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CHAPTER 1

Choosing the Right Plan and Design for a Tax Exempt Organization or State and Local Government Requires Knowing the Rules and Motivation

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Synopsis

§ 1.01 INTRODUCTION

Employers approach qualified retirement benefits in different ways depending on their overall philosophy regarding benefits and depending on various factors such as where their business is in terms of success and growth. Some employers regard providing retirement benefits as a necessity to attract and retain top-notch employees. These employers tend to be paternal in their approach to benefit design and see the retirement benefits as "taking care" of their employees. These employers are more likely to provide a defined benefit plan or both matching contributions to any employee contributions as well as an employer contribution in a defined contribution plan. They are also more likely to take measures to reduce the costs to participants under the plan to improve the return to such participants.

Some owner-employers regard qualified plans as a great tax shelter that permits the employer to get a current deduction for employer contributions and yet permits the participants (including owners) to defer income. Other owner-employers are only concerned with how much they can benefit under the plan. These owner-employers are most interested in plan designs such as cross-tested plans and cash balance plans that permit the owners to accrue much higher benefits than other employees so they get more "bang for their buck." These owner-employers would likely not have a plan if they could not get the bulk of the benefit.

Finally, some owner-employers, particularly small businesses, don't provide retirement benefits at all or, at best, only provide a plan that permits employees to make elective deferrals with no matching contribution or other employer contribution. These are the owners who often believe that the business is their retirement vehicle and when the time comes they will sell their business and the profits will provide for them in retirement.

These generalities apply to for-profit employers who try to operate their businesses at a profit and who pay income taxes on such profits. Governmental organizations and tax exempt organizations have factors affecting any deferred compensation arrangements that they provide for employees that differ from those that affect for-profit employers. The most obvious is the fact that they are not motivated by getting a tax deduction for compensation paid or contributions made to employee benefits plans. State and local governments[1] as well as tax exempt organizations[2] generally do not pay income tax, therefore a deduction is worthless to them. These organizations are motivated by other factors such as competing with private employers for available human capital in the workforce. Often they are not able to offer as high of salaries as private employers due to budget restraints. In addition, being tax-exempt, they cannot offer equity in the employer as compensation (such as restricted stock, stock options, or phantom stock) to tie an employee's performance and remuneration to the performance of the employer. Therefore, providing deferred compensation as a benefit is often a way to make up for the fact that the employee's current compensation is lower than he or she may be able to receive in the private sector. As a result, a primary purpose of a retirement plan for these organizations is to provide compensation to the employee in the future and avoid it being taxed currently. Further, many such organizations have very small staff often with one full time executive and several part-time employees or volunteers. Therefore, various nondiscrimination rules can be problematic if trying to provide robust benefits for the executive to the exclusion of the others.

State and local governments and tax exempt organizations also have different restraints on their ability to compensate employees. Governmental organizations may be subject to constitutional restraints, investigation by oversight bodies, and public scrutiny if they were to pay excessive compensation to any employee. Likewise, most tax exempt organizations (i.e., Section 501(c)(3) charitable organizations, Section 501(c)(4) social welfare organizations, and Section 501(c)(6) trade associations) must be concerned with the Internal Revenue Code's prohibition against private inurement which is a requirement for their exempt status. Additionally, charitable organizations and social welfare organizations may be subject to excise taxes if compensation paid to any one individual is deemed excessive under the excess benefit transactions rules.[3]

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[1] For purposes of this article, unless otherwise noted, a State or local government includes any State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State. IRC § 457(e).

[2] For purposes of this article, unless otherwise noted, a tax-exempt organization is any organization, other than a governmental unit, exempt from income tax under the Internal Revenue Code.

[3] IRC § 4958.

This article will discuss the main types of defined contribution plans available to tax exempt and State and local government employers that permit elective deferrals of compensation by employees. It will compare and contrast the available plans by type of employer eligible to maintain the plan, employee coverage requirements, benefit limitations, and other rules. Specifically, it will discuss Code Section 401(k) plans, Code Section 457(b) plans, Code Section 457(f) plans, and Code Section 403(b) plans available to tax exempt organizations and State and local government employers. The objective is to point out the similarities and important differences among these plans to help assist the reader in determining which plan design best suits a particular tax exempt organization or State and local governmental employer. The history behind the rules is also often addressed to help aid understanding.

§ 1.02 401(k) PLANS

[1] Overview

By far the most common type of qualified retirement plan offered by employers today is the Code Section 401(k) plan. Due to legislative requirements, State and local governmental entities cannot offer such a plan to their employees unless it was offered prior to 1987 or the entity is a rural cooperative.[4] Likewise, tax exempt organizations could not offer a 401(k) plan from 1987 through 1996, unless one was offered prior to 1987 by the organization and was thereby grandfathered. This strange situation was the result of the enactment of the massive Tax Reform Act of 1986[5] (TRA 86) and the perception of Congress that 401(k) plans allow employers to push the burden of retirement planning on to employees,[6] as well as changes that were being made to Code Section 457 to allow tax exempt organizations to adopt those plans.[7]

The reason given for restricting the availability of 401(k) plans, according to the Joint Committee on Taxation, was that Congress believed that 401(k) plans allowed employers to shift too much of the cost of retirement savings to employees. The Committee's explanation states:

> ***Another way of reducing the shifting of the burden of retirement savings to employees was to limit the number of employers that can maintain cash or***

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[4] IRC § 401(k)(4)(B).

[5] Pub L 99-514, 100 Stat 2085, October 22, 1986

[6] The changes to the Federal tax laws brought about under TRA 86 were so comprehensive that the legislation actually changed the name of the Internal Revenue Code from the Internal Revenue Code of 1954 to the Internal Revenue Code of 1986. TRA 86 made sweeping changes to qualified employee benefits plans and individual retirement accounts. These included limiting the amount of elective deferrals into 401(k) plans and coordinating that limit with elective deferrals under a 457 plan or a 403(b) plan. Changes were also made to nondiscrimination requirements and uniform distribution rules.

[7] The history of IRC § 457 plans is addressed in the next Section.

deferred arrangements. Thus, Congress believed it was necessary to preclude the availability of qualified cash or deferred arrangements to State and local governments and tax exempt employers.[8]

However, 10 years after TRA 86 was passed, Congress enacted pension simplification legislation as part of the Small Business Jobs Protection Act of 1996 (SBJPA)[9] that included increasing access to retirement savings plans as a theme. As part of this legislation, nongovernmental tax exempt organizations were once again allowed to adopt 401(k) plans. SBJPA also included Indian Tribal Governments and related organizations as tax exempt organizations for this purpose. The prohibition on adopting 401(k) plans still applied to State and local governments though and still does today.

The blanket statement made for this change back to allowing tax exempt organizations to adopt 401(k) plans as stated in the Senate Finance Committee Report was:

Nongovernmental tax-exempt entities should be permitted to maintain qualified cash or deferred arrangements for their employees on the same basis as other employers.[10]

However, tax exempt organizations paid a cost to regain the ability to adopt 401(k) plans in the form of having elective deferrals "coordinated" with other elective deferrals under other plans, including 457 plans, 403(b) plans, 408(p) SIMPLE Plans, and 408(k) SEPs.[11] In 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[12] removed 457 plans from this coordination for years beginning in 2002, providing such plans with their own non-coordinated deferral limit. This means that if an employer maintained both a 457 plan and a 401(k) plan, a participant could electively defer the maximum deferral into each plan. The same could be done with a 457 plan and a 403(b) plan. However, this could not be done if the employer maintained both a 401(k) plan and a 403(b) plan because the deferrals are coordinated.

Thus, today, tax exempt organizations can adopt 401(k) plans but State and local governmental employers can only continue their plan if it is grandfathered because it was adopted before TRA 86. However, just because one of these organizations can adopt a 401(k) plan doesn't necessarily mean it is the best plan to meet its benefits goals. For example, if the organization has a number of low-paid staff and one

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[8] General Explanation of the Tax Reform Act of 1986, Prepared by the Joint Committee on Taxation p. 634

[9] Pub L 104-188, 110 Stat 1755, August 20, 1996.

[10] Small Business Jobs Protection Act of 1996, Senate Finance Committee Report, p. 72.

[11] IRC § 402(g)(3).

[12] Pub L 107-16, 115 Stat 38, June 7, 2001.

full-time Executive Director eligible to participate in the plan, but the staff do not electively defer or only in small amounts, the plan could annually fail the Average Deferral Percentage (ADP) test, preventing the Executive Director from being able to maximize his or her elective deferral. A safe harbor plan design could avoid this but could be cost prohibitive given the financial restraints on such organizations.

[2] Tax Qualification

401(k) plans are subject to all the participation and service requirements of a qualified plan. This means it is difficult to exclude employees from participating in the plan if they earn 1,000 hours of service in a year unless they are under age 21 or subject to a collective bargaining agreement. In addition to the ADP test mentioned above, 401(k) plans are subject to the Average Contribution Percentage test for matching contributions as well as the coverage and nondiscrimination rules for all qualified plans.[13]

[3] Elective Deferrals

The amount an employee can electively defer into a 401(k) plan for the 2017 year is limited to $18,000.[14] Participants age 50 or older can defer up to an additional $6,000, if the plan so provides.[15] These amounts are adjusted for cost of living increases periodically. The amount a participant can electively defer is also limited by the ADP test designed to prevent the average percentage of compensation deferred by Highly Compensated Employees (HCEs) from being too much higher than the average percentage of compensation deferred by non-highly compensated employees (NHCEs). The test determines the ADP of all HCEs by adding each respective deferral as a percentage of compensation and dividing by the number of HCEs. The same is done for the NHCEs. Importantly, if an employee is eligible to defer under the plan but elects not to, such employee is a zero in the numerator but counted in the denominator. This has the effect of lowering the average. Generally, the ADP of the HCEs cannot exceed the ADP of the NHCEs by more than the greater of 125%; two times the ADP of the NHCEs; or the ADP of the NHCEs plus 2 or the plan fails the test.[16] If a plan fails the ADP test, corrective action must be taken to reduce the HCE ADP or to increase the NHCE ADP to pass the test. This means that elective deferrals of HCEs must be distributed back to them in a sufficient amount to bring down the ADP to pass the test or the employer must contribute fully vested amounts to the NHCEs to bring up their ADP to pass the test.

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[13] IRC §§ 410(b), 401(a)(4), and 401(a)(26).

[14] IRC § 402(g).

[15] IRC § 414(v)(6)(A)(i).

[16] IRC § 401(k)(3)(A).

Thus, employers who have a significant percentage of NHCEs who are eligible but do not defer, often find themselves having to refund elective deferrals to HCEs to pass the ADP test which makes the plan design less than optimal for the HCEs who wind up unable to defer the maximum amount. There are plan designs to avoid failing the ADP test, most notably a safe harbor plan whereby the employer makes a fully vested employer contribution or matching contribution for all eligible employees and thereby escapes the ADP test altogether.[17] However, this comes at increased employer cost that can be a burden on the budgets of tax exempt organizations.

[4] Contribution Limits

Additionally, the total amount of compensation in 2017 that may be taken into account under a 401(k) plan in a year is capped currently at $270,000[18] and the total contributions that can be made to the plan in 2017 is capped at $54,000 under Code Section 415.

§ 1.03 457 PLANS

[1] Overview

Internal Revenue Code Section 457 is one of the most interesting and complex Sections of tax law due to its breadth, nuances, and history. Addressing the tax consequences of deferred compensation of employees of both State and local governmental entities and tax exempt organizations, yet treating them differently adds to its complexity. Likewise, providing for the favorable tax consequences for "eligible" plans that meet its requirements as well as the less favorable consequences for "ineligible" plans that fail to meet its requirements demonstrates its breadth.

Section 457 was first enacted in 1978 to govern nonqualified deferred compensation plans of State or local governments. It was enacted in response to proposed regulation § 1.61-16 that would have provided any individual who electively deferred fixed basic or regular compensation to another tax year was in constructive receipt of such compensation and taxed on it in the year of deferral. The proposed regulation would have applied to all individuals regardless of whether their employer was a for-profit entity, tax exempt organization or governmental institution.

Due to the public outcry against the proposed regulation, Congress added Code Section 457 to the Code,[19] addressing unfunded deferred compensation arrangements

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[17] There are two safe harbor formulas under Treas Reg § 1.401(k)-3. The first requires a nonelective, fully vested employer contribution to all eligible employees of 3% of compensation. The second requires a matching contribution of 100% of the first 3% of compensation electively deferred and a match of 50% for the next 2% of compensation deferred by employees.

[18] IRC § 401(a)(17).

[19] Revenue Act of 1978, Pub L 95-600, 92 Stat 2763, November 6, 1978.

of State and local governments and exempted such plans from application of the proposed regulation. It also suspended application of the proposed regulation to taxable employers. Prior to the issuance of the proposed regulation, State and local governments relied on the same guidance as the private sector regarding nonqualified deferred compensation plans. Revenue Rulings discussed the application of the constructive receipt doctrine to various deferred compensation arrangements set forth in the ruling[20] and set forth the requirements for receiving a private letter ruling from the IRS that the deferred compensation arrangement did not result in current taxation of the deferred amounts.[21] However, in 1977 the IRS issued a moratorium on any such advanced rulings as it issued proposed regulation § 1.61-16.[22]

[2] Tax Reform Act of 1986

As originally enacted in 1978, Code Section 457 only applied to deferred compensation plans of State and local government organizations. However, this changed with the enactment of the TRA 86. The reason for this change was that Congress believed that the Revenue Act of 1978 precluded the application of proposed regulation § 1.61-16 to taxable employers and Code Section 457 precluded its application to unfunded deferred compensation plans of State and local governments, but if the proposed regulation were finalized it would apply to employees of nongovernmental tax exempt organizations.[23] Congress also believed it was inappropriate to apply the constructive receipt principles of the proposed regulation to these employees but also recognized that, as with governmental organizations, because the usual tension between the employees desire to defer taxation and the employer's desire

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[20] *See* Rev Rul 60-31, 1960-1 CB 174. The constructive receipt doctrine is codified under IRC Section § 451 and basically says that a cash basis taxpayer is taxable on income that is credited to him where he or she can draw upon it even if he or she has not actually received it, unless the receipt of the compensation is subject to substantial restrictions. Treasury regulations cited in Rev Rul 60-31 describe it as follows:

> ***Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.*** [IRS Reg. 1.451-2(a)].

[21] *See* Rev Rul 71-19, 1971-1 CB 43

[22] *See, e.g.*, Rev Proc 99-3, 1999-1 IRB 103.

[23] General Explanation of the Tax Reform Act of 1986, Prepared by the Joint Committee on Taxation p. 653.

for a current deduction is not present, limits should be placed on how much compensation may be deferred just as with State and local governments.[24]

However, as mentioned above, making Section 457 apply to tax exempt organizations was counteracted by the fact that TRA 86 also prohibited tax exempt organizations and State and local governments from adopting 401(k) plans after 1986.[25]

[3] Classes of 457 Plans

[a] Overview

Section 457 sets forth a regime of taxation for deferred compensation plans of State and local governmental organizations and tax exempt organizations. It generally separates deferred compensation of such organizations into two classifications, eligible plans known as 457(b) plans and plans that are not eligible plans, known as "457(f)" plans. As one would suspect, 457(b) plans generally have better tax consequences than 457(f) plans.

In addition, Section 457 generally provides that there are two types of eligible employers: a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State (governmental employers); and any other organization, other than a governmental unit, exempt from tax (tax exempt employers).[26] The tax treatment of compensation deferred under a 457(b) plan is different depending on whether the eligible employer is a governmental employer or a tax exempt employer.[27]

Code Section 457(b) sets forth the definition of an "eligible deferred compensation plan." It begins with the pre-condition that it must be a plan maintained by an "eligible employer" and then sets forth numerous conditions of eligibility such as participants must only be individuals providing services to the employer and limitations on the amount that can be deferred, distribution requirements, etc.[28]

The tax rules for governmental employer 457(b) plans are much more liberal than the rules for tax-exempt employers. Compensation deferred by participants in a governmental employer 457(b) plan, and the earnings thereon, are only taxed when paid to the participant or his or her beneficiary.[29] Compensation deferred by

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[24] *Id.* at p. 654.

[25] As provided *infra*, this was corrected for tax exempt organizations in 1996 with the enactment of SBJPA

[26] IRC § 457(e).

[27] IRC § 457(a).

[28] IRC § 457(b).

[29] IRC § 457(a)(1)(A).

participants in a 457(b) plan of a tax exempt employer, and any earnings, is taxed when paid or otherwise made available to the participant or his or her beneficiary.[30] The difference, of course, is the "or otherwise made available" language for tax exempt organizations. This language is necessary because another difference between 457(b) plans of governmental employers and tax exempt employers is that a 457(b) plan maintained by a governmental employer must be funded with a trust for the exclusive benefit of the employees.[31] On the other hand, the title to the assets of a 457(b) plan of a tax exempt employer must remain in the employer and subject to its creditors.[32] If the assets are made available to the participant, by being set aside in an exclusive benefit trust, it will be taxable to the participant.

Section 457 not only provides the tax consequences of eligible 457(b) plans, that meet the eligibility requirements, it also provides tax consequences for plans that don't meet 457(b). Code Section 457(f) provides the tax consequences for compensation deferred under a plan of an eligible employer that does not meet the requirements of a 457(b) plan. Under a 457(f) plan, deferrals are taxed to the participant when they are vested. That is, when they are no longer subject to a substantial risk of forfeiture.[33] Thus, if an employee defers salary into a 457(f) plan and is vested in such deferral, whereby he could withdraw it at any time, he would still be taxed on the deferred income in the year of deferral even though he has not actually received it. Likewise, any earnings on such deferrals are also taxed when vested. So in the example, if the deferrals are credited with earnings of 5% annually, but the earnings are only available upon a termination of employment, the earnings would not be taxed until the employee terminates. On the other hand, if the earnings were also vested when credited, the employee would have additional income in the year the earnings are credited. If the employee has paid income tax on the deferral, he or she will not pay income tax again on the deferrals when they are distributed.[34]

Section 457(f) provides that compensation deferred under an ineligible plan will be taxed to the participant when the right to such compensation is no longer subject to a substantial risk of forfeiture and distributions would then be taxed under Code Section 72(t) similar to annuities. Compensation is subject to a substantial risk of forfeiture if its receipt is conditioned upon the future performance of substantial services by any

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[30] IRC § 457(a)(1)(B).

[31] IRC § 457(g).

[32] IRC § 457(b)(6).

[33] Unlike 401(k), 403(b) and 457(b) plans, 457(f) plans are also subject to the requirements for deferred compensation under IRC § 409A which provides draconian tax consequences for failing to meet its requirements. However, a discussion of IRC § 409A is beyond the scope of this article.

[34] IRC § 72(t).

individual.[35] Thus, if a 457(f) plan provides that the participant does not vest in the deferred compensation until the participant terminates employment with the employer, the participant will not pay income tax on the deferrals until he or she terminates such employment. However, once the participant terminates employment all the deferred compensation will be taxable in the year of termination regardless of when paid. If the deferred compensation is payable in installments over a period of years, the participant will pay tax on the present value of the income stream in the year of vesting. Earnings credited on the deferrals are also taxed upon the lapse of the substantial risk of forfeiture.[36] However, to the extent that earnings are still subject to a substantial risk of forfeiture they are only taxed when paid or made available.[37] When distributions are actually made the tax consequences are governed under Code Section 72(t) and the participant will not be subject to income tax again to the extent he or she has already paid tax on the deferred compensation and/or earnings.[38] Under Code Section 72(t) if distributions are made in installments each installment payment consists of some tax-free return of basis and some taxable earnings.[39] Obviously, unless the participant's tax rate is likely to increase after termination of employment, this is not a good plan design for the participant as he or she pays income tax on phantom income in the year of vesting. For this reason, 457(f) plans often provide for lump sum distributions.

While the tax consequences of a 457(f) plan are generally worse than under a 457(b) plan because the participant can pay tax on income not yet received, under the right circumstances, a 457(f) plan can still be quite useful. In fact, an employee could participate in both a 457(b) plan up to its limits on deferrals and a 457(f) plan for amounts above those limits.

[b] Governmental 457(b) Plans

[i] Overview

A governmental 457(b) plan can cover some or all of the employer's common law employees. It can restrict which employees are eligible by its terms because it is not

[35] IRC § 457(f)(3)(B).

[36] 26 CFR § 1.457-11(a)(1).

[37] 26 CFR § 1.457-11(a)(2).

[38] 26 CFR § 1.457-11(a).

[39] For example, assume a participant deferred $20,000 per year for 10 years until he retired and was credited with earnings annually and the deferrals and accrued earnings only vested upon termination of employment but the deferrals were only payable in annual installments over 10 years upon termination of employment, but the undistributed account continued to accrue earnings. Upon termination of employment, the participant would pay tax on the present value of the income stream of his vested account balance (deferrals and earnings) in the year of termination even though he or she would only receive one installment in that year. The following year the only portion of the installment paid that would be taxable would be that portion consisting of the new earnings credited for that year.

subject to any minimum coverage rules like a 401(k) or other qualified retirement plan. Likewise, a governmental 457(b) plan can permit independent contractors rendering services for the governmental employer to participate in the plan.

[ii] Trust Requirement

Contributions to a governmental 457(b) plan must be made to a trust for the exclusive benefit of the participants and their beneficiaries.[40] This is similar to the requirement for qualified retirement plans under ERISA and the Code. The trust itself is exempt from tax like a tax exempt organization under Code Section 501(a). Participants are generally only taxed when distributions are actually received from the trust.[41] The trust must be written and be a valid trust under applicable State law.[42] The terms of the trust must require that its assets may not be used for anything but the benefits of participants and beneficiaries until all such benefits have been paid.[43] Instead of an exclusive benefit trust, custodial accounts and annuity contracts described in Code Section 401(f) can be used and will be treated as trusts for this purpose.[44] Custodial accounts, annuity contracts, and a trust may be used in conjunction with one another under the same eligible governmental plan.[45]

[c] Tax Exempt Organization 457(b) Plan

Eligible 457(b) plans sponsored by tax exempt organizations are quite different from those sponsored by governmental organizations. Unlike a governmental 457(b) plan, the title to the assets of a tax exempt 457(b) plan must remain in the employer and subject to its general creditors.[46] This is the polar opposite of a governmental 457(b) plan where the assets must be held in a trust, custodial account, or annuity contract for the exclusive benefit of participants and beneficiaries. Additionally, because tax exempt 457(b) plans are subject to Title I of ERISA,[47] such a plan must be a "top hat" plan that is designed primarily for a "select group of management or highly

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[40] IRC § 457(g)(1).

[41] IRC § 457(g)(2)(B).

[42] 26 CFR § 1.457-8(a)(2)(i).

[43] *Id.*

[44] 26 CFR § 1.457-8(a)(3).

[45] *Id.*

[46] IRC § 457(b)(6).

[47] The U.S. Department of Labor has announced that deferred compensation plans of tax-exempt organizations are subject to the requirements of Title I of ERISA. DOL News Release/USDL:86-527/12-19-86. Additionally, the IRS has announced that compliance with the requirement of an exclusive benefit trust under Title I of ERISA would cause a plan to fail to be a Section 457(b) plan, causing it to be a 457(f) plan. IRS Notice 87-13, January 5, 1987, Q&A 25. Thus, to reconcile these two provisions, a Section 457(b) plan of a tax exempt employer cannot cover all employees but must only cover select

compensated employees." Top hat plans avoid the requirement of Title I that the assets of a retirement plan be held in an exclusive benefit trust.[48] Thus, the only way for a tax exempt organization 457(b) plan to meet the requirement that title to the plan assets remain in the employer and also comply with Title I of ERISA is to be a top hat plan. Due to having to be a top hat plan that only covers a select group of management and highly compensated employees, it is questionable whether such a plan could permit independent contractors of the tax exempt employer to participate other than compensated members of the board of directors.

If a deferred compensation plan of a tax exempt employer permitted employees that weren't part of the top hat group to participate, it would be a 457(f) plan. For example, if the National Association of Widget Makers adopted a plan intending it to be a tax exempt 457(b) plan but permitted all 200 of its employees to participate, the plan would be a 457(f) plan. The consequence of which would be that all participants would be taxed upon vesting as opposed to upon receipt of distributions as under a 457(b) plan.

[4] Tax Qualification

Unlike a 401(k) plan or other qualified plans, the tax benefits to a 457 plan are set forth in Code Section 457 and not governed by the requirements of Code Section 401(a). However, Section 457 does incorporate several of the 401(a) requirements into the eligibility requirements for governmental 457(b) plans. In this manner, they are much more like qualified plans than tax exempt 457(b) plans. For example, they are subject to required minimum distribution rules,[49] as well as the exclusive benefit trust.[50] Additionally, they can permit catch-up deferrals for any participant age 50 or older[51] whereby tax exempt organizations cannot offer such a catch-up in their 457(b) plans. Governmental 457(b) plans can also permit participant loans like a qualified plan but tax exempt organizations cannot offer that feature without the participant-borrower being taxed.

[5] Elective Deferrals

A participant in an eligible 457(b) plan may elect to defer the lesser of 100% of compensation or $18,000 annually, for 2017. While this sounds like the same rule as the 401(k) plan, there is an important difference. As previously discussed, since 2002, 457(b) contributions are not coordinated with elective deferrals under Code Section

management or highly compensated employees to avoid the requirement of funding through an exclusive purpose trust under ERISA.

[48] 29 USC § 1081(a)(3)

[49] IRC § 457(d)(2).

[50] IRC § 457(g).

[51] IRC § 457(e)(18).

402(g), but has its own dollar limit. This is quite useful when planning for the top hat group of a tax exempt organization as it permits members of the group to participate in a 401(k) plan for all employees and supplement it with contributions under a 457(b) plan. Further, the 457(b) contributions do not count against the Code Section 415 limit of the 401(k) plan. Additionally, a 457(b) plan need not be designed to be funded solely by elective deferrals of salary by participants but can be funded by nonelective employer contributions alone or in conjunction with elective deferrals. However, it is important to note that unlike a 401(k) plan, where employer matching or discretionary contributions are not coordinated with elective deferrals for purposes of the limit on elective deferrals, but are limited by the Code Section 415 limits, elective and nonelective contributions are cumulated and subject to the single $18,000 annual limit for 2017 in a 457(b) plan.

A governmental 457(b) plan can permit the age-50 catch-up contributions of up to $6,000 just like a 401(k) plan for 2017.[52] Again these are not coordinated with elective deferrals for purposes of the 402(g) limit on elective deferrals under other plans after 2001.

In addition, all 457(b) plans can have an additional catch-up contribution for participants in the last three years of service before reaching normal retirement age under the plan.[53] The maximum special catch-up amount is the lesser of: 1) twice the current year's maximum elective deferral (currently $36,000 for 2017); or 2) the "underutilization amount" for prior years.[54] The underutilization amount is basically the difference between the maximum amount of elective deferrals a participant could have made while participating in the plan less the amount actually made. However, any age-50 catch-up contributions are disregarded in determining the deferrals actually made by the employee. Calculating this underutilization amount can be quite challenging due to the changes in the law regarding 457 plans over the years. To calculate the amount the administrator must have good records regarding the employees participation all the way back to 1979, if necessary. In addition, prior to 2002, elective deferrals were limited to the lesser of the statutory deferral amount or 33 1/3 percent of compensation and were coordinated with elective deferrals under other plans. When a governmental plan offers both the age-50 catch-up and the special 457(b) catch-up, a participant eligible for both will be limited to the catch-up provision that provides the bigger deferral.

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[52] IRC § 414(v)(6)(A)(iii).

[53] IRC § 457(b)(3).

[54] *Id.*

[6] Contribution Limits

Importantly, contributions to a 457(b) or 457(f) plan are not subject to the $54,000 contribution limit under Code Section 415. Thus, to the extent the employer also has a 401(k) or 403(b) plan, the 457 plan will not reduce the annual additions available under those plans. Additionally, the total amount of compensation that may be taken into account under a 457 plan in a year is not capped by Code Section 415. However, as mentioned above, both elective deferrals and employer contributions are limited to the $18,000 amount during 2017.

§ 1.04 403(b) PLANS

Tax sheltered annuity plans for employees of public educational organizations and other organizations exempt from tax under Code Section 501(c)(3) have been around for a long time.[55] First codified in 1958, Code Section 403(b) governs such plans and was enacted to limit the amount of current compensation an employee could elect to defer to a later year to shelter it from current tax, pursuant to a salary reduction agreement under such plans.[56] It is important to note that not all organizations that are exempt from taxation are eligible to adopt 403(b) plans.[57] For example, a trade or professional association exempt from tax under Code Section 501(c)(6) is not eligible.

[1] Tax Qualification

Like 401(k) plans and 457(b) plans as well as other employee benefit plans, the requirements for 403(b) plans were significantly changed by TRA 86. Those 403(b) plans that weren't purely funded by elective deferrals, but to which employers made nonelective contributions were required to meet many of the same requirements as a 401(k) plan or other qualified plan. Thus, other than governmental plans or plans maintained by churches,[58] 403(b) plans are required to meet the coverage rules of Section 410(b), the ACP test with respect to matching contributions under 401(m),[59]

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[55] As originally enacted only organizations exempt from tax under IRC § 501(c)(3) were eligible but in 1961 these plans were extended to employees of public schools, colleges and universities under Pub L 87-370, 75 Stat 796, October 4, 1961.

[56] Technical Amendments Act of 1958, sec. 23, Pub L 85-866, 72 Stat 1606, September 2, 1958.

[57] 26 CFR § 1 403(b)(2)(b)(8) defines "Eligible employer" as: (A) A State, but only with respect to an employee of the State performing services for a public school; (B) A Section 501(c)(3) organization with respect to any employee of the Section 501(c)(3) organization, (C) Any employer of a minister described in IRC § 414(e)(5)(A), but only with respect to the minister; or (D) A minister described in IRC § 414(e)(5)(A), but only with respect to a retirement income account established for the minister.

[58] IRC § 403(b)(1)(D).

[59] Importantly, elective deferrals are not subject to the ADP test. This is an important consideration when choosing between a 401(k) plan and a 403(b) plan.

nondiscrimination rules of Sections 401(a)(4), (5), and (26), and the compensation limit under Section 401(a)(17).[60]

In 2007, final treasury regulations were issued regarding 403(b) plans, implementing changes to the law made by the Pension Protection Act of 2006,[61] as well as other legislation. These changes made 403(b) plans even more similar to 401(k) plans in terms of rules that must be followed.[62] In particular, the regulations require that all 403(b) plans have a written plan document that satisfies the requirements of Section 403(b) in form and the plan must also comply in operation.[63]

As a result of the changes in the requirements of these plans to get the tax advantage of tax deferral for contributions and earnings, it has become very difficult for these plans to not be subject to Title I of ERISA.[64] While the Code's requirement of a written plan document does not automatically make a 403(b) plan subject to Title I, each plan must be examined on a case by case basis. In general, too much employer involvement will make the plan a Title I plan. If the employer contributes to the plan it will be subject to Title I. Additionally, a plan that is only funded by elective deferrals will be subject to Title I if the employer requires participation by employees or limits the availability of funding vehicles, (i.e., the vendors who an employee could choose to use to fund the annuity or custodial account).[65]

[2] Elective Deferrals

Unlike a 401(k) plan, a 403(b) plan that permits elective deferrals is not subject to the ADP test that could result in deferrals being refunded to HCEs. Instead, 403(b) plans, other than plans maintained by a church or church controlled organization,[66] that permit elective deferrals must meet a special nondiscrimination in eligibility test known as the "Universal Availability" test.[67] Under this test, generally, if any employee of the employer maintaining the 403(b) plan may make elective deferrals, then all of the employer's employees must be given the opportunity to make elective deferrals. However, certain employees are permitted to be excluded from eligibility under the Universal Availability test, provided the exclusion is uniformly applied to all employees. These include: 1) employees who worked less than 1,000 hours the

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60 IRC § 403(b)(12).

61 Pub L 120 Stat 780, August 17, 2006.

62 26 CFR § 1.403(b)-1 through 11.

63 26 CFR § 1.403(b)-3(b)(3)(i)

64 29 USC § 1001, et. seq.

65 29 CFR § 2510.3-2(f)

66 As defined in IRC § 3121(w)(3).

67 IRC § 403(b)(12)(A)(ii).

previous year, or new employees who are expected to work less than 1,000 hours in the current year; 2) employees eligible to participate in a 401(k), 457(b) or another 403(b) plan of the same employer; 3) nonresident aliens with no U.S. source of income; and 4) students performing services under a work-study program.[68] Additionally, the plan can only require a minimum annual elective deferral of $200.[69]

It's important to note that while the ADP test of 401(k) plans retroactively tests the actual deferrals and compares the HCEs to the NHCEs, the Universal Availability test is only concerned with being effectively eligible to make deferrals. That is, provided an employee has the right to make elective deferrals, it doesn't matter whether they fail to do so because they believe they cannot afford to do it. This is an important distinction because under the ADP test such employees lower the ADP of NHCEs, making it more difficult to pass the test, because they add to the denominator but not the numerator. On the other hand, they have no such effect under a 403(b) plan's operation.[70]

[3] Catch-up Contributions

A 403(b) plan can permit participants who are age 50 or over to make up to $6,000 in catch-up contributions just like a 401(k) plan during 2017. However, similar to 457 plans, 403(b) plans sponsored by particular types of employers can permit a total of $15,000 in additional catch-up contributions for employees with at least 15 years of service.[71] Public school systems, hospitals, home health service agencies, health and welfare service agencies, churches, and conventions or associations of churches[72] can permit such participants to make an additional deferral of the lesser of: $3,000; $15,000, reduced by the amount of catch-up contributions made in prior years under the 15-year catch-up rule; or $5,000 times the number of the employee's years of service for the organization, minus the total elective deferrals made for earlier years.[73]

[4] Contribution Limits

Like a 401(k) plan, the total amount of compensation that may be taken into account under a 403(b) plan for purposes of employer contributions and the universal

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68 26 CFR § 1.403(b)-5(b)(4).

69 IRC § 403(b)(12)(a).

70 They would have an effect on the ACP test if the plan provided for matching contributions or after-tax employee contributions because they would again be zeroes in the numerator but counted in the denominator.

71 IRC § 402(g)(7)(A).

72 IRC § 402(g)(7)(B).

73 IRC § 402(g)(7).

availability test is capped currently at $270,000 for 2017[74] and the total contributions that can be made to the plan is capped at $54,000 for 2017.[75]

§ 1.05 HOW TO CHOOSE?

Tax exempt organization and State and local government employers and their benefits advisors should analyze the similarities and differences among 401(k) plans, 457 plans, and 403(b) plans to decide which plan or plans can be designed to meet their particular goals. The first and most important step in such analysis must be to determine which plans the organization is eligible to adopt. For example, a State or local governmental organization cannot adopt a 401(k) plan. Likewise, only certain tax exempt organizations can adopt a 403(b) plan. Finally, as shown above, a governmental 457(b) plan is much different from a 457(b) plan of a tax exempt organization. If an organization adopts a plan that it is ineligible to adopt, it will not receive the tax benefits of such plan and correcting the situation can be difficult, time-consuming, expensive and embarrassing.

After determining which plans the organization can adopt, which plan or combination of plans can be designed to meet the particular goals of the organization should be analyzed. For example, an organization exempt from tax under Section 501(c)(3) is eligible to adopt a 401(k), and 403(b) plan for all employees and a top hat 457(b) or 457(f) plan.

Other factors not addressed in this article should also be considered such as ease of administration, and understanding by employees, and availability of pre-approved plan documents,[76] as well as whether the organization is part of a controlled group that includes for profit entities. Like plan design for private sector employers the motivation behind the benefits goals of the employer with respect to HCEs or other key management employees[77] compared to NHCEs and rank and file employees will be a key factor.

§ 1.06 CONCLUSION

Given the range of available plans and myriad of rules governing the plans available to tax exempt organizations and State and local governmental employers, the designing of a retirement plan for such organizations is not a simple task and should not be made hastily. Often one type of plan will accomplish the employer's goals better than another. However, the employer might not be eligible to sponsor such a plan. Additionally, often a combination of plans is best to meet the goals.

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[74] IRC § 403(b)(12)(A)(i), citing Section 401(a)(17).

[75] IRC § 415

[76] Unlike 401(k) plans and 403(b) plans, currently there are no pre-approved 457 plans.

[77] In contrast to owners in the private sector.

This article has attempted to set forth the important differences among the various plans to assist the reader in understanding which plans are appropriate for which objectives.

(CX 2017-9/2017 Pub 1646)