A Choice for Tax-Exempt Employers: 403(b) or 401(k) Plan?

Tax-exempt organizations can have either a 403(b) or 401(k) plan, or both, which leads some to consider whether they should have one over the other. Key differences between 403(b) and 401(k) plans are summarized in a convenient table of contrasts. Enough differences remain between 403(b) and 401(k) plans that a Code Section 501(c)(3) tax-exempt organization considering one or the other, or both, should review the differences with its plan advisors and consider how the differences may affect the organization and its retirement arrangements. This also is true for such organizations that may include for-profit entities in their controlled groups, particularly with respect to coverage and nondiscrimination testing. Most tax-exempt employers are likely to find a 403(b) plan preferable, but some may prefer the more widely understood rules of a 401(k) plan.

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Due primarily to statutory and regulatory changes over the past decade or more, 403(b) and 401(k) plans have become increasingly similar. However, significant differences remain, including the inability to merge a 403(b) plan into a 401(k) plan or another plan qualified under Internal Revenue Code Section 401(a), or vice versa.[1] This article provides an overview of key differences between 403(b) and 401(k) plans. Code Section 501(c)(3) tax-exempt organizations can have either a 403(b) or 401(k) plan, or both, which leads some tax-exempt organizations to consider whether they should have one over the other or have both types of plans.[2] Governmental employers cannot establish 401(k) plans[3] and, among governmental entities, only public schools, including public colleges and universities, can maintain 403(b) plans, so governmental plans generally are not considered in this article.

Contrasting 401(k) and 403(b) Plan Differences

The intent of this article is to focus on the differences between 401(k) and 403(b) plans as sponsored by Code Section 501(c)(3) tax-exempt organizations. That said, this article does not claim to include every possible difference and generally does not expressly point out the similarities.[4] Nor does this article describe in any detail differences that might apply to church plans. The table contrasts key differences with additional details contained in endnotes.

TABLE

Key Differences Between 401(k) and 403(b) Plans That Tax-Exempt Entities Should Consider

Contrast	401(k) Plan	403(b) Plan
Eligible employers	For-profit and nongovernmental nonprofit entities	Public educational organizations and 501(c)(3) tax-exempt organizations
Permissible funding	Any investment option permitted under the Employee Retirement Income Security Act of 1974 (ERISA), including annuity contracts, mutual funds, collective funds and individually managed portfolios	Annuity contracts or custodial accounts invested in mutual funds[5]
Eligible employees	All, or a subset, of the employer's employees, provided that nondiscriminatory coverage and minimum age/service requirements are satisfied	All employees must be eligible for elective deferrals (including Roth contributions) if any are eligible, with certain limited exclusions permitted.[6] With respect to employer contributions and employee non-Roth after-tax contributions, all, or a subset, of the employer's employees, provided that nondiscriminatory coverage and minimum age/service requirements are satisfied[7]
Annual limit on elective deferrals, including Roth contributions[8]	Basic limit of $18,000 for 2016, not including the aged 50 catch-up	Basic limit of $18,000 for 2016, not including the 15-year service catch-up or aged 50 catch-up
Aged 50 catch-up contribution limit[9]	$6,000 for 2016	$6,000 for 2016
15-year service catch-up[10]	Not permitted	Permitted but must be applied first if aged 50 catch-up also applies
Limit on annual additions (Section 415 limit)[11]	Total of employee elective deferrals, Roth contributions and after-tax contributions, plus employer contributions (whether matching or not), and allocated forfeitures for the limitation year is limited to lesser of $53,000 (for 2016) or 100% of the employee's compensation[12]	Total of employee elective deferrals, after-tax contributions and Roth contributions, plus employer contributions (whether matching or not), and allocated forfeitures for the limitation year is limited to lesser of $53,000 (for 2016) or 100% of the employee's "includible" compensation[13] Special rules apply if an employee owns or controls more than 50% of another employer that maintains a 401(k) or other qualified defined contribution plan.[14]

TABLE continued

Key Differences Between 401(k) and 403(b) Plans That Tax-Exempt Entities Should Consider

Contrast	401(k) Plan	403(b) Plan
Actual deferral percentage (ADP) test of elective deferrals (including Roth contributions)[15]	Required	Not applicable
Actual contribution percentage (ACP) test of employer matching contributions and employee non-Roth after-tax contributions[16]	Required	Required
Amounts testing, under Code Section 401(a)(4), of employer contributions that are not matching contributions[17]	Required[18]	Required[19]
Annual compensation limit under Code Section 401(a)(17)[20]	$265,000 for 2016	$265,000 (for 2016) on employer and employee non-Roth after-tax contributions[21] No Code Section 401(a)(17) compensation limit on elective deferrals, including Roth contributions, unless required by plan terms
Postseverance compensation for purposes of determining contributions	Generally limited to compensation paid prior to severance, except for certain compensation paid by later of 2½ months after severance date or end of the limitation year that includes severance date[22]	Same rules as apply to 401(k) plans, except: • Employer nonmatching contributions can also be made for up to five years after year of severance based on "includible compensation" for an employee's last "year of service."[23] • A severance date also occurs if the employee ceases employment with a tax-exempt employer, even if continuing employment with the employer controlled group.[24]

TABLE continued

Key Differences Between 401(k) and 403(b) Plans That Tax-Exempt Entities Should Consider

Contrast	401(k) Plan	403(b) Plan
In-service withdrawals of employer matching or nonmatching contributions	Allowed due to hardship,[25] after a fixed number of years, after attainment of specified age or upon disability or certain other prior events	In-service withdrawals from annuity contracts allowed due to hardship, after a fixed number of years, after attainment of a specified age or upon disability or certain other prior events[26]
		In-service withdrawals from custodial accounts allowed only at the age of 59½ or upon disability, even if later transferred to annuity contract[27]
Applicability of ERISA	Generally subject to ERISA[28]	Plan with only elective deferrals (including Roth contributions) not subject to ERISA under certain conditions[29]
		Matching contributions, even if made to a plan other than the 403(b) plan, or other employer contributions to the 403(b) plan, generally will cause the 403(b) plan to be subject to ERISA.[30]
Plan termination	Plan may be terminated, with distribution of all assets and subject to successor defined contribution plan rules[31] and other rules.	Plan may be terminated, with distribution of all assets and subject to successor 403(b) plan and other rules.[32]
Determination from Internal Revenue Service (IRS) that plan document satisfies qualification requirements	Available for preapproved (prototype, volume submitter) plan documents	Available for preapproved (prototype, volume submitter) plan documents
	Available for individually designed plan documents only upon establishment or termination of the plan or other circumstances as may be permitted in written guidance from IRS[33]	Not available for individually designed plan documents[34]
Plan disqualification	Document, demographic or operational failures may result in plan disqualification.	Failure to comply with 403(b) regulations may result in disqualification of the plan, but an operational failure may result in disqualification only as to affected participants.
	Most failures can be corrected through the Employee Plans Compliance Resolution System (EPCRS).[35]	Most failures can be corrected through EPCRS.[36]

TABLE continued

Key Differences Between 401(k) and 403(b) Plans That Tax-Exempt Entities Should Consider

Contrast	401(k) Plan	403(b) Plan
Excess elective deferrals	Excess is taxable and, if not timely distributed, may result in disqualification of entire plan if not otherwise corrected under EPCRS.	Excess is taxable and, if not timely distributed, all 403(b) annuity contracts and custodial accounts of the individual are treated as not satisfying 403(b) if not otherwise corrected under EPCRS.
ADP test failure	ADP test failure may result in disqualification of entire plan if not timely corrected by taxing and distributing excess amounts deferred by highly compensated employees and not otherwise corrected under EPCRS.	ADP test not applicable
Excess annual additions	May result in plan disqualification if not corrected using correction methods permitted under Code Section 415 or EPCRS	Excess is taxable as separate Code Section 403(c) account that may be distributed in accordance with Code Section 403(b) rules.[37] A 6% annual excise tax applies to the amount of excess annual additions to a custodial account until the excess is distributed.
Transfers among investment alternatives within same plan	Allowed, subject to plan restrictions, if any	Allowed, if: • Plan permits • Receiving annuity contract or custodial account imposes distribution restrictions no less stringent than transferor contract or account • Information-sharing agreements are in place.
Transfers (other than rollovers of eligible rollover distributions) to another plan	Allowed to another Code Section 401(a) qualified plan (but not to a 403(b) or 457(b) plan), subject to protection of certain benefits, rights and features, if both plans permit	Allowed to another 403(b) plan, subject to protection of certain benefits, rights and features (if transferor plan is subject to ERISA), if both plans permit and receiving plan imposes distribution restrictions no less stringent than those imposed on transferor plan
Federal Insurance Contributions Act (FICA) taxation of mandatory employee contributions	A reduction in an employee's compensation made as a condition of employment or under a one-time irrevocable election made before becoming eligible to participate in any plan of the employer (i.e., not a cash or deferred election), for which the employer makes a contribution to the plan on the employee's behalf, is not subject to FICA taxation.	A salary reduction agreement subject to FICA taxation includes not only a cash or deferred election to participate in a 403(b) plan but also a salary reduction agreement to participate in a 403(b) plan made as a condition of employment or under a one-time irrevocable election made before becoming eligible to participate in any plan of the employer.[38]

In Summary

Enough differences remain between 403(b) and 401(k) plans that a Code Section 501(c)(3) tax-exempt organization considering one or the other, or both, should review the differences with its plan advisors and consider how the differences may affect the organization and its retirement arrangements. This is also true for such organizations that may include for-profit entities in their controlled groups, particularly with respect to coverage and nondiscrimination testing. Most tax-exempt employers are likely to find a 403(b) plan preferable, but some may prefer the more widely understood rules of a 401(k) plan. IRS *Publication 4484,* available on the IRS website, www.irs.gov, provides a high-level overview of plan features intended to help employers choose a retirement plan. Additional insights may be gleaned from the "403(b) Plan Fix-It Guide" and "401(k) Plan Fix-It Guide," both of which are also available on the IRS website. BQ

Endnotes

1. See Treasury Regulations §1.403(b)-10(b)(1)(i). Mergers or transfers of assets between 403(b) and 401(k) plans generally are not allowed, but an eligible rollover distribution from one may be rolled into the other, provided the recipient plan allows such rollover contributions. The Church Plan Clarification Act, enacted as part of the 2016 Consolidated Appropriations Act, permits transfers between, or mergers of, 403(b) church plans and 401(a) church plans, including 401(k) church plans.

2. Note that Treasury Regulations §1.410(b)-6(g) provides special rules when coverage testing a 401(k) plan of a tax-exempt organization that also has a 403(b) plan. Also note that Treasury Regulations §1.410(b)-7(f) provides special rules regarding coverage and nondiscrimination testing when the employer has a 403(b) plan and a 401(k) plan or other 401(a) qualified plans.

3. Certain governmental 401(k) plans adopted by a governmental entity before May 6, 1986 are grandfathered.

4. For example, eligible rollover distribution rules are the same and, therefore, not included.

5. A church 403(b) plan may include other investments in a retirement income account. Further, the Church Plan Clarification Act permits church plans generally to invest assets in collective investment trusts pursuant to Revenue Ruling 81-100.

6. Permitted exclusions include employees eligible to make deferrals under another 403(b) plan, a 401(k) plan or a 457(b) eligible governmental plan of the employer; nonresident aliens who do not receive any U.S. source income from the employer; students performing certain services; and employees who normally work fewer than 20 hours per week and do not ever work 1,000 hours in a year; but the exclusions do not include collectively bargained employees or employees who make a one-time election to participate in a governmental plan. See Treasury Regulations §1.403(b)-5(b)(4). See also D. Schwallie, "Excluding Part-Time Employees Under the 403(b) Universal Availability Rules," 39 *Journal of Pension Planning & Compliance,* p. 31 (2013).

7. See Code §403(b)(12)(A)(i). A 403(b) plan subject to ERISA must follow the minimum age and service participation standards of ERISA §202. Note that Treasury Regulations §1.410(b)-6(g) provides special rules when coverage testing a 401(k) plan of a tax-exempt organization that also has a 403(b) plan.

8. The annual limit, which is indexed for inflation, is applied to all 401(k) and 403(b) plans in which an individual participates for the same calendar year.

9. The aged 50 catch-up is subject to a universal availability rule across all plans of the employer's controlled group if any plan subject to 401(a)(4) nondiscrimination testing offers the aged 50 catch-up, but collectively bargained employees can be excluded. The aged 50 catch-up contribution applies to deferrals plus Roth contributions in excess of an applicable limit on deferrals. Applicable limits on deferrals (including Roth contributions) include statutory limits (e.g., the limit on annual additions and the annual dollar limit, but not the annual compensation cap), employer-provided limits (e.g., plan limit on compensation percentage that can be deferred) and (for a 401(k) plan) ADP test limit. Determination of whether contributions exceed an applicable limit is based on the plan year, calendar year or limitation year that corresponds to the applicable limit. Unless a separate dollar amount election is offered for the aged 50 catch-up contributions, the percentage of compensation eligible for elective deferrals (including Roth contributions) must generally be at least 75%.

10. For employees of a qualified organization (e.g., university, hospital, health and welfare service agency) with at least 15 years of service, the employee deferral limit is increased by the least of $3,000, $15,000 minus previous service catch-up amounts or $5,000 times years of service minus all deferral amounts (including Roth) for prior years with the organization. These amounts are not indexed for inflation. See, e.g., D. Schwallie, "The Sky Is Not the Limit: Coordinating the Dollar Limit, Pay Cap, and Other 403(b) Limits," 18 *Journal of Deferred Compensation,* p. 12 (2012).

11. Limit applies for the same limitation year to all Code §401(a) qualified plans of the same employer combined and to all 403(b) plans of the same employer combined, but applies independently to the 401(a) and 403(b) plans, except as described in endnote 13. Aggregation of employers for Code §415 is based on more than 50% ownership or control rather than the "at least 80%" ownership or control applicable to determining controlled group membership for purposes of coverage and nondiscrimination testing.

12. The limitation year for a 401(k) plan is the calendar year unless the plan specifies a different 12-month period. For purposes of applying Code §415, one of several permitted definitions of *compensation* may be used.

13. The limitation year for a 403(b) plan is the calendar year, unless the individual specifies a different 12-month period or, if the individual owns or controls greater than 50% of an employer, the limitation year of that employer. For purposes of applying Code §415 to a 403(b) plan, only compensation includible in gross income for federal income tax may be used. This can be an issue if nonresident aliens with income excludible under a tax treaty participate in a 403(b) plan. See, e.g., D. Schwallie, "The Sky Is Not the Limit: Coordinating the Dollar Limit, Pay Cap, and Other 403(b) Limits," 18 *Journal of Deferred Compensation,* p. 12 (2012).

14. If an employee owns or controls more than 50% of another employer with a 401(k) or other Code §401(a) defined contribution plan, that plan and the 403(b) plan must satisfy Code §415 limits both separately and combined. When applying the Code §415 limit separately to the plans, compensation received from the two employers cannot be combined.

15. Certain "safe harbor" designs are permitted to avoid ADP testing, which generally requires accelerated vesting, certain restrictions on withdrawals and employer contributions, as well as certain other requirements. See, e.g., D. Schwallie and A. Steinberg, "How Safe Is Your ADP/ACP Safe Harbor?," 29 *Benefits Quarterly,* p. 35 (2013).

16. Certain "safe harbor" designs are permitted to avoid ACP testing, which generally requires an ADP safe harbor design be met and also limit matching contributions on employee contributions to the first 6% of safe harbor compensation, as well as certain other requirements. See, e.g., D. Schwallie and A. Steinberg, "How Safe Is Your ADP/ACP Safe Harbor?," 29 *Benefits Quarterly,* p. 35 (2013).

17. Certain "safe harbor" designs are permitted to avoid testing nonmatching employer contributions, which generally require that contributions be a uniform flat dollar amount or a uniform percentage of Code §414(s) "safe harbor" compensation, as well as certain other requirements.

18. An employer may be able to use 401(k) plan contributions to help qualified defined benefit and defined contribution plans pass Code §401(a)(4) nondiscrimination testing and Code §410(b) coverage testing through plan aggregation.

19. An employer cannot use 403(b) plan contributions to help Code §401(a) qualified defined benefit and defined contribution plans, including 401(k) plans, pass Code §401(a)(4) nondiscrimination testing or Code §410(b) coverage testing through plan aggregation, but the qualified plans may be used to help the 403(b) plan pass nondiscrimination and coverage testing.

20. The applicable compensation limit for a plan year is the limit in effect for the calendar year in which the plan year begins. If a plan bases contributions on a period of less than 12 months for a plan year, the pay cap may need to be prorated.

21. Many 403(b) plan documents apply the Code §401(a)(17) compensation limit on elective deferrals, even though it is not required under the Code or the 403(b) regulations.

22. Severance from employment occurs when the individual ceases to be an employee of the employer maintaining the plan, aggregating employers based on more than 50% ownership or control rather than at least 80% ownership or control; but if the individual's new employer maintains the plan with respect to the individual by continuing or assuming sponsorship or accepting a transfer of assets and liabilities, the individual does not have a severance from employment.

23. The terms *includible compensation* and *year of service* are as defined by Treasury Regulations §§1.403(b)-2(b)(11) and 1.403(b)-2(b)(21). 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,* p. 12 (2012).

24. 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). 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.

25. Hardship withdrawal is not allowed if a 401(k) plan uses ADP or ACP safe harbor design or a 403(b) plan uses ACP safe harbor design.

26. Hardship withdrawal is not allowed if a 401(k) plan uses ADP or ACP safe harbor design or a 403(b) plan uses ACP safe harbor design.

27. See Treasury Regulations §1.403(b)-6(c).

28. Grandfathered governmental 401(k) plans adopted by a governmental entity before May 6, 1986 are not subject to ERISA. A church plan is not subject to ERISA, unless an election to be subject to ERISA under Code §410(d) has been made.

29. For example, employee participation must be completely voluntary and the plan must be funded solely by elective deferrals (including Roth contributions). The employer may enter into salary reduction agreements and remit funds collected as required by vendor agreements, hold one or more group contracts in the employer's name and exercise rights as representative of its employees under the contract (at least with respect to contract amendments), limit investments and vendors to a number and selection designed to afford employees reasonable choice in light of all relevant circumstances (more than one vendor) and act to ensure compliance with 403(b) but cannot make discretionary determinations in administering the plan, such as determinations regarding loans, hardships, QDROs or plan-to-plan transfers. See 29 C.F.R. §2510.3-2(f) and U.S. Department of Labor (DOL) *Field Assistance Bulletin No. 2007-02.*

30. See *DOL Advisory Opinion 2012-02A*. Nonelecting church plans and plans of public schools (including public colleges and universities) are not subject to ERISA.

31. See Treasury Regulations §1.401(k)-1(d)(4)(i).

32. See Treasury Regulations §1.403(b)-10(a)(1).

33. See IRS Announcement 2015-19.

34. See Revenue Procedure 2013-22, §§4.02(2) and 4.02(3).

35. EPCRS is described in Revenue Procedure 2013-12, Revenue Procedure 2015-27 and Revenue Procedure 2015-28, which can be obtained on the IRS website, www.irs.gov. EPCRS permits self-correction of many, but not all, plan errors. Some corrections require a compliance fee and filing with IRS.

36. 403(b) plan failures prior to 2009 can be corrected under EPCRS only if correction is available under prior version of EPCRS in Revenue Procedure 2008-50. Furthermore, certain corrections involving a retroactive amendment to a 403(b) plan (such as for hardships and loans) are available only for 2009 and later years.

37. The entire applicable contract or custodial account is treated as not satisfying Code §403(b) if the excess is not held in a separate Code §403(c) account.

38. See Treasury Decision 9367 and Treasury Regulations §31.3121(a)(5)-2.

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