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A Few 403(b) Compliance Quirks

DANIEL SCHWALLIE

Daniel Schwallie, JD, PhD is an attorney with Aon Hewitt's Retirement Legal Consulting & Compliance practice. His areas of consulting include the design and administration of qualified pension and profit-sharing plans, 403(b) and 401(k) plans, and 457(b) nonqualified deferred compensation plans. He has published numerous articles on plan design and compliance and is the primary author of the *Cash Balance Plan Answer Book*, 3d ed. (New York: Wolters Kluwer, 2016).

Some 403(b) plan compliance issues can arise due to idiosyncratic characteristics of 403(b) plans rather than statutory or regulatory requirements different from other defined contribution plans such as 401(k) plans.

INTRODUCTION

The many similarities between 403(b) and 401(k) plans belie the remaining differences between them. Many of the remaining differences are due to differences in statutory or regulatory requirements and have been described elsewhere.[1] This article focuses on idiosyncratic differences between 403(b) and 401(k) plans that can result in 403(b) compliance quirks and are not due to differences in statutory or regulatory requirements.[2] Before continuing, it is important to note that only public schools, including public colleges and universities, churches and certain related organizations, and employers exempt from federal taxation under Internal Revenue Code (Code) section 501(c)(3) can sponsor a 403(b) plan and that, with the exception of certain grandfathered plans, state and local governments cannot have a 401(k) plan.[3]

ANNUITY AS THE DEFAULT FORM OF PAYMENT

A defined contribution plan that is subject to Title I of the Employee Retirement Income Security Act of 1974 (ERISA) and provides an annuity as the default (or "normal") form of payment must comply with a set of "qualified joint and survivor annuity" (QJSA) and "qualified preretirement survivor annuity" (QPSA) rules that otherwise apply to defined benefit pension plans.[4] Governmental plans,[5] church plans,[6] and salary-reduction-only 403(b) plans that satisfy the regulatory requirements to not be "established or maintained by an employer"[7] are not subject to Title I of ERISA and, therefore, are not subject to these QJSA and QPSA rules.

It is highly unusual for a 401(k) plan to provide an annuity as the default form of payment for a plan participant who does not elect another form of payment. It is not unusual for a 403(b) plan to provide an annuity as the default form of payment for a plan participant who does not elect another form of payment. This idiosyncrasy of 403(b) plans may be a remnant from before 403(b) plans could have custodial accounts, when 403(b) plans were truly "tax sheltered annuity plans."[8] Further, some 403(b) plan sponsors have, or had, defined benefit pension plans or defined contribution money purchase pension plans, both of which are required to have an annuity as the default form of payment.[9] Such plan sponsors may have wanted the default form of distribution from the 403(b) plan to match the default distribution form of their other plans. Often, if such 403(b) plan sponsors provided a matching contribution on elective deferrals to the 403(b) plan, the matching contribution would be made to the money purchase pension plan, although such arrangements are becoming somewhat less common with the elimination of the "maximum exclusion allowance" rules as part of the changes included in the Economic Growth and Tax Relief Reconciliation Act of 2001.[10]

With the advent of 401(k) plans in 1980, 401(k) plans replaced many existing money purchase pension plans among for-profit employers. The move to 401(k) plans was driven by a number of factors, but the actual replacement of money purchase pension plans with 401(k) plans was, in some part, due to the additional administrative and regulatory burdens regarding annuity distributions as the default form of payment that were introduced by the Retirement Equity Act of 1984 (REA).[11] REA imposed some additional distribution requirements on 401(k) plans generally, but not to the same degree as on defined contribution plans that provide an annuity as the default form of payment (whether or not a 401(k) plan).[12] Because money purchase pension plans are required to provide an annuity as the default form of payment, the QJSA and QPSA rules apply to a money purchase pension plan as though it were a defined benefit pension plan. Note, however, that if a 401(k) plan (or other defined contribution plan) offers optional annuity forms of payment and a participant elects one of those optional annuity forms, then the QJSA and QPSA rules apply to that individual, even though the plan does not provide an annuity as the default form of payment.[13]

Oversimplifying, the QJSA and QPSA rules are a set of rules defining the minimum surviving spouse benefits that must be provided and the timing and content of notices for a participant to waive, with spousal consent, the default annuity form (which includes surviving spouse benefits for married participants), if the participant wishes to elect a form of payment other than the default. While this may not initially appear burdensome, the details can prove to be so. For example, the QPSA is the default surviving spouse benefit if the participant dies prior to commencing the participant's plan benefit and a written notice explaining the QPSA must be provided within whichever of the following periods ends last:[14]

- The period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year preceding the plan year in which the participant attains age 35.

- A reasonable period after the individual becomes a participant.

- A reasonable period ending after the plan ceases to fully subsidize the QPSA with respect to the participant.

- A reasonable period ending after the QJSA and QPSA rules apply to the participant.

- A reasonable period after separation from service in the case of a participant who separates from service prior to age 35.

A "reasonable period" for purposes of the above is the two-year period beginning one year prior to and ending one year following the date the applicable event occurs.[15]

As another example, if a participant wants to waive the QPSA to name someone other than the participant's spouse to receive the pre-retirement survivor death benefit, such election must be made during the period that begins on the first day of the plan year in which the participant attains age 35 and ends on the date of the participant's death.[16] If a married participant is permitted to waive the QPSA and name a (nonspouse) pre-retirement death beneficiary prior to the first day of the plan year in which the participant attains age 35, such prior waiver and election becomes invalid as of the first day of the plan year in which the participant attains age 35, unless there is then a new waiver and election.[17]

The above examples are only meant to be illustrative of the complexity of the QJSA and QPSA rules and why most 401(k) plans avoid them. The same QJSA and QPSA regulations apply to 403(b) and

401(k) plans subject to Title I of ERISA. Neither 401(k) nor 403(b) plans are required to provide a default annuity distribution form, nor are either required to provide optional annuity forms. Nevertheless, for historical and other reasons, 403(b) plans are much more likely than 401(k) plans to provide an annuity as the default form of payment or to provide optional annuity forms of payment. This 403(b) plan quirk may increase the likelihood of a compliance issue, due to the complexity of the QJSA and QPSA rules and particularly if the plan sponsor or record keeper is not familiar with the rules.

MATCHING CONTRIBUTION RATES IN EXCESS OF 100 PERCENT

It is rare for a 401(k) plan to provide matching contributions at a rate in excess of 100 percent. Although not common, a 403(b) plan is more likely than a 401(k) plan to provide matching contributions at a rate in excess of 100 percent, particularly among institutions of higher education. For those 401(k) and 403(b) plans subject to actual contribution percentage (ACP) nondiscrimination testing that have a matching contribution rate greater than 100 percent, a special ACP testing rule applies.[18]

Under this special ACP testing rule, a matching contribution with respect to an elective deferral of a nonhighly compensated employee[19] cannot be taken into account for purposes of the ACP test to the extent it exceeds the greatest of the following three amounts:

1. Five percent of the nonhighly compensated employee's compensation;

2. The nonhighly compensated employee's elective deferrals for the year; or

3. Twice the plan's representative matching rate times the nonhighly compensated employee's elective deferrals for the year.[20]

Because this rule limits only matching contributions of nonhighly compensated employees, and not of highly compensated employees, that can be used in calculating the ACP test, this rule can only worsen the ACP test results (possibly requiring more or larger match distributions or forfeitures among highly compensated employees), but only if matching contributions exceed the largest of (1), (2), or (3) with respect to any of the nonhighly compensated employees.

The plan's *representative matching rate* is defined as the lowest matching rate for any eligible nonhighly compensated employee among a group of nonhighly compensated employees consisting of half of all eligible nonhighly compensated employees in the plan for the plan year who make elective deferrals for the plan year (or, if greater, the lowest matching rate for all eligible nonhighly compensated employees in the plan who are employed by the employer on the last day of the plan year and who make elective deferrals for the plan year).[21] Generally, the lowest matching rate from the half of all eligible non-highly compensated employees with the largest matching rates (*i.e.*, the median matching rate) would provide the best result for item (3) of the three amounts listed above. Note that, for purposes of this special rule, the matching rate is not necessarily the same as the matching rate (or rates) defined in the plan, but rather the matching rate is defined as the matching contributions made for the nonhighly compensated employee for the plan year divided by the nonhighly compensated employee's elective deferrals for the plan year. However, if this matching rate is not the same for all levels of elective deferrals for a nonhighly compensated employee, the nonhighly compensated employee's matching rate is determined assuming that the nonhighly compensated employee's elective deferrals are equal to 6 percent of compensation.[22]

A corresponding rule applies with respect to matching contributions on non-Roth employee after-tax contributions and with respect to matching contributions for plans that provide matching contributions on the sum of elective deferrals and non-Roth employee after-tax contributions.[23]

Because matching contribution rates in excess of 100 percent are not common, some plan sponsors may not be aware of this special rule. However, because contribution rates in excess of 100 percent are more common among 403(b) plans than among 401(k) plans, this 403(b) plan quirk may increase the likelihood of a compliance issue.

PLAN LOAN DEFAULTS AND SUBSEQUENT PLAN LOANS

Regulations for receipt of a plan loan not to be a taxable event for the plan participant taking the loan generally apply to governmental and church plans as well as other 403(b) and 401(k) plans, whether or not the plans are subject to Title I of ERISA.[24] Failure by the participant to make loan repayments required under the terms of the loan results in the entire outstanding balance of the loan to be deemed a distribution from the plan to the participant.[25] The great majority of 401(k) plans provide for loan repayments through payroll reductions, so the failure to make loan repayments typically only occurs under a 401(k) plan due to a separation from employment, an unpaid leave of absence, or other circumstances causing the participant's pay to be insufficient to cover the payroll reduction for loan repayments. On the other hand, many 403(b) plan sponsors do not use payroll reduction for participant plan loan repayments. Instead, repayments may be made by check or automatic deductions from a participant's bank account. This idiosyncrasy of 403(b) plans presents another compliance quirk.

Unless the outstanding loan balance is repaid (including through an offset against the participant's account balance, provided that the participant is eligible for a distribution under the plan at the time of the offset), the loan (including interest accrued before and accruing after the deemed distribution) is considered outstanding for purposes of determining the maximum amount of any subsequent loan to the participant.[26] Further, if a plan loan has been deemed distributed and not repaid, then no subsequent payment can be treated as a nontaxable plan loan, unless either:

- Repayments on the subsequent loan are made through payroll reduction; or

- The plan receives adequate security from the participant that is in addition to the participant's plan account balance.[27]

Some 403(b) plan sponsors, as a means to continue not requiring repayment through payroll reduction, limit participants to a single outstanding loan from the plan and treat a loan deemed distributed as the outstanding loan until repaid by the participant. However, this limitation may present its own challenges for a plan with multiple record keepers, as discussed in the following compliance quirk.

MULTIPLE VENDORS/RECORD KEEPERS

It is virtually unheard of for a 401(k) plan to have more than one record keeper providing administrative services to the plan. It is not uncommon for a 403(b) plan to have more than one record keeper providing administrative services to the plan, and there are a few reasons contributing to this fact.

One reason is that the regulations under ERISA provide an exception from the application of Title I of ERISA for a salary-reduction-only 403(b) plan of a Code Section 501(c)(3) tax-exempt employer if the plan satisfies the regulatory requirements to not be "established or maintained by an employer."[28] One of those requirements is that the employer's involvement is limited, but can include, among certain other actions, "permitting annuity contractors (which term shall include any agent or broker who offers annuity contracts or who makes available custodial accounts within the meaning of section 403(b)(7) of the Code) to publicize their products to employees...."[29] More recently, the US Department of Labor (DOL) reiterated this requirement that, for the ERISA exception to apply, the 403(b) "arrangement generally must offer a choice of more than one 403(b) contractor and more than one investment product."[30] Many 403(b) plans of Code section 501(c)(3) tax-exempt employers have multiple vendors/record keepers, perhaps due to this ERISA exception or other reasons, such as to provide more investment options, but there appears to be a growing trend to consolidate to fewer vendors, in part to reduce fees and administrative complexity.

Another reason is that some states have, or have had, "any willing vendor" laws, which require 403(b) plans of public schools, colleges, and universities to permit plan participants to invest with any willing 403(b) vendor, or similar laws that require more than one vendor. Such laws explain multiple vendors/record keepers for some governmental 403(b) plans and can limit the ability of the plan sponsors to consolidate the vendors/record keepers to a smaller number or a single vendor/record keeper.

Whatever the reason for multiple vendors in a 403(b) plan, having multiple vendors increases the likelihood of operational compliance issues. This 403(b) compliance quirk was recognized in the final 403(b) regulations released in 2007 and effective as of January 1, 2009. The final regulations require a written 403(b) plan document and coordination among multiple vendors and the plan sponsor to ensure that contribution limits, distributions (including hardship and required minimum distributions), plan loans, and other requirements of Code Section 403(b) are satisfied. For instance, it was not uncommon for contribution and loan limits to be exceeded because participants were dealing (often directly) with multiple record keepers. The preamble to the final regulations states, in relevant part, the following:

> The existence of a written plan facilitates the allocation of plan responsibilities among the employer, the issuer of the contract, and any other parties involved in implementing the plan. Without such a central document for a comprehensive summary of responsibilities, there is a risk that many of the important responsibilities required under the statute and final regulations may not be allocated to any party.... In the case of a plan that is funded through multiple issuers, it is expected that an employer would adopt a

single plan document to coordinate administration among the issuers, rather than having a separate document for each issuer.

Even with such improved coordination, it is not surprising that compliance issues related to multiple vendors continue. When possible, some 403(b) plan sponsors have reduced the number of vendors to a handful or even one or two. Some have designated a "master record keeper" to be primarily responsible for coordination among vendors. Nevertheless, Internal Revenue Service (IRS) audits of 403(b) plans continue to find increased noncompliance resulting from multiple vendors.[31]

CONCLUSION

Sponsors of 403(b) plans and their advisors should be aware of these idiosyncratic differences from 401(k) plans as well as the various, sometimes subtle, differences due to the different rules and regulations applicable to 403(b) plans versus 401(k) plans in order to minimize noncompliance.

NOTES

1. *See, e.g.*, D. Schwallie, "A Choice for Tax-Exempt Employers: 403(b) or 401(k) Plan?," 32 *Benefits Quarterly* 36 (2d Quarter 2016), D. Schwallie, "Lesser Known Differences between 403(b) and 401(k) Plans," 41 *Journal of Pension Planning & Compliance* 1 (Summer 2015), and IRS Publication 4484, "Choose a Retirement Plan: Plan Feature Comparison Chart."
2. Another such quirk is not included in this article, as the author has dealt with it in some detail in another article. It involves the general difficulty in tracking hours of service for purposes of becoming eligible to participate in a plan. This is often a problem for both 401(k) and 403(b) plan sponsors, but is likely more acute for 403(b) plan sponsors with part-time employees whose work is not based on scheduled hours, such as school teachers and college professors whose part-time status is based on the number of classes or credit hours taught and has limited relationship to the number of hours actually worked. *See* D. Schwallie, "Excluding Part-Time Employees Under the 403(b) Universal Availability Rules," 39 *Journal of Pension Planning & Compliance* 31 (Spring 2013).
3. *See* Code §§ 401(k)(4)(B)(ii) and 403(b)(1) and Treas. Reg. §§ 1.401(k)-1(e)(4) and 1.403(b)-2(b)(8).
4. *See* Code § 401(a)(11) and Treas. Reg. § 1.401(a)-20, Q&A-3.
5. Because the vesting standards of Code section 411 do not apply to governmental plans, as defined by Code § 414(d), Code § 401(a)(11) does not apply to governmental plans. *See* Code §§ 411(e)(1)(A) and the very last sentence of Code § 401(a), which follows Code § 401(a)(37).
6. As defined by Code § 414(e) and for which no election for the church plan to be subject to ERISA has been made under Code § 410(d). Because the vesting standards of Code § 411 do not apply to nonelecting church plans, Code § 401(a)(11) does not apply to nonelecting church

plans. *See* Code §§ 411(e)(1)(B) and the very last sentence of Code § 401(a), which follows Code § 401(a)(37).

7. *See* ERISA regulation, 29 C.F.R. § 2510.3-2(f), US Department of Labor (DOL) Field Assistance Bulletin No. 2007-02, DOL Field Assistance Bulletin No. 2010-01, and DOL Advisory Opinion 2012-02A.
8. 403(b) plans investing in annuity contracts have been available to public schools, including public colleges and universities, and employers exempt from tax under Code § 501(c)(3) since 1958, but 403(b) plan custodial accounts investing in mutual funds under Code § 403(b)(7) have only been permitted since 1974.
9. Both defined benefit pension plans and defined contribution money purchase pension plans are subject to minimum funding standards under Code § 412 and are, therefore, subject to the QJSA and QPSA rules of Code § 401(a)(11). *See* Code §§ 401(a)(11)(B), 412(a)(2), and 412(e).
10. The elimination of the maximum exclusion allowance made the tax implications of including employer contributions with a vesting schedule in a 403(b) plan less onerous, but *see* T. Peller, "The Paradox of 403(b) Vesting Schedules," *Journal of Pension Planning & Compliance,* vol. 39 (Winter 2014).
11. A major factor in the move to 401(k) plans was the ability of an employee to defer taxation on a portion of income by electing to reduce a portion of income in exchange for an equal amount of pre-tax contributions to the 401(k) plan made on the employee's behalf by the employer. Another was that money purchase pension plans require the employer to make a contribution on behalf of the employees as defined by the plan, generally defined as a percentage of compensation. 401(k) plans are cash or deferred arrangements that are part of a profit sharing plan (or stock bonus plan, per-ERISA money purchase plan, or rural cooperative plan). *See* Code § 401(k)(2). Employer contributions to a profit sharing plan can be discretionary, often based on profits, but no longer required to be based on profits and, unlike employer contributions to a money purchase pension plan, the amounts do not need to be defined by the plan document (and could even be zero), only the allocation formula needs to be defined in a profit sharing plan. *See* Code § 401(a)(27) and Treas. Reg. § 1.401-1(b)(1)(ii). Another distinction between a profit sharing plan and a money purchase plan is that, upon the complete discontinuance of contributions to the plan, accounts in a profit sharing plan must become nonforfeitable, but accounts in a money purchase pension plan need not; however, an ERISA 204(h) notice must be provided to the participants in the money purchase plan. This is because a money purchase pension plan is subject to the minimum funding standards under Code § 412. *See* Code §§ 411(d)(3), 412(a)(2), 412(e), and 4980F(f)(2) and ERISA § 204(h)(8)(B).
12. *See* Code § 401(a)(11)(B)(iii) and Treas. Reg. § 1.401(a)-20, Q&A-3. Some of the administrative differences between a defined contribution plan subject to Code § 401(a)(11) and a defined contribution plan not subject to Code § 401(a)(11) can be found in Treas. Reg. § 1.401(a)-20, Q&A-20, Q&A-24, Q&A-32, and Q&A-33.
13. *See* Code § 401(a)(11)(B)(iii)(II) and Treas. Reg. § 1.401(a)-20, Q&A-4.
14. *See* Code § 417(a)(3)(B).
15. *See* Treas. Reg. § 1.401(a)-20, Q&A-35.
16. *See* Code § 417(a)(6)(B).

17. *See* Treas. Reg. § 1.401(a)-20, Q&A-33(b).
18. Plans not subject to ACP testing include state and local governmental plans, collectively bargained plans, plans with an ACP safe harbor design (but ACP testing of non-Roth after-tax employee contributions still required), and 403(b) plans of a church, as defined in Code § 3121(w)(3)(A), or a qualified church-controlled organization, as defined in Code § 3121(w)(3)(B), but would not include the 403(b) plan of a nonqualified church-controlled organization, such as a church related hospital providing services to the general public for a fee. *Se*e Treas. Reg. §§ 1.401(m)-1(b)(2), 1.401(m)-3, and 1.403(b)-5(d) and Code § 3121(w)(3).
19. A nonhighly compensated employee is an employee who is not a highly compensated employee. Highly compensated employee has the meaning provided in Code § 414(q). *See* Treas. Reg. § 1.401(m)-5. In general, a highly compensated employee is an employee who had compensation from the employer for the preceding year in excess of an indexed dollar amount ($120,000 for 2016).
20. *See* Treas. Reg. § 1.401(m)-2(a)(5)(ii)(A).
21. *See* Treas. Reg. § 1.401(m)-2(a)(5)(ii)(B).
22. *See* Treas. Reg. § 1.401(m)-2(a)(5)(ii)(C).
23. *See* Treas. Reg. § 1.401(m)-2(a)(5)(ii)(D).
24. *See* Code § 72(p)(4) and Treas. Reg. § 1.72(p)-1. *See also* D. Schwalie, "Plan Loans−Whose Money Is It Anyway and Why Should You Care?" 42:03, *Journal of Pension Planning and Compliance* 1, (Fall 2016)
25. The plan loan must have satisfied the requirements of Code § 72(p) to not be deemed a distribution from the outset. The plan administrator may allow a cure period, which cannot continue beyond the last day of the calendar quarter following the calendar quarter in which the required loan repayment was due, during which, if the repayment is made, the loan is not deemed a plan distribution. *See* Treas. Reg. § 1.72(p)-1, Q&A-3 and Q&A-10.
26. *See* Treas. Reg. § 1.72(p)-1, Q&A-13 and Q&A-19(b)(1).
27. *See* Treas. Reg. § 1.72(p)-1, Q&A-19(b)(2).
28. *See* ERISA regulation, 29 C.F.R. § 2510.3-2(f), DOL Field Assistance Bulletin No. 2007-02, DOL Field Assistance Bulletin No. 2010-01, and DOL Advisory Opinion 2012-02A.
29. *See* ERISA regulation, 29 C.F.R. § 2510.3-2(f)(3)(i).
30. *See* DOL Field Assistance Bulletin No. 2010-01, Q-16.
31. For example, *see* IRS Publication 4483, "Tax-Sheltered Annuity Plans for Sponsors: Be Aware of Common Mistakes," and the 403(b) Plan Fix-It Guide at *https://www.irs.gov/pub/irs-tege/403%28b%29_fixit_guide.pdf.*