WRMarketplace

An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Deferred Compensation for Tax-Exempt Organizations (Part I) - Tax-Qualified Arrangements

MARKET TREND: Increased tax rates have made deferring compensation increasingly popular in recent years. While tax-exempt employers and their executives are as interested in tax-deferral opportunities as taxable companies, there are differences in the deferral arrangements available to them.

SYNOPSIS: To provide deferred compensation using a tax-qualified arrangement, tax-exempt employers can offer the typical 401(k) plan as well as the 403(b) tax-sheltered annuity plan. Although the rules governing 401(k) plans and 403(b) plans have become increasingly similar over time (e.g., similar annual contribution limits apply to each arrangement), significant differences remain, particularly with regard to the ability to structure 403(b) plans as exempt from ERISA. The following summarizes the requirements for obtaining ERISA exemption for a 403(b) plan and similarities and differences in the rules governing the tax-qualification requirements applicable to both plans.

TAKE AWAYS: Advisers to tax-exempt organizations should understand the full range of available tax-qualified deferred compensation vehicles, particularly the 401(k) and 403(b) plans. While both plans provide largely the same benefits for participants, 403(b) plans offer the potentially significant advantage of an ERISA-exempt structure, which eliminates the need to comply with ERISA's fiduciary and other requirements and thus can help avoid the substantial expense and potential liability associated with monitoring the investments offered under the plan. Obtaining this exemption, however, requires the plan to forgo employer plan contributions, limiting the amount that can be deferred on behalf of participating employees to employee salary reduction contributions.

MAJOR REFERENCES: *IRC §§ 401(k) and 403(b) and underlying Treasury Regulations; Dept. of Labor Reg. § 2510.3-2.*

While distinctions between deferred compensation planning for tax-exempt and taxable employers have diminished over the years, some significant difference remain. To help guide clients in selecting and implementing the deferred compensation plan(s) most appropriate to their needs, advisers who work with tax-exempt employers should understand which plans are available to these employers and the distinctions among them.

There are differences among both tax-qualified plans and nonqualified plans available to these employers. This *WRMarketplace* will focus on the tax-qualified plans; an upcoming *WRMarketplace* will address nonqualified deferred compensation planning for tax-exempt employers.

401(k) PLANS vs. 403(b) TAX-SHELTERED ANNUITIES

The two types of tax-qualified plans available to tax-exempt employers are the 401(k) plan and the 403(b) tax-sheltered annuity, and employers may maintain one or both types of plans. While regulation of these plans has become more similar over time, several differences remain, including the ability of a 403(b) plan to be exempt from ERISA, which may be a key factor in determining whether an employer wishes to maintain a 403(b) plan or the more commonly known 401(k) plan.

ERISA Application. Because both 401(k) plans and 403(b) plans are designed to defer the receipt of compensation until retirement or other termination of covered employment, they generally constitute pension plans within the meaning of ERISA. This classification results in the imposition of ERISA's fiduciary duties on plan administrators with respect to the administration of the plans and the investment of plan assets.

403(b) plans, but not 401(k) plans, can be exempt from ERISA if they meet all the following requirements under applicable Department of Labor regulations:

- Participation is completely voluntary for employees.
- All rights under the annuity contract are enforceable solely by the employee, by a beneficiary of the employee, or by any authorized representative of the employee or beneficiary.
- The sole involvement of the employer other than the creation of the plan is limited to any of the following:
    - Permitting annuity providers to publicize their products to employees,
    - Requesting information concerning proposed funding media, products or annuity providers,
    - Summarizing/compiling the information collected to facilitate review and analysis by the employees,
    - Collecting salary reduction or similar contributions from employees and remitting them to the annuity provider,
    - Holding in the employer's name one or more group annuity contracts covering its employees, or
    - Limiting the products available to employees, or the providers who approach employees, to a number and selection that is designed to afford employees a reasonable choice in light of all relevant circumstances, including the administrative burdens and costs to the employer.

- The employer receives no direct or indirect compensation or consideration other than reasonable compensation to cover administrative expenses actually incurred by the employer in performing its duties pursuant to the salary reduction agreements.

A significant number of employers try to stay within these parameters so that their 403(b) plans remain exempt from ERISA's fiduciary and other requirements (and the associated costs and potential liability of monitoring plan investments). Note, though, that this approach only works for employers that want to provide only salary reduction contributions for their employees; if an employer wants to provide matching or nonelective employer contributions, it will need to adopt a plan that is subject to ERISA.

Other Notable Requirements. Other notable similarities and difference between 401(k) and 403(b) plans include the following:

Features/Requirements	401(k) Plan	403(b) Plan
Eligibility	Employer may establish minimum age and/or service requirements for any type of contributions, so long as plan satisfies minimum coverage and participation requirements	Generally, all employees willing to make annual salary reduction contributions of at least $200 must be allowed to participate ("universal availability requirement") Employer may establish minimum age and/or service requirements for employer contributions, so long as minimum coverage and participation rules are satisfied for these contributions (ERISA plans only)
Limits on Annual Deferrals (2014)	$17,500 - applies jointly to pre-tax and Roth contributions	$17,500 - applies jointly to pre-tax and Roth contributions
Catch-Up Contributions for Participants Age 50+ (2014)	$5,500	$5,500 - participant with 15+ years of service with plan sponsor can contribute an added $3,000 per year to a lifetime maximum of $15,000
Limits on Total Annual Contributions for Participant (2014)	Lesser of $52,000 or 100% of compensation (limit increases by amount of catch-up contributions permitted for the year by participants age 50+)	Lesser of $52,000 or 100% of compensation (limit increases by amount of catch-up contributions permitted for the year by participants age 50+ (but not for 15+ years of service)) (ERISA plans only)
Satisfaction of Minimum Coverage Requirements	Required for salary reduction and employer contributions (matching and/or nonelective), if any	Required for employer contributions (matching and/or nonelective), if any (ERISA plans only) Must meet universal availability requirement (see above)
Nondiscrimination Requirements	Satisfaction of annual numerical nondiscrimination test for salary reduction contributions ("ADP test"), similar test for matching and after-tax contributions ("ACP test"), and general nondiscrimination requirements (for nonelective	Satisfaction of ACP test (matching and after-tax contributions) and general nondiscrimination requirements (nonelective contributions) (ERISA plans only) Can avoid ACP testing if plan meets

Features/Requirements	401(k) Plan	403(b) Plan
	contributions) Can avoid ADP/ACP testing if plan meets safe harbors rules	safe harbor rules Nondiscrimination requirement for salary reduction contributions satisfied if universal availability requirement and certain notice requirements are met
Ability to Withdraw Account Balances	Withdrawals before participant is age 59-1/2 (or meets other limited exception) subject to 10% penalty tax. Withdrawals of Roth contributions further restricted to 5 years after first Roth contribution was made No withdrawal of salary reduction contributions before participant is age 59-1/2, has severance from employment, dies, becomes disabled or has a financial hardship Employer, after-tax, and rollover contributions may be distributed as provided under plan terms	Withdrawals before participant is age 59-1/2 (or meets other limited exception) subject to 10% penalty tax. Withdrawals of Roth contributions further restricted to 5 years after first Roth contribution was made No withdrawal of salary reduction contributions before participant is age 59-1/2, has severance from employment, dies, becomes disabled or has a financial hardship Employer contributions under an annuity contract issued: (1) before 2009 are limited only by plan terms or (2) after 2008 are limited to severance from employment, death or an event specified in the plan document
Ability to Transfer Account Balances to Other Tax-Favored Vehicle	Rollover generally permitted to other tax-qualified plan, 403(b) plan, governmental 457(b) plan or IRA. (Roth rollovers only allowed by a direct rollover to another Roth vehicle) Death beneficiaries allowed certain rollover rights	Rollover generally permitted to other tax-qualified plan, 403(b) plan, governmental 457(b) plan or IRA. (Roth rollovers only allowed by a direct roll over to another Roth vehicle) Death beneficiaries allowed certain rollover rights

TAKE-AWAYS

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- While both plans provide largely the same benefits for participants, 403(b) plans offer the potentially significant advantage of an ERISA-exempt structure, which eliminates the need to comply with ERISA's fiduciary and other requirements and thus can help avoid the substantial expense and potential liability associated with monitoring the investments offered under the plan.
- Obtaining this exemption, however, requires the plan to forgo employer plan contributions, limiting the amount that can be deferred on behalf of participating employees to employee salary reduction contributions.

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WRM #14-26 was written by Greenberg Traurig, LLP
Jonathan M. Forster
Martin Kalb
Richard A. Sirus
Steven B. Lapidus
Rebecca Manicone

Counsel Emeritus
Gerald H. Sherman 1932-2012
Stuart Lewis 1945-2012