if the employer has not previously and, with limited exceptions, does not currently offer, another qualified plan, such as a 401(a), 403(a), 403(b), SIMPLE or SEP.[116] For purposes of determining whether the employee has more than 100 employees, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE IRA. Thus, employees who are excludible from the plan,[117] or who have not met the plan's minimum eligibility requirements must be taken into account.[118] The rules regarding controlled businesses, affiliated service groups and leased employees apply, so that all of the employees of related employers must be aggregated when applying the 100 employee limitation, and all of the employees of the related employers must be offered

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[113] Although the Internal Revenue Code also provides for a SIMPLE 401(k) plan, that type of plan generally is not used since it has all of the complexity of a trust based plan without the higher contribution limitations permitted under a 401(k).

[114] Governmental entities and tax exempt employers may also maintain a SIMPLE IRA. Notice 98-4, 1998-1C.B. 269, Q&A B-4 (hereafter ANotice 98-4").

[115] "Compensation@ includes wages as defined in I.R.C. §6051(a)(3) and total elective deferrals under I.R.C. §401(g)(3), including elective deferrals under a 401(k) plan, 403(b) annuity, SEP or SIMPLE, or compensation deferred under a 457 plan. I.R.C. §408(6)(A). For self-employed individuals, however, "compensation@ means net earnings from self-employment without regard to any contribution under the SIMPLE plan.

[116] I.R.C. §§408(p)(2)(C)(i) and 408(p)(2)(D); Notice 98-4, Q&A B-3. An employer may maintain a SIMPLE IRA even if it maintains another qualified plan if the other plan covers only union employees under a contract in which retirement benefits were subject to good faith bargaining and if the SIMPLE IRA excludes these other employees. Notice 98-4, Q&A B-4.

[117] Collectively bargained employees, air pilots and nonresident aliens with no US source income may all be excluded from the plan. I.R.C. §408(p)(4)(B).

the SIMPLE plan if either employer wants to offer the plan.[119]

[1] Eligibility

All employees who received at least $5,000 in compensation from the employer during any 2 preceding years and are reasonably expected to receive at least that amount during the current year must be eligible to make a salary reduction election or receive the 2% employer nonelective contribution.[120] Employees subject to collective bargaining agreements, nonresident aliens with no US source income, and air pilots may be excluded.[121]

[2] Salary Reduction Contributions

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[118] I.R.C §408(p)(2)(C)(i)(I); Notice 98-4, Q&A B-1.

[119] I.R.C. §§408(p)(4) and 408(p)10); Notice 98-4, Q&A C-1.

[120] I.R.C. §408(p)(4)(A).

[121] I.R.C. §408(p)(4)(B).

A SIMPLE IRA permits eligible employees to make elective contributions under a salary reduction agreement.[122] The plan must permit the employee to express the salary reduction as a percentage of compensation, and it may permit the employee to elect a salary reduction of a specific dollar amount.[123] The salary reduction may not exceed $8,000 in 2003, increasing by $1,000 per year up to $10,000 in 2005.[124] The plan may impose no restrictions on the employee in making the salary reduction election other than those needed to ensure compliance with these salary reduction limitations.[125]

[3] Age 50 Catch-up Contributions

In addition to an elective deferral under a salary reduction agreement, employees who have attained age 50 may make a catch-up contribution if they have elected the maximum salary deferral. The catch-up contribution is $500 in 2002, increasing by $500 per year until it reaches $2,500 in 2006. The catch-up contribution is further limited so that it may not exceed the employee's contribution reduced by elective contributions to other plans, including 401(k) plans, SARSEPs, SIMPLEs, tax sheltered annuities and 457 plans.[126]

[4] Matching Contributions and Nonelective Contributions

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[122] I.R.C. §408(p)(2)(A)(i)

[123] I.R.C. §408(p)(2)(A)(ii); Notice 98-4, Q&A D-2.

[124] I.R.C. §408(p)(2)(E)(i). The elective deferral limitation is thereafter increased for inflation in multiples of $500. I.R.C. §408(p)(2)(E)(ii). Thus, elective deferral limits remain lower than those in trust based plan.

[125] I.R.C. §408(p)(2)(A)(ii); Notice 98-4, Q&A D-2.

[126] I.R.C. §414(v)(2)(D) coordinates the age 50 catch-up contributions among 401(k) plans, 403(b) annuities, 408(p) SIMPLE plans, and 408(k) SEP plans.

The employer must either make a matching contribution[127] or a nonelective contribution.[128] The matching contribution and nonelective contribution are in addition to the maximum amounts that the employee may defer under the salary reduction agreement. Under the matching contribution, the employer must match the elective deferral up to 3% of the employee's compensation[129] unless the employer either (1) elects a lower match percentage[130] or (2) elects to make a 2% nonelective contribution for all eligible employees,[131] whether or not an employee enters into a salary reduction agreement.[132] The employer may reduce the match percentage, although not below 1% in any year, if the employer notifies employees of this reduction reasonably prior to the 60 day election period,[133] and if the reduction for a particular year does not result in matching rates of less than 3% for more than 2 of the 5 years ending with the year in which the reduction will occur.[134] Similarly, the employer must notify employees within a reasonable period before the 60-day election period that the employer

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[127] I.R.C. §408(p)(2)(A)(iii).

[128] I.R.C. §408(p)(2)(B).

[129] I.R.C. §408(p)(2)(C)(ii); Notice 98-4, Q&A D-4.

[130] I.R.C. §408(p)(2)(A)(iii)

[131] The employer may, but is not required, to limit nonelective employer contributions to eligible employees who have at least $5,000 (or some lower amount) of compensation. Notice 98-4, Q&A D-6.

[132] I.R.C. §408(p)(2)(B).

[133] The notice requirement ensures that employees, when deciding during the 60 day election period whether to enter into or modify a salary reduction agreement, will know the amount of matching contribution that the employer will make since the amount of the match may influence the employee's decision regarding the amount of the salary deferral.

[134] I.R.C. §408(p)(2)(C)(ii)(II). For any year during that five year period in which the plan did not exist, or in which the employer chose to make a nonelective 2% contribution, the matching rate is presumed to be 3%. I.R.C. §§408(p)(2)(B) and 408(p)(2)(C)(ii)(III); Notice 98-4, Q&A D-5.

intends to make a nonelective 2% contribution rather than a matching contribution.[135]

[5] Contributions May Not Be Subject to Conditions

[135] Again, the notice is important since this information may influence the employee's decision regarding a salary reduction agreement.

The plan may not condition employer contributions on the employee's having to retain the contributions in the plan. The employee must have the right at all times to withdraw all employer contributions. Thus, employer contributions may not be subject to a vesting schedule.[136] Withdrawals, however, are subject to the I.R.C. §72(t) 10% early withdrawal penalty for amounts withdrawn before the employee reaches age 59½.. In order to counter the ease with which employees may access their SIMPLE IRA accounts and to encourage employees to get into the habit of contributing to the SIMPLE, the penalty is increased to 25% for amounts withdrawn during the first 2 years in which an employee participates in the SIMPLE. [137] Thus, in contrast to a trust based plan, and similar to a regular IRA, employees easily may access all contributions to the SIMPLE.

[6] Taxation

A SIMPLE plan is not subject to the 25% of compensation deduction limitation. Accordingly, an employer may deduct all of the elective, matching and nonelective contributions made under the plan, regardless of the level of the employee's compensation.[138] Contributions to the SIMPLE are excludible from the employee's income when made and are not subject to withholding.[139] Elective contributions are subject to FICA and FUTA, but

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[136] I.R.C. §408(p)(3).

[137] I.R.C. §72(t)(6); Notice 98-4, Q&A I-2.

[138] I.R.C. §§404(a)(3) and 404(m)(1); Notice 98-4, Q&A I-7.

[139] In addition, through 2006, individuals with lower incomes are allowed a non-refundable tax credit equal to the applicable percentage of the individual's contributions to a qualified retirement savings vehicle up to $2,000. I.R.C. §25B.

matching and nonelective contributions are not.[140] Distributions from the SIMPLE IRA are taxable to the employee under the rules applicable to IRAs.

§1.11 SECTION 457(b) ELIGIBLE PLANS

All of the plans discussed above are currently funded qualified retirement plans in which plan assets grow income tax deferred and are not subject to the claims of creditors. In exchange for these very desirable features, the plan must cover a significant amount of the tax exempt organization's employees. The next group of plan designs deals with benefits that are "non-qualified." The plans are subject to special rules because they are offered by tax exempt organizations. The funds are subject to claims of the organization's general creditors, and the organization can freely discriminate among its employees in designing the plan and are only allowed to offer the benefits to its top hat employees.

Prior to EGGTRA, contribution limits for 457(b) plans were considerably less than the limits for 401(k) and 403(b) plans, and all employee deferrals under a 401(k), 403(b), SARSEP or SIMPLE plan reduced dollar for dollar the amount that the employee could defer under a 457(b) plan. Thus, if the employee deferred $8,500 or more to a 403(b) plan in 2001, the employee could not defer any amounts to a 457(b) plan. As mentioned above, EGGTRA decoupled the employee deferral contributions to a 457(b) plan from those made to a 401(k), 403(b), SARSEP or SIMPLE. With the increased contribution limits and other changes in EGGTRA, 457(b) plans now become a more meaningful option for providing deferred compensation to certain top hat employees.

[140] Notice 98-4, Q&A I-1.

A 457(b) plan is an eligible deferred compensation plan of a state or local government or tax exempt employer.[141] The plan may be offered to any individual who performs services for the employer. Thus, unlike 401(k) and 403(b) plans, a 457(b) plan may be offered to independent contractors.[142] Assets of government sponsored plans are held in trusts[143] and, in this respect, government sponsored 457(b) plans are similar to 401(a) and 403(b) plans. Tax exempt 457(b) plans, however, must be unfunded; the assets must be owned by the employer[144] and remain subject to the claims of the employer's general creditors.[145] This requirement directly conflicts with ERISA. Governmental plans are expressly exempt from ERISA,[146] but 457(b) plans sponsored by a tax exempt entity need to qualify for an exemption from ERISA. Tax exempt plans are therefore designed to meet the top hat exemption to ERISA[147] : they are

[141] 457(b) plans may not be offered by a church or church-controlled organization. I.R.C. §457(e)(13).

[142] I.R.C. §457(e)(2); Prop. Treas. Reg. §1.457-2(j).

[143] I.R.C. §457(g). For this purpose, custodial accounts, annuity contracts and certain insurance contracts are treated as trusts.

[144] I.R.C. §457(b)(6). Although the assets of a 457(b) tax exempt plan are owned by the employer, the assets may be segregated in a Rabbi Trust so long as they remain subject to the claims of the employer's general creditors.

[145] This difference between governmental and tax exempt 457(b) plans underlies the different rules applicable to the two types of plans regarding rollovers. Because government 457(b) plans are trust-based plans, assets can be freely transferred among 457(b), 401(k) and 403(b) plans and IRAs, whereas assets of an unfunded 457(b) plan sponsored by a tax exempt organization can only be transferred to another tax exempt 457(b) plan. Note, however, that as a result of the distribution rules for 457(b) plan assets, discussed in §1.11[8], <u>infra</u>., 457(b) assets are generally not subject to the I.R.C. §72(t) tax for early withdrawals. Accordingly, assets transferred to a 457(b) government plan from an IRA or trust based plan that is subject to the I.R.C. §72(t) tax need to be segregated from other 457(b) assets, since the rollover assets will continue to be subject to penalties for early withdrawals.

[146] 29 U.S.C. §1003(b)(1).

[147] ERISA §§201(2), 301(a)(3) and 401(a)(1).

offered only to a select group[148] of management and highly compensated employees.[149]

[1] Contributions

[148] The regulations do not define what constitutes a "select group@ of management employees. The underlying guideline is that ERISA protections are not needed for employees with sufficient clout to influence the design and administration of their own benefits. Under the approach taken by the Department of Labor, a top-hat plan must cover only those employees who, as a result of their compensation level or position with the employer, have the power to negotiate the design and operation of the deferred compensation plan and its application to them. DOL Op. Ltr. 90-14A (1990). The IRS and courts generally look at the percentage of employees involved and their compensation. A group consisting of fewer than 5% of employees is commonly accepted. See, Duggan v. Hobbes, 99 F.3d 307 (9th Cir. 1996); Belka v. Rowe Furniture Corp. 571 F. Supp. 1249 (D. Md 1983), but one that includes over 18% of employees is not a "select@ group. Darden v. Nationwide Mutual Insurance Company, 717 F. Supp. 388 (E.D.N.C. 1989). Generally, a "select group@ includes employees with compensation over the I.R.C. §401(a)(17) threshold ($200,000 in 2002), whereas the IRS threshold ($90,000 in 2002) is not considered appropriate.

[149] DOL Reg. §2520.104-23.

The plan ceiling, that is, the maximum amount that may be contributed annually to a 457(b) plan, whether as an elective deferral or employer contribution, is 100% of includible compensation[150] up to the "applicable deferral amount." The applicable deferral amount is $12,000 in 2003, and increases by $1,000 annually until it reaches $15,000 in 2006, increasing thereafter for inflation.[151] This maximum amount is not coordinated with contributions to a 401(k) or 403(b) plan, so that in 2003, an employee participating in both a 457(b) plan and either a 401(k) plan or 403(b) plan (or both) may defer up to $12,000 to the 457(b) plan plus a total of $12,000 to the 401(k) and 403(b) plans (assuming that the 100% of compensation limitation does not reduce these amounts).[152] This deferral limitation, and all other contribution limitations applicable to 457(b) plans,[153] applies on a plan basis and on an individual employee basis, so that all eligible 457(b) plans maintained by one employer are aggregated, and all eligible 457(b) plans of all employers for whom a participant has performed

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[150] "Includible compensation@ has the same meaning as under I.R.C. §415(c)(3) and includes compensation from the employer for the year, including elective deferrals as defined in I.R.C. §402(g)(3), that is, elective deferrals to a 401(k), 403(b), SEP or SIMPLE plan, and amounts contributed by the employer at the election of the employee and not included in gross income under I.R.C. §§ 125 (cafeteria plans), 132(f)(4) (transportation fringe) or 457. I.R.C. §457(e)(5); Prop. Treas. Reg. §1.457-2(g).

[151] I.R.C. §§457(b)(2) and 457(e)(15). Note that the I.R.C. §415(c) limitation of the lesser of $40,000 and 100% of compensation does not apply to a 457(b) plan. Contributions may include accumulated sick pay, vacation pay and back pay. Prop. Treas. Reg. §1.457-4(d).

[152] The lack of coordination between a 457(b) plan and either the 401(k) or 403(b) plan means that an employer may contribute to the 457(b) plan without reducing the employer's contributions to the other two plans. In essence, assuming no employee contributions to any of the plans, in 2006 the employer could contribute a maximum of $55,000, consisting of $40,000 in some combination to the 401(k) and 403(b) plan plus $15,000 to the 457(b) plan (assuming no catch-ups).

[153] These additional contribution limitations include the special 457(b)(3) catch-up and, with respect to governmental plans, the age 50 catch-up.

services also must be taken into account.[154]

[2] The 457(b)(3) Catch-Up

[154] I.R.C. §457(c); Prop. Treas. Reg. §§1.457-4(e) and 1.457-5.

A 457(b) plan may permit the employee, during the three years prior to normal retirement age, to contribute the lesser of (i) twice the deferral limitation for that year and (ii) the plan ceiling for that year plus so much of the plan ceiling for prior years as has not been used (the underutilized limitation).[155] For example, in 2006, the plan may permit, during this three year period, annual contributions of the lesser of (i) $30,000 and (ii) $15,000 plus unused deferrals from prior years.

[3] Underutilized Limitation

The underutilized limitation for years before 2002 is complicated to calculate. If the employer did not offer a 457(b) plan for a prior year, there can be no underutilized limitation for that year.[156] If the employer did offer a 457(b) plan for that year, then all of the employee's elective deferrals for that prior year (whether to the 457 plan or to a 403(b) or 401(k) plan) need to be taken into account when calculating the unused deferral,[157] because the rules at that time required coordination of contributions among 457(b) plans and other retirement plans, including those not sponsored by the same employer.[158] One complicating factor is that the regulations do not clearly define "includible compensation" for the prior years, although the rule appears to be that "includible compensation" for those years includes regular compensation plus deferrals to a 457(b) plan but no other elective deferrals.[159]

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[155] I.R.C. §457(b)(3); Prop. Treas. Reg. §1.457-(c)(3).

[156] Prop. Treas. Reg. 1.457-4(c)(3)(iv)(C).

[157] Prop Treas. Reg. 1.457-4(c)(3)(iv).

[158] Id.

[159] Prop. Treas. Reg. §1.457-4(c)(3)(iii).

[4] Normal Retirement Age

The plan can establish "normal retirement age" or may allow the employee to establish "normal retirement age," but "normal retirement age" must be between 65 and 70½ (inclusive), unless the employer sponsors a basic pension plan that provides for an unreduced benefit at an earlier age than 65.[160] If an employer offers more than one plan, an employee may have only one normal retirement age under all the plans for which he or she is eligible.[161]

[5] Age 50 Catch-Up

An eligible governmental plan (but not a tax exempt plan) may offer age 50 catch-up contributions up to the I.R.C. §414(v) amount.[162]

[6] Discrimination Rules

I.R.C. §457 does not impose any non-discrimination requirements on 457(b) plans. As previously mentioned, 457(b) plans offered by tax exempt organizations are inherently discriminatory since they are designed to meet the top hat exception to ERISA. Because non-discrimination rules do not apply, these plans can be tailored to the needs of an individual employee or group of employees.[163]

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[160] Prop. Treas. Reg. §1.457-4(c)(3)(v).

[161] Id.

[162] I.R.C. §414(v)(6)(A)(iii). This catch-up contribution is not coordinated with the age 50 catch-up contribution under a 401(k), 403(b), SIMPLE or SEP plan and thus represents an additional, independent catch-up contribution. I.R.C. §414(v)(2)(D). If an employee also qualifies for the I.R.C. §457(b)(3) catch-up contribution for the threeyears prior to normal retirement year, then the employee may elect the larger of these two catch-up amounts but may not take advantage of both catch-up provisions. I.R.C. §414(v)(6)(C); Prop. Treas. Reg. §1.457-4(c)(2)(ii).

[163] Governmental plans, in practice, are generally offered to a wider range of employees, but they are not subject to the non-discrimination requirements applicable to 401(k) and 403(b) plans. They may, however, be subject to state statutory or constitutional nondiscrimination requirements.

[7] Excess Deferrals

Excess deferrals are deferrals in excess of the amount that an individual may defer, taking into account the basic annual deferral limitations and any applicable age 50 and 457(b)(3) catch-up contributions. Excess deferrals are measured both with respect to the individual participant (the individual limitation) and with respect to a particular plan to which contributions are made. Because of the individual limitation, a person may have excess deferrals even though none of the deferrals to a particular plan in which the individual participates exceeds the deferral limitations for that individual in that plan.

An individual's deferral will exceed the individual limitation to the extent that the individual's combined contributions, including basic annual deferrals, age 50 catch-ups and 457(b)(3) catch-ups, to all of the 457(b) plans in which the individual participates exceed the amount which that individual is permitted to contribute. A contribution to a particular plan that exceeds this individual limitation will not cause that plan to lose its eligible status, whether or not the plan returns this excess.[164] The individual must take the excess (plus income earned on the excess) into income, however, whether or not the excess is returned.[165] In contrast, under the proposed regulations, excess deferrals to a tax exempt plan (taking into account only deferrals to that plan and other 457(b) plans sponsored by the same employer) will cause the plan to lose its eligible status.[166] Thus, it appears that under the proposed regulations, it may not be possible to correct the excess deferral simply by returning the excess amount.

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[164] Prop. Treas. Reg. §1.457-5(a).

[165] Prop. Treas. Reg. §1.457-4(e)(4).

[166] Prop. Treas. Reg. §1.457-4(e)(3).

All excess deferrals, whether or not as a result of the individual limitation, are included in gross income in the year the income is deferred, or if later, the year in which the deferral is not subject to a substantial risk of forfeiture.[167]

[8] Distributions

[167] Prop. Treas. Reg. §1.457-4(e).

Generally, distributions may not be made until there is a severance from employment or the employee reaches age 70½.[168] Earlier distributions may be made in the event of an unforeseeable emergency[169] or if the distributions constitute a qualified distribution of a small amount.[170] These distributions may be made without rendering the entire account immediately taxable.[171]

[9] Unforeseeable Emergency

[168] I.R.C. §457(d)(1)(A).

[169] I.R.C. §457(d)(1)(A)(iii).

[170] I.R.C. §457(e)(9) (tax exempt plans); I.R.C. §457(d)(3) (governmental plans).

[171] Governmental plans may also permit loans under certain circumstances.

Early distributions for an unforeseeable emergency do not cause the entire account to be treated as having been "made available" to the employee and thus subject to immediate taxation. The regulations give some guidance as to what constitutes an "unforeseeable emergency" but do not create any safe harbors.[172] An "unforeseeable emergency" is defined to include (1) the participant's or beneficiary's severe financial hardship resulting from the illness or accident of the participant, the beneficiary or a spouse of either, (2) loss of property due to casualty, or (3) similar extraordinary circumstances. Examples of these extraordinary circumstances include (1) imminent foreclosure of, or eviction from, a primary residence, (2) payment for medical expenses, and (3) funeral expenses for a family member.[173] If the emergency could be relieved through other resources, such as insurance, liquidation of assets or ceasing deferrals of additional income, then the distribution will not qualify as a distribution for an unforeseeable emergency.[174] Moreover, only the amount needed to cover the emergency, plus attendant taxes and penalties, will be treated as a qualified distribution. In short, the "unforeseeable emergency" standard under I.R.C. §457(b) is more stringent than that for financial hardship under §401(k) and §403(b).[175]

[10] Voluntary or Involuntary Distributions of Small Accounts

A 457(b) plan may require or permit distribution of the account balance if the

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[172] Prop. Treas. Reg. §1.457-6(c).

[173] Prop. Treas. Reg. §1.457-6(c)(2).

[174] Prop. Treas. Reg. §1.457-6(c)(2)(ii).

[175] See, Treas. Reg. §1.401(k)-1(d)(2).

distributed amount[176] does not exceed the I.R.C. §411(a)(11)(A) limit ($5,000 in 2003),[177] no amount has been deferred under the plan for the participant during the 2 year period preceding the distribution, and the participant has not previously received an in-service distribution under this exception.[178] The plan may permit the participant voluntarily to withdraw a small distribution under the same circumstances.[179] Mandatory and discretionary small distributions may also be combined, so that the plan can require termination of an account that drops below a stated value and also permit small distributions (of a lower value) at the participant's election.[180]

[11] Loans

Amounts loaned to a participant of a tax exempt plan are treated as having been paid or made available to the participant, and thus subject to taxation as a distribution that violates the requirements of I.R.C. §457(d).[181]

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[176] The Code is not clear in its use of "amount.@ Some commentators believe that the involuntary distribution can be made if the account balance is $5,000 or less. Others claim that the regulations permit an involuntary distribution if the distribution is $5,000 or less, even if the account balance exceeds $5,000.

[177] The plan may set a lower standard as well, triggering mandatory distributions only if the account balance decreases to a smaller amount.

[178] I.R.C. §457(e)(9)(A); Prop. Treas. Reg. §1.457-6(e)(1).

[179] Prop. Treas. Reg. §1.457-6(e)(2).

[180] Id.

[181] Prop. Treas. Reg. §1.457-6(f)(1). Loans are permitted from governmental 457(b) plans but, because the assets are held in a trust, the loan must satisfy the exclusive benefit rule of I.R.C. §457(g)(1) and be reasonable to all beneficiaries of the trust. What constitutes reasonable terms and conditions, however, depends upon the partic ular facts and circumstances. Prop. Treas. Reg. §1.457-6(f)(1). Factors include whether the loan has a fixed repayment schedule and reasonable interest rate, and whether there are repayment safeguards to which a prudent lender would adhere. *See* Rev. Rul 69-494, 1969-2 C.B. 88 for typical standards. In general, the loan needs to satisfy the requirements of I.R.C. §72(p)(2) regarding the maximum amount of the loan and the repayment terms. If these requirements are not satisfied, the participant must take the loan distribution into

income in the year received.

[12] Taxation

Distributions from a 457(b) governmental plan are included in income when paid, but distributions from a plan provided by a tax exempt organization are included in income when paid or made available.[182] Thus, a constructive receipt approach applies, and deferred amounts are taxed at the earliest date after severance from employment on which the plan permits distributions to commence (but in any event, not later than when the participant reaches age 70½).

[13] Elections to Defer Commencement of Distributions from Plans Offered by Tax Exempt Organizations

[182] I.R.C. §457(a)(1).

Section 457(b) plans offered by a tax exempt organization typically indicate the time when distributions must commence following a severance from service. For example, the plan may provide that distributions will commence six weeks after severance from service. At that time, the deferred amounts will be considered "made available" and will be taxable to the employee.[183] The plan may permit the employee, during a discrete period of time, to elect to defer the commencement of distributions to a fixed and determinable future date.[184] The election period must terminate no later than the earlier of (i) the default date under the plan on which distributions would otherwise commence and (ii) the participant's required beginning date. The selected future date also may not be later than the participant's required beginning date under I.R.C. §401(a)(9).[185] The election, if made, will defer the time at which the account balance will be deemed to be "made available," and thus, taxable, to the participant.

The tax exempt organization's 457(b) plan may permit the employee to make multiple elections during this initial election period. The plan may also permit the employee to make one more election, after the election period but before distributions actually commence under the initial election, to further defer (but not accelerate) distributions.[186] If no election is made, then amounts will be taxable when made available under the plan's default schedule.[187]

For example, if a plan provides that distributions commence two months after severance

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[183] Prop. Treas. Reg. §1.457-7(c)(2).

[184] I.R.C. §457(e)(9)(B); Prop. Treas. Reg. §1.457-7(c)(2)(ii)(A). Elections as to the form of payout (e.g., lump sum, annuity or installment method, are discussed in §1.10[14], *infra*.

[185] Id.

[186] Prop. Treas. Reg. §1.457-7(c)(2)(iii).

[187] Prop. Treas. Reg. §1.457-7(c)(2)(ii)(B).

from employment unless an election otherwise is made prior to commencement of distributions, and an employee retires on June 1, 2003 at age 55, the employee might elect on June 2 to defer commencement of distributions until January 1, 2007, then elect on June 15, 2003, to defer distributions until January 1, 2010, and decide again on June 30, 2003 to defer distributions until January 1, 2012. Since each of these elections is made prior to August 1, 2003, when distributions otherwise would commence under the default provisions of the plan, all of the elections count as a single, "first" election. Moreover, all of the elections are permissible since distributions would commence prior to the participant's required beginning date. If the plan permits a second election, then the participant could make a single election, after August 1, 2003, to further defer the commencement of distributions until after January 1, 2012, as long as the selected date ensured that distributions would commence prior to the participant's required beginning date.

[14] No Early Withdrawal Penalty

Unlike 401(k) and 403(b) plans, 457(b) plans are not subject to the early withdrawal penalty. However, amounts rolled over to a 457(b) governmental plan from a plan that is subject to the early withdrawal penalty need to be segregated since these rolled over amounts continue to be subject to the early withdrawal penalty.[188]

[15] Form of Payout

An 457(b) plan may provide the form of payment or permit the participant to elect the form of payout any time before distributions must commence (either under the default

[188] I.R.C. §72(t)(9).

provisions of the plan or under the terms of any election to defer distributions).[189] If the employee does not elect a form of distribution, then unless the plan default terms provide for something other than a lump sum distribution, the entire account will be included in the employee's income when the account first is treated as "made available."[190] The proposed regulations do not restrict the permissible forms of payout, although a lump sum distribution, annuity or periodic installments are all typical. If distributions are made over time, then plan assets will be deemed to be "made available," and thus taxable to the employee, over time as well.

[16] Designing the 457(b) Plan

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[189] Prop. Treas. Reg. §1.457-7(c)(2)(iv).

[190] Id.

A 457(b) plan is a relatively flexible plan that can be designed to meet the needs of the employer and a select group of top hat employees. As previously discussed, a plan may include a wide variety of optional features, including additional deferrals during the three years prior to normal retirement age, distributions in the event of an unforeseeable emergency, and distributions of smaller accounts.[191] In addition, a plan offered by a tax exempt organization may permit plan-to-plan transfers (from one tax exempt plan to another), but these plans are not eligible for rollover to other types of plans and cannot accept rollovers from other plans.[192]

[17] Deferrals

A 457(b) plan permits considerable flexibility in determining the conditions under which contributions may be made to the plan. The plan can be designed to provide only for elective deferrals. These can include regular compensation, accumulated sick pay, accumulated vacation pay and back pay. The agreement providing for the deferral must be entered into before the beginning of the month in which the amounts would otherwise be paid or made available, and the participant must be an employee during the month in which the deferral takes place.[193]

The plan can require that deferrals be a percentage of compensation and/or a set dollar amount. The plan can require a minimum deferral amount per pay period, per month or per

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[191] Governmental plans may also offer age 50 catch-up contributions and loans.

[192] Prop. Treas. Reg. §1.457-10(b)(1). Governmental plans may permit rollovers to and from 457(b) governmental plans, 401(k)s, 403(b)s, IRAs, SEPs and SIMPLEs. Rollovers between 457(b) governmental plans and tax exempt plans are not permitted, however, since one is a trust based plan and the other requires that amounts in the plan be subject to the employer's general creditors.

[193] I.R.C. §457(b)(4); Prop. Treas. Reg. §1.457-4(d).

year. It can also provide that any salary reduction agreement will remain in force until revoked or amended.[194]

The employer may also make employer contributions up to the maximum deferral limit (either in addition to or without allowing for elective deferrals). Employer contributions can be nonelective contributions of a fixed amount, a percentage of compensation, or a discretionary amount or percentage of compensation determined annually. The plan may include (instead or in addition) matching contributions up to a specific dollar amount or percentage of compensation. Matching contributions can be tied to employee deferrals to the 457 plan or to employee deferrals to a 401(k) or 403(b) plan. This second approach can enable the employer to avoid the nondiscrimination rules that apply to 401(k) and 403(b) plans with respect to the matching contributions. For example, matches could be made only to the 457 plan, with no matches for any 457 plan participating employees under the 401(k) or 403(b) plan. Under another design, the 457 plan could provide for employer contributions to the 457 plan only if the employer was unable to make additional contributions to a 401(k) or 403(b) plan, for example, as a result of the I.R.C. §401(a)(17) limitation on the amount of compensation that may be taken into account in a 401(k) plan, or as a result of the I.R.C. §415(c) limitation on total contributions to a 401(k) or 403(b) plan on behalf of a single employee. Because there are no nondiscrimination rules in the 457 plan, employer contributions may be made for some eligible employees in the plan and not for others.

[18] Vesting

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[194] Prop. Reg. 1.457-4(b).

Vesting schedules for 457 plans are not subject to Section 411 vesting requirements that apply to 401(k) or 403(b) plans. Vesting schedules may be keyed to attaining a specified number of years of service, promotion to a certain position or attainment of normal retirement age (all of which represent cliff vesting). Alternatively, vesting can occur gradually over a period of years. Despite this apparent flexibility, in fact flexibility is limited. Unvested deferrals and their earnings are taken into account, for purposes of the plan ceiling, when the deferrals vest, rather than when they are contributed.[195] Since excess deferrals to a particular plan offered by a tax exempt organization cause the plan to become ineligible,[196] subjecting these contributions to a vesting schedule involves significant risks.

[19] Investment Flexibility in Plans Offered by Tax Exempt Organizations

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[195] Prop. Treas. Reg. §1.457-2(b).

[196] Prop. Treas. Reg. §1.457-4(e)(3).

Defined contribution plans offered by a tax exempt organization may permit the employee to direct the investment of the funds.[197] However, because the assets remain general assets of the employer, subject to the claims of its creditors, some employers choose to limit the employee's investment choices.

The plan may provide that investment returns will be calculated at a fixed rate set forth in the plan, or will be based upon the rate of return on the investments designated by the employer or selected by the employee from among investment opportunities provided by the employer. Even if the employee is permitted to designate investments, the employer does not actually have to invest the deferred amounts in the investments designated by the employee since the plan assets remain solely the property of the employer. Where employees are permitted to direct investments, however, the employer generally follows the employee's direction, since the benefit is measured by the investment performance of the directed funds, whether or not the employer actually invests in these funds.

While the assets in the plan must remain subject to claims of the employer's general creditors, the deferred amounts may be maintained in the employer's general accounts or in a Rabbi Trust or any other type of investment fund so long as the assets remain available in the event of the employer's insolvency.

§1.12 SECTION 457(f) PLANS

A Section 457(f) plan is a non-qualified deferred compensation agreement sometimes referred to as an "ineligible" 457 plan. Generally it works like this: the tax exempt

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[197] Prop. Treas. Reg. §1.457-8(b)(1).

organization contributes funds to the plan, or to a Rabbi Trust, for one or more of its top-hat employees. There are no dollar limits on the amount of compensation that can be deferred into the plan. For instance, it is not unusual for a tax exempt organization to contribute $25,000 annually to a 457(f) Rabbi Trust for a valued CEO. Often these plans are tied into an incentive bonus package so that contributions may be based on the executive's achieving designated levels of membership in the association or target amounts of reserves or contributions.

To avoid immediate taxation of this money to the employee, the contributions must be subject to a "substantial risk of forfeiture." The substantial risk of forfeiture requirement is troubling because it is not a defined term. One can, however, draw conclusions as to its meaning from case law, private letter rulings, and Treasury regulations. Typically, the requirement is satisfied by requiring the executive (or other key employees, if the tax exempt organization desires) to work for a stated period of time (e.g., 10 years, to age 60, etc.). Sometimes, a deferred compensation plan will include a restrictive covenant and provide that the employee will forfeit the deferred compensation benefits if he or she violates the terms of the covenant. The IRS has indicated in private letter rulings and regulations under IRC §83 that a restrictive covenant, in and of itself, does not constitute a substantial risk of forfeiture.[198] Rather, the substance of the covenant must be carefully considered. For example, in a covenant not to compete, if the likelihood of an employee competing with the tax exempt organization is minimal because of the age or health of the employee (or perhaps the absence of any real competitors), then IRS may not consider the restrictive covenant to amount to a substantial risk

[198] I.R.C. §83 defines a substantial risk of forfeiture, unlike §457.

of forfeiture. The IRS regulations under §83 put the burden on the taxpayer to overcome the presumption that restrictive covenants are not substantial risks of forfeiture.

Because restrictive covenants in the context of a tax exempt organization are so difficult to evaluate, may tax practitioners choose to add other conditions of forfeiture in order to enhance the chances of a 457(f) plan surviving IRS scrutiny. Unfortunately, these other conditions often create a quite real possibility that the employee may not receive the deferred compensation benefits for which he or she bargained. For example, one common forfeiture provision provides for forfeiture of benefits if either the employer or the employee terminates the employment agreement before a date certain (for example, before the employee attains age 65). This kind of a provision exposes the employee to the very real risk that the employee will fall out of favor with a new board or CEO. Another approach, which is less risky, provides that benefits are forfeited if the employee voluntarily terminates employment before a date certain. Death and disability would not be treated as "voluntary" termination, but the condition operates as a golden handcuff, requiring the key employee to stay with the association for a stated period of time. Using this condition in combination with a restrictive covenant creates a legitimate risk of forfeiture that the authors believe would be sufficient to satisfy IRS scrutiny.

A 457(f) plan can also be used to enable a key employee to defer a substantial portion of his or her compensation. While this plan allows the employee to defer more compensation than would be possible under a 401(k) or 403(b) plan, the employee's deferrals must remain subject to a substantial risk of forfeiture. Thus, the possibility of larger deferrals comes at the price of real risk that the employee's contributions will be left on the table.

When employee funds, rather than association funds, are used, often the substantial risk of forfeiture is created through a restrictive covenant or a condition that the employee not unilaterally terminate employment for a stated number of years, rather than through a condition requiring the employee to work for the organization until reaching a specified age, that is, a condition that could be violated through the unilateral action of the employer.

When only employee funds are contributed to the plan, often the plan allows the executive (or other key employee) to determine the length of the risk period. This is entirely legal as long as the election is made prior to the time the deferral is made. For instance, the plan could allow the employee to determine how long he or she must work with the association before the contribution will vest. This is referred to as a "rolling" substantial risk of forfeiture.

A 457(f) plan has no discrimination rules and no limits on employee or employer contributions. The plan can thus permit one or more key employees to defer significant amounts of compensation, but this flexibility comes at a price. The plan often operates as a golden handcuff, however, requiring the key employee to stay with the association for a stated period of time. The assets in the Rabbi Trust or 457(f) plan are subject to the claims of the association's general creditors, and receipt of promised benefits is conditioned upon satisfying the conditions constituting a real risk of forfeiture.

§1.13 TRUSTEE CONSIDERATIONS

Whether a tax exempt organization should have an institution serve as a trustee for its qualified retirement plans or have two or three key employees, officers or board members serve as trustee is a decision that will be driven by the philosophy and unique circumstances of the tax exempt organization. As a general rule, the use of an institutional trustee gives the impression of independence to staff employees. It also appears to insulate the plan from the management of the tax exempt organization. This is a matter of perception only - in most cases, management or a plan committee selected either by management or by the board, will direct the institutional trustee in all meaningful decisions. Institutional trustees will charge a fee for their services. Key employees, officers and board members, on the other hand, are generally not given any compensation for serving as trustees.

Moreover, utilizing key employees or board members as trustees provides greater flexibility. Some institutions will only serve as trustee when the tax exempt organization adopts one of the institutional trustee's own prototype plans. Many tax exempt organizations want a plan that is tailored to their needs, whether this involves using comparability plans, 401(k)s with additional matches for employees with more years of service and/or age, or any kind of defined benefit plan. These features cannot be found in a prototype plan; they are only available in a carefully designed plan that takes into account the unique objective and demographics of the particular tax exempt organization. Institutional trustees are by and large simply not geared up to either design or administer these specialized types of plans. If an institutional trustee requires the use of its prototype plan, then part of the price of using that trustee may be foregoing a plan expressly designed to meet the unique needs and objectives of the particular employer.

A self-trusteed and individually designed plan can be structured to provide total flexibility with respect to the choice of investments and investment managers. If an investment manager is not performing up to par, the trustees simply change to another investment manager. In contrast, if an institutional trustee is also responsible for investing plan assets (often in its own investment vehicles or products), changing investment managers is more difficult since there is no separation of identity between the trustee and the investment management. In essence, the trustee would need to fire itself. In this situation, the officers or board members need to effect the change; the change cannot be effected simply through the actions of the plan trustees, and the procedure, as a result, becomes more complex. It is not unusual for the tax exempt organization to be required to adopt a new plan document as well as hire a new trustee.

To change the institutional trustee, often times the tax exempt organization's board or officers must provide the institutional trustee notice, and the new institutional trustee will likely require accountings, relief of any fiduciary obligations and indemnification against any actions undertaken before it assumes trusteeship under the plan. In addition, some institutional trustees assess penalties for early withdrawal of pension funds from certain institutional investments.

A tax exempt organization should consider implementing a written investment policy. This policy should be well thought out and carefully drafted to protect the trustees and the plan administrator from Department of Labor audits or legal scrutiny from participants. The policy should contain broad objectives and procedures. Once written, however, it must be followed. Otherwise, the tax exempt organization is better off without written investment policies or procedures.

The investment policy should define acceptable investment risks, set forth allowable classes of investments, and, for a plan in which participants do not direct investments, include broad guidelines as to allocations among different types or classes of investments. The trustees should select investment managers whose investment philosophy is reflective and representative of the plan's written investment policies, taking into account the managers' methodology and style of investment. The plan trustees need to review investment performance and the investment management fees at least semi-annually, though quarterly is preferable. The world of investments has gotten so sophisticated that there are now companies that do nothing but work with the plan administrators and/or trustees of retirement plans sponsored by relatively small organizations to ensure that they are meeting their fiduciary standards and to help them adequately assess the various investment managers available to them.

While the plan trustees clearly need to undertake this type of analysis, an organization's officers or board of directors also need to consider these issues even if the plan uses an institutional trustee. Using an institutional trustee simply does not shelter a plan sponsor from liability. Just imagine a scenario where a tax exempt organization uses an institutional trustee that invests all of the plan assets in the trustee's proprietary products. The investments over a ten year period earn well below average and a cursory review by the plan sponsor would have brought this dismal performance to light. Who should be liable for this consistently poor investment return --only the trustee? only the plan sponsor? both parties? Suffice it to say, the prudent plan sponsor cannot ignore investment yields or its own investment policy just because the trustee of the plan is an outside institution. In the end, in delegating investment responsibility to the institutional trustee, the plan sponsor has a fiduciary responsibility to select the trustee carefully and continually monitor its performance. A full analysis of who is deemed to be a fiduciary under the law, as expounded by the courts, is well beyond the scope of this chapter. The trustee and the plan administrator are almost always deemed to be liable fiduciaries. An institutional trustee that can show that the plan's investment policy was established by the sponsoring institution (e.g., by a plan committee) will be largely successful in transferring liability to the plan committee.

The question of liability is a major issue under the 404(c) regulations. The plan fiduciaries are allegedly off the liability hook if the requirements of 404(c) are met, but of course, one of those requirements is that the plan offer prudent investment choices. If a participant can show that even one of the investment choices is not prudent, liability (at least as to that investment choice) remains with the plan fiduciary. This is why some plans do not even bother to try to come under the 404(c) regulations - they consider the regulations more trouble than they are worth. This discussion goes beyond the scope of this brief analysis, but its purpose is to show that liability will not necessarily shift to an institutional trustee simply because the investment strategy of an institutional trustee is not prudent. If the institutional trustee follows the written investment policies or directions of the plan committee or another named fiduciary, liability will remain with the named fiduciary.

Key employees, officers or board members who are named as fiduciaries can be indemnified by the employer. Employers or plans can purchase insurance for themselves and for their fiduciaries to cover liability or loss resulting from a fiduciary's acts or omissions.

§1.14 IMPLEMENTATION OF THE PLAN - TURN-KEY OPERATIONS VERSUS INDIVIDUALLY TAILORED PLANS

Often smaller tax exempt organizations prefer an institutional trustee that delivers a turn-key operation: the institutional trustee delivers a prototype plan document and takes care that the plan complies both in operation and in form with the Internal Revenue Code and the

Department of Labor and IRS regulations. With a valid prototype plan, the plan will have a valid determination letter, and the institutional trustee provides any required plan amendments, prepares the Form 5500s annually and sends out all necessary notices to plan participants.

Quality turn-key service is a great asset for a smaller tax exempt organization. The tax exempt organization, however, should carefully read the fine print to be certain what services it will really receive. The prudent CEO, COO or CFO should have legal counsel competent in retirement plan law review all documents and fee and investment agreements before signing the agreements. Often the institutional trustee will define its responsibilities quite narrowly, and without careful review of the contract by an experienced retirement plan attorney, the tax exempt organization may not appreciate that it will still need to rely on its accountant, plan administrator or retirement plan attorney.

In addition, the tax exempt organization needs to evaluate carefully the institutional trustee's expertise. Many institutional trustees have developed extensive technical expertise and provide excellent advice. Unfortunately, the authors have also seen the costly results of erroneous advice offered by institutional trustees. The tax-exempt organization sponsoring the plan understandably assumes that the institutional trustee has properly educated its employees and that the organization can follow the trustee's advice. In plans administered by institutional trustees, the authors have seen seven and five year cliff vesting in top heavy plans, both money purchase and profit sharing plans integrated with social security, plans in which only key employees are eligible to participate during the plan's first three years of its existence because a three year waiting period applies only to staff employees, and adoptive agreements sent home with a key employee who is told to fill it out the best he or she is able. On the other hand, the authors have also seen plans run in a very prudent and capable fashion by institutions offering turn-key retirement plans.

The alternative to a turn key plan is an individually designed plan that utilizes a team of advisors -- generally an ERISA attorney, a CPA or qualified plan administrator, and an investment advisor. Under this team approach, each professional brings extensive experience in his or her own area of expertise and the service often can be better tailored to the unique needs of the particular tax exempt organization. Often one of the advisors has already assembled a group of professionals who are used to working together and who can provide the tax exempt organization a seamless approach in which one of the advisors serves as the primary interface with the tax exempt organization.

§1.15 CONCLUSION

This chapter analyzes a number of retirement plan designs available to tax exempt organizations. Several of these plan designs can be tailored to the unique circumstances and goals of the sponsoring organization and many can be designed to enable the tax exempt organization to provide generous contributions for its most valued employees. Before using any of these more sophisticated plan designs, however, a tax exempt organization is well advised to seek professional assistance to design and implement the plan properly.