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Lesser Known Differences between 403(b) and 401(k) Plans

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The rules surrounding 403(b) and 401(k) plans have become more similar, but a number of important differences remain. While many of the remaining differences are well known, this article describes some of the lesser known differences.

MANY DIFFERENCES WELL UNDERSTOOD, OTHERS LESS SO

Over the past 15 years, the rules surrounding 403(b) and 401(k) plans have become more similar, starting with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and continuing with subsequent guidance from the Department of Treasury and the Internal Revenue Service (IRS), including the 403(b) regulations effective January 1, 2009. Despite increased similarities between 403(b) and 401(k) plans, a number of important differences remain. Sponsors of 403(b) plans generally are aware of most of the remaining differences, such as the universal availability requirements applicable to 403(b) plans, but not 401(k) plans, and the actual deferral percentage (ADP) test applicable to 401(k) plans, but not 403(b) plans. However, there are a number of differences of which, in the author's experience, some 403(b) plan sponsors appear unaware. These differences include, but are not limited to, the following.

Severance from Employment

A *severance from employment* for purposes of a 403(b) plan is generally the same as for purposes of a 401(k) plan and generally occurs when the employee ceases to be employed by the employer maintaining the plan.¹ For these purposes, an *employer* means the employer maintaining the plan and those employers part of the same controlled group with the employer, such that a severance from employment requires ceasing to be employed by all employers of the controlled group.² An employee does not have a severance from employment if, in connection with a change of employment, the employee's new employer maintains such plan with respect to the employee.³ Among other things, an employee's severance from employment date can determine whether the employee can take a distribution from the plan.

However, for purposes of a 403(b) plan, a severance from employment also occurs on the date an employee ceases to be an employee of an employer eligible to sponsor a 403(b) plan. This can occur even when the employee continues to be employed by an employer in the same controlled group, if the other employer is not eligible to sponsor a 403(b) plan (such as where the employee transfers from a 501(c)(3) organization to a for-profit subsidiary of the 501(c)(3) organization). This also can occur when the employee becomes employed in a capacity that is not employment with an employer eligible to sponsor a 403(b) plan (such as where the employee ceases to be an employee performing services for a public school but continues to work for the same governmental employer). On

the other hand, there is not a severance from employment if an employee transfers from one 501(c)(3) organization to another 501(c)(3) organization within the same controlled group or if an employee transfers from one public school to another public school of the same employer.⁴

Separate Limit on Annual Additions, Except If Employee Controls Another Employer

Generally, the limit on annual additions applies separately to the contributions on behalf of an individual to all 403(b) plans of an employer and any affiliate within the employer's controlled group and the contributions on behalf of the individual to all qualified defined contribution plans (e.g., 401(k) plans) of the employer and any affiliate within the employer's controlled group. The limit on annual additions applies separately to 403(b) plans and tax-qualified defined contribution plans, such as 401(k) plans, except when an individual is *in control* of another employer. An individual is considered in control of another employer if the individual owns or controls more than 50 percent of the other employer. If an individual is in control of another employer (i.e., an employer other than the 403(b) plan sponsor and employers in its controlled group) that maintains a qualified defined contribution plan (i.e., a 401(a) plan, such as a 401(k) plan), such qualified defined contribution plan and any 403(b) plan in which the individual participates must satisfy the limit on annual additions both separately and combined.⁵ Compensation the individual receives from the 403(b) plan sponsor cannot be combined with compensation received from the other employer when testing the 403(b) plan and the other employer plan separately for compliance with the limit on annual additions. For example, if a physician is employed by a 501(c)(3) nonprofit hospital that provides the physician with a 403(b) plan, and the physician also maintains a private practice in which the physician owns more than 50 percent, then any qualified defined contribution plan of the practice must be combined with the 403(b) plan for purposes of the limitation on annual additions.⁶

Includible Compensation of Nonresident Aliens with US Source Income

For purposes of 403(b), annual additions cannot exceed 100 percent of an individual's *includible compensation*. This rule can be a problem for nonresident alien employees participating in their employer's 403(b) plan. Tax treaties between the United States and a nonresident alien's country of citizenship may exclude some or all of the nonresident alien's US source compensation from gross income for federal income tax purposes. Includible compensation is similar, but not quite identical,

to compensation for purposes of limiting annual additions to 401(k) and other tax-qualified plans. Unlike compensation for purposes of limiting annual additions to tax-qualified plans, includible compensation cannot include US source income that is excluded by a tax treaty.⁷ For example, if compensation paid to a nonresident alien is excluded entirely from federal income taxation due to a tax treaty and, therefore, from includible compensation, no contributions can be made on behalf of that employee to a 403(b) plan without exceeding the limitation on annual additions. This difference has been raised during IRS audits and may require a 501(c)(3) tax-exempt employer to consider a 401(k) plan for its nonresident alien employees, as participants in a 401(k) plan can be excluded from consideration under 403(b)'s universal availability rules. However, such an employer should be cognizant of the potential impact on nondiscrimination testing of its 403(b) and tax-qualified plans. Public schools and universities may need to cover nonresident aliens under a governmental 457(b) plan rather than a 403(b) plan.⁸

FICA Taxation of Mandatory Employee Contributions

For purposes of a 403(b) plan, a *salary reduction agreement* that is subject to Federal Insurance Contributions Act (FICA) taxation includes a cash or deferred election, like under a 401(k) plan. Unlike under a 401(k) plan, a *salary reduction agreement* that is subject to FICA taxation also includes a 403(b) contribution that reduces the employee's compensation and is made as a condition of employment (whether by statute, contract, or otherwise). Further, an agreement to reduce compensation under a onetime irrevocable election to participate in a 403(b) plan is a salary reduction agreement subject to FICA taxation, unlike a onetime irrevocable election to participate in a 401(k) plan.⁹ However, a contribution made pursuant to an employee's onetime irrevocable election made on or before the employee first becoming eligible to participate under the employer's plans or a contribution made as a condition of employment that reduces the employee's compensation is not an elective deferral for purposes of the 402(g) limit on elective deferrals under either a 401(k) or 403(b) plan.¹⁰ The applicability of FICA taxation is independent of any applicable coverage or nondiscrimination testing rules that might apply to mandatory employee contributions to a 403(b) plan, which generally would be treated as nonelective employer contributions like under a 401(k) plan.¹¹

No Hardship Distributions of Employer Contributions to Custodial Accounts

Amounts held in a 403(b) custodial account (rather than an annuity contract) attributable to employer contributions (*i.e.*, amounts that

are not 403(b) elective deferrals, Roth contributions, or employee after-tax contributions) may not be paid to a participant before the participant dies, has a severance from employment, becomes disabled, or attains age 59½. This rule also applies to such amounts transferred out of a custodial account and into an annuity contract, including earnings.¹² Thus, unlike employer contributions to a 401(k) plan, employer contributions to a 403(b) custodial account cannot be distributed upon the occurrence of some event, such as after a fixed number of years, attainment of a stated age, or hardship, even if later transferred to a 403(b) annuity contract. Employer contributions made directly to and remaining in a 403(b) annuity contract, however, can be distributed upon the occurrence of some event, such as after a fixed number of years, attainment of a stated age, or hardship, like employer contributions under a 401(k) plan.¹³ Note, however, that employer contributions to a 403(b) plan for purposes of the actual contribution percentage (ACP) safe harbor are not eligible for hardship distribution, regardless of whether made to a custodial account or annuity contract.¹⁴

Amounts attributable to Section 403(b) elective deferrals (including Roth contributions), whether to a custodial account or annuity contract, may not be paid to a participant earlier than the date on which the participant dies, has a severance from employment, has a hardship, becomes disabled, or attains age 59½.¹⁵ However, if elective deferrals are not maintained in an account separate from other contributions, then distributions may not be made earlier than *the later of* a date elective deferrals would be permitted to be distributed or a date the other contributions would be permitted to be distributed.¹⁶

Inadvertent Application of ERISA

Some 501(c)(3) tax-exempt employers maintain a 403(b) plan intended to be excepted from the Employee Retirement Income Security Act of 1974 (ERISA) under Department of Labor (DOL) regulations that permit such exception.¹⁷ There is no similar exception for 401(k) plans. Essentially, such an excepted 403(b) plan is not “established or maintained by an employer” for purposes of ERISA because all the following apply:

- (1) Participation of employees is completely voluntary,
- (2) All rights under the annuity contract or custodial account are enforceable solely by the employee or beneficiary of such employee, or by an authorized representative of such employee or beneficiary,

- (3) The involvement of the employer is limited to certain specified activities, and
- (4) The employer receives no direct or indirect consideration or compensation in cash or otherwise, other than reasonable reimbursement to cover expenses properly and actually incurred in performing the employer's duties pursuant to the salary reduction agreements.

The DOL has indicated that tax-exempt employers can comply with the requirements of the 403(b) regulations and remain within the DOL regulations exception from ERISA.¹⁸ However, the DOL has provided guidance as to certain actions that would remove the 403(b) plan from the ERISA exception. First, the DOL views employer contributions to the 403(b) plan, or to a separate plan but conditioned on employee elective deferrals to the 403(b) plan, as inconsistent with the limited employer involvement required by the exception and as conflicting with the requirement that employee participation in the 403(b) plan be completely voluntary.¹⁹

Second, in the opinion of the DOL, it would be inconsistent with the ERISA exception for the employer to have responsibility for, or make, discretionary determinations in administering the 403(b) plan. Examples from the DOL of such discretionary determinations are: authorizing plan-to-plan transfers; processing distributions; satisfying applicable qualified joint and survivor annuity requirements; and making determinations regarding hardship distributions, qualified domestic relations orders (QDROs), and eligibility for, or enforcement, of loans. Further, negotiating with annuity providers or account custodians to change the terms of their products for other purposes, such as setting conditions for hardship withdrawals, would be a form of employer involvement outside the safe harbor. The DOL guidance notes that the 403(b) regulations allow a plan to allocate responsibility for performing administrative functions to persons other than the employer, so to maintain the ERISA exception the plan documents should identify the parties responsible for administrative functions (including those related to tax compliance), correctly describe the employer's limited role, and allocate discretionary determinations to the annuity provider, custodian, participant, or other third party selected by the provider or participant.²⁰

Universal Availability and Hours Requirements

The 403(b) universal availability rules apply only to elective deferrals, which include Roth contributions if Roth contributions are

permitted under the plan. Under these universal availability rules, which do not apply to 401(k) plans, employees who normally work fewer than 20 hours (or some lesser specified number of hours) per week can be excluded from making elective deferrals, but only if all such employees are excluded. For purposes of the 403(b) universal availability rules, an employee normally works fewer than 20 hours per week *if and only if*—

1. For the 12-month period beginning on the date the employee's employment commenced, the employer reasonably expects the employee to work fewer than 1,000 hours of service in such period; and
2. For each plan year ending after the close of the 12-month period beginning on the date the employee's employment commenced (or, if the plan so provides, each subsequent 12-month period), the employee worked fewer than 1,000 hours of service in the preceding 12-month period.²¹

Once an employee, who normally works fewer than 20 hours (or the specified lesser number of hours) per week, works at least 1,000 hours in the applicable 12-month period under the terms of the plan, the employee is thereafter eligible to make elective deferrals, even if the employee works fewer than 1,000 hours in a subsequent year.²²

For those 403(b) plans subject to ERISA, the rules that would apply to a 401(k) plan to determine eligibility to make elective deferrals would apply to the 403(b) plan in addition to the universal availability rules described in the prior paragraph.²³ Under the ERISA rules, once an employee has at least 1,000 hours of service in the applicable 12-month period, the employee can no longer be excluded and must be allowed to participate in making elective deferrals no later than the earlier of (1) the first day of the first plan year beginning after the date the employee satisfied the 1,000 hours of service requirement or (2) the date six months after the date the employee satisfied the 1,000 hours of service requirement.²⁴

Aggregating a 403(b) Plan for Coverage or Nondiscrimination Testing of Other Plans

A 403(b) plan is disregarded for purposes of coverage or nondiscrimination testing of a 401(a) qualified defined contribution or defined benefit plan. However, a 401(a) qualified defined contribution or defined benefit plan can be taken into account for purposes of coverage or nondiscrimination testing of a 403(b) plan.²⁵ An illustration of

the practical importance of this difference can be shown in the following example. A 501(c)(3) tax-exempt hospital with a 403(b) plan and a qualified defined benefit plan wants to close its defined benefit plan to new hires and instead provide new hires with employer contributions to a defined contribution plan. If the new employer contributions for new hires were provided under the existing 403(b) plan, the contributions would need to be disregarded for purposes of testing the defined benefit plan. Suppose in this instance the defined benefit plan could not pass an average benefit percentage test when the 403(b) contributions are disregarded. Instead, the hospital would need to establish a new qualified defined contribution plan for the employer contributions to new hires so the defined benefit plan could pass the average benefit percentage test. Contributions under a 401(a) qualified defined contribution plan can be included in an average benefit percentage test when testing a plan that is not a 403(b) plan, such as the hospital's defined benefit plan, but contributions under a 403(b) plan cannot be included when testing the defined benefit plan. Note, however, that if the hospital establishes a 401(k) plan (or a qualified matching plan) to provide the new hires with employer contributions, certain coverage rules applicable to an employer that maintains both a 403(b) plan and a 401(k) plan may apply and would need to be reviewed.²⁶

Separate Accounting for Excess Annual Additions

Unlike a 401(k) plan, if an excess annual addition is made to a 403(b) plan, the excess fails to be a 403(b) amount (and, instead, the rules of 403(c) relating to nonqualified annuity contracts apply) and the remaining portion of the plan that includes the contribution not in excess of the limitations on annual additions is a Section 403(b) plan. However, this rule under which only the excess annual addition is subject to 403(c) does not apply unless, for the year of the excess and each year thereafter, the issuer of the annuity contract (or custodian of custodial accounts, as applicable) maintains separate accounts for the portion that includes the excess contribution and for the portion of the plan that includes the amount not in excess of the annual addition limitations.²⁷ The excess is included in gross income for the taxable year in which the excess contribution is made (or, if later, the taxable year in which amounts become nonforfeitable).²⁸ The excess contribution can be distributed without violating 403(b).²⁹ If a participant's 403(b) account invests in mutual funds and the limit on annual additions is exceeded, the participant may be subject to a 6 percent excise tax on the excess contribution. The excise tax does not apply to funds in an annuity account or to excess deferrals. The excise tax applies for each year in which there are excess contributions in the custodial account.³⁰

Importance of Understanding All Relevant Differences

Employers and plan advisors considering the differences between 403(b) and 401(k) plans should ensure they are aware of all the differences relevant to their circumstances. This is important for the 501(c)(3) tax-exempt organization considering whether to maintain or adopt a 403(b) or 401(k) plan for the organization or a related employer, for the human resources professional moving between 403(b) and 401(k) plan administration, or an attorney or other plan advisor consulting on both 403(b) and 401(k) plan design and compliance.

NOTES

1. See Treas. Reg. § 1.403(b)-2(b)(19).
2. The preamble to the 403(b) regulations states that, until further guidance is issued, the IRS Notice 89-23 good faith reasonable standard continues to apply to state and local public schools (and certain church entities) for determining the controlled group [72 Fed. Reg. 41138, July 26, 2007].
3. See Treas. Reg. §§ 1.401(k)-1(d)(2), 1.401(k)-6, and 1.410(b)-9.
4. See Treas. Reg. § 1.403(b)-6(h).
5. Note that the requirement to combine a 403(b) plan and qualified defined contribution plan for purposes of applying the limitation on annual additions could apply when there is only one employer involved, if the employer controlled by the individual maintains the 403(b) plan and a qualified defined contribution plan in which the individual participates. The two plans would need to satisfy the limitation on annual additions both separately and combined.
6. See Internal Revenue Code (Code) § 415(k)(4) and Treas. Reg. § 1.415(f)-1(f).
7. See Code §§ 415(c)(3)(E) and 403(b)(3) and Treas. Reg. §§ 1.415(c)-2(g)(1) and 1.415(c)-2(g)(5). See also D. Schwallie, “The Sky Is Not the Limit: Coordinating the Dollar Limit, Pay Cap, and Other 403(b) Limits,” 18 *Journal of Deferred Compensation* 12 (Fall 2012).
8. Under the universal availability rules, a 403(b) plan can exclude a nonresident alien with no US-source income from making elective deferrals. See Code § 403(b)(12)(A) and Treas. Reg. § 1.403(b)-5(b)(4)(ii)(C).
9. See T.D. 9367 and Treas. Reg. § 31.3121(a)(5)-2.
10. See Treas. Reg. § 1.402(g)(3)-1(b).
11. See Treas. Reg. § 1.401(a)(4)-1(b)(2)(ii).
12. See Treas. Reg. § 1.403(b)-6(c).
13. See Treas. Reg. § 1.403(b)-6(b) and the preamble to the 403(b) regulations [72 Fed. Reg. 41133, July 26, 2007].
14. See Code §§ 401(k)(12)(E)(i), 401(k)(13)(D)(iii)(II), 401(k)(2)(B)(i)(IV), and 402(e)(3) and Treas. Reg. §§ 1.401(k)-3(b)(1), 1.401(k)-3(c)(1), 1.401(k)-1(d)(3)(ii)(A), and the definitions of *qualified nonelective contribution* and *qualified matching contribution* in Treas. Reg. § 1.401(k)-6. See also D. Schwallie, “Nuanced ADP/ACP Safe Harbor Plan Design,” 40 *Journal of Pension Planning & Compliance* 1 (Fall 2014).
15. See Treas. Reg. § 1.403(b)-6(d)(1).

16. See Treas. Reg. § 1.403(b)-6(d)(3).
17. See 29 C.F.R. § 2510.3-2(f).
18. See DOL Field Assistance Bulletin No. 2007-02.
19. See DOL Advisory Opinion 2012-02A.
20. See DOL Field Assistance Bulletin No. 2007-02.
21. See Treas. Reg. § 1.403(b)-5(b)(4)(iii)(B).
22. See D. Schwallie, “Excluding Part-Time Employees Under the 403(b) Universal Availability Rules,” 39 *Journal of Pension Planning & Compliance* 31 (Spring 2013).
23. See Treas. Reg. § 1.403(b)-5(b)(4)(iii)(B).
24. See Code §§ 410(a)(3) and 410(a)(4); Treas. Reg. §§ 1.410(a)-1(b)(5), 1.410(a)-4(b), and 1.410(a)-5(a); and Example (3) of Treas. Reg. § 1.410(a)-3(e)(2).
25. See Treas. Reg. §§ 1.410(b)-7(f), 1.401(a)(4)-1(c)(4), 1.401(a)(4)-2(c), and 1.401(m)-1(b)(4)(iii).
26. See Treas. Reg. § 1.410(b)-6(g).
27. See Treas. Reg. § 1.403(b)-4(f).
28. For an interesting discussion of vesting schedules in 403(b) plans, see T. Peller, “The Paradox of 403(b) Vesting Schedules,” *Journal of Pension Planning & Compliance*, vol. 39 (Winter 2014).
29. See Treas. Reg. § 1.403(b)-4(f)(3).
30. See IRS Publication 571, Tax-Sheltered Annuity Plans (403(b) Plans), chapter 7 on excess contributions.