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Postretirement Split-Dollar and Increasing Term Costs

Part one of two-part series.

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"The boiling frog is an anecdote describing a frog slowly being boiled alive. The premise is that if a frog is placed in boiling water, it will jump out, but if it is placed in cold water that is slowly heated, it will not perceive the danger and will be cooked to death. The story is often used as a metaphor for the inability or unwillingness of people to react to or be aware of threats that occur gradually." *Wikipedia*

Fortunately, there is no evidence that this story is true; however, the mental image creates a powerful message on the danger of inertia. Unfortunately, some employers face a real-life analogy with a postretirement executive life insurance arrangement called split-dollar. Like the frogs, split-dollar participants who endure gradually increasing taxes on imputed term costs as wages may not be aware of the magnitude of taxes at older ages. They may not even realize that they are in hot water. When the realization hits, participants may continue to rationalize future, higher taxes in an effort to recover past taxes at death. Absent premature death, many of these participants would benefit by waiving the coverage and thus avoiding the taxes.

This article is part one of a two-part series on postretirement economic benefit regime split-dollar. Part one describes the issues that participants and their employers face in these arrangements. Part two describes what employers that still sponsor these arrangements can do to rescue the participants.

WHAT IS SPLIT-DOLLAR?

Split-dollar is an agreement between two parties detailing their respective rights and obligations regarding a cash value life insurance policy. In the context of this article, the two parties are an employer and its (usually retired) executives. There are two methods of taxing split-dollar: economic benefit taxation[1] and loan taxation.[2] This article focuses on economic benefit taxation, in which the economic benefit of the life insurance protection is either imputed as wages or contributed as premium by the executive.

Although new split-dollar plans are rare, a surprising number of plans still exist. The following factors have reduced the appeal of split-dollar.

- Confirmation by the IRS in 2002 that employee cash value is taxable and artificially low term insurance rates are no longer available to new arrangements[3]
- Possibility that payment of premium on collateral assignment split-dollar insuring the life of a Sarbanes-Oxley executive officer is a prohibited personal loan[4]
- Accrual of benefit obligations on most postretirement split-dollar obligations[5]
- Poor policy performance relative to expectations
- Complexity of split-dollar arrangements
- Longer life expectancies combined with term insurance rates that increase with age[6]
- Increased estate tax credit reduces the need for life insurance to preserve estate[7]

WHY DO PLANS STILL EXIST?

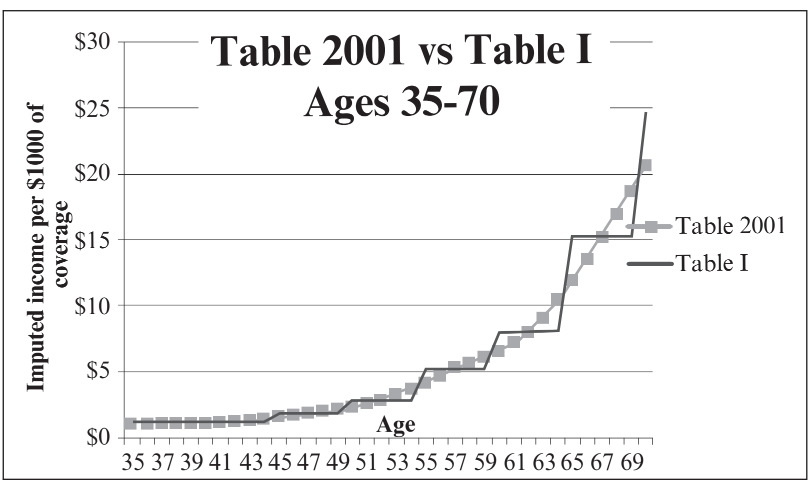
Considering the list of split-dollar challenges above, readers may wonder why any such plans continue to exist. Employers may have a legal obligation to continue the benefit, and termination of the arrangement may require written consent of the participants. This is particularly true for many arrangements that include vesting due to change of control provisions. Even when there is no legal obligation, some employers believe they have a moral obligation to continue the benefit. Where settlement of the arrangement requires a lump sum payment, some employers cannot reach an agreement with participants on how much that lump sum should be. Where settlement of the arrangement does not require a lump sum payment, some employers take the approach that participation is voluntary: Retirees who complain about the increasing amounts of imputed income are free to waive the benefit to avoid the taxes. The reasons for continuing split-dollar plans can appear endless in spite of the challenges and pitfalls discussed previously. Status quo is often the path of least resistance, at least in the short term.

How Is Imputed Income Measured?

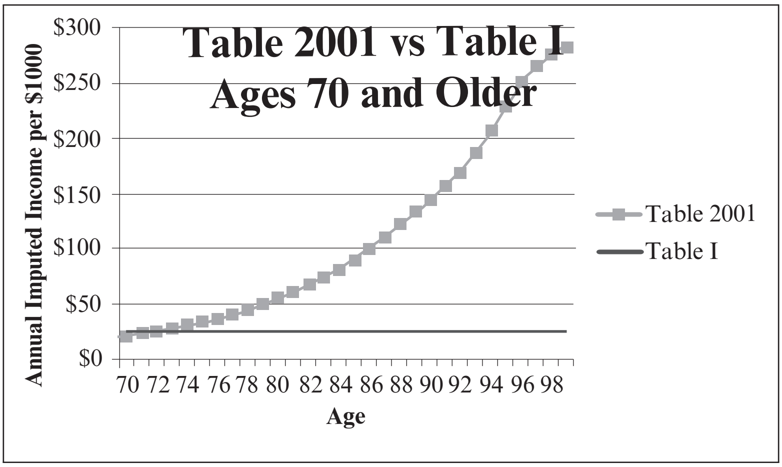
Under the economic benefit method of taxation, the current right to death benefit is an economic benefit measured as the death benefit amount multiplied by an age based term insurance rate. Although participants can contribute this term cost to avoid imputed income, noncontributory arrangements with term costs imputed as wages are more common.

> Example 1: Al is a participant in a split-dollar arrangement that allows him to name the beneficiary for $1 million of death benefit. The applicable term rate for Al's age is $10 per thousand, and Al contributes none of the premium. Al's employer includes $10,000 of imputed income on Al's IRS Form W-2.

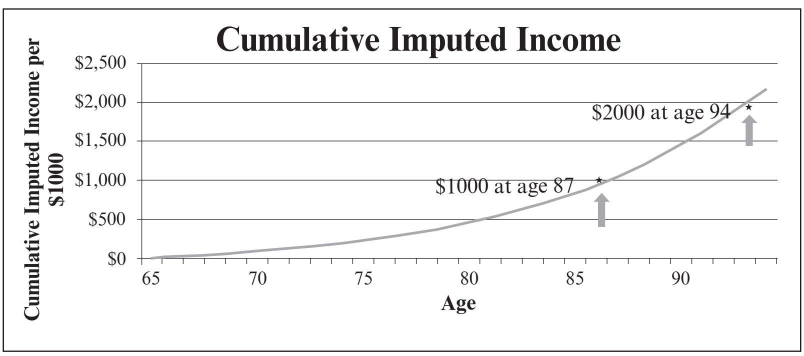
IRS Table 2001, included at the end of IRS Notice 2001-10, is the default table. Table 2001 shares the same underlying mortality table as Table I,[8] which measures economic benefit for group term life plans and is much more widely used. However, the rates in Table 2001 increase at each age, whereas the rates in Table I are in five-year brackets through age 70.



After age 70, Table I remains level, whereas Table 2001 continues to increase.



Although Table 2001 appears costly on an annual basis after age 70, the cumulative cost is even worse. Cumulative imputed income for $1,000 of coverage exceeds $1,000 between ages 65 and 87, then doubles in just another seven years by age 94.



Some arrangements qualify for the life insurance carrier's own term rates, which can be significantly lower. The IRS publishes guidelines[9] for its auditors in determining the applicability of these lower carrier rates. The following features will disqualify a carrier's term rate as a measure of split-dollar imputed income, thus requiring the use of Table 2001:

- Higher rate charged for smokers
- Rate based on a renewal feature

- Minimum policy size requirement

- Rate sheet that includes “not for publication” or “internal use only,” or similar language

- Restricting coverage to corporate buyers (but not individuals)

The current IRS criteria for the lower term rates are consistent with the criteria in Technical Advice Memorandum 199918060, in which the IRS cited the following problems with a taxpayer’s use of a carrier’s rate:

1. First, the rates are not one-year term rates; they are three-year duration rates.

2. Second, the rates are not available to all standard risks since they apply only to nonsmokers. In the life insurance industry, nonsmokers are generally considered either a preferred risk or a subclass of the standard risk classification (with smokers being another subclass of the standard risk classification). Thus, because these rates are not available to standard risk smokers, they are not available to all standard risks.

3. Also, the rates used apply only to policies of $200,000 or more, so that they are not available to individuals seeking to purchase only a basic policy of term insurance of less than that amount.

4. In addition, the rates used are only available for the employer-sponsored market and are not, therefore, available to standard risk individuals who do not have an employer sponsor.

5. Finally, the file contains no indication that these rates have been published, as required by Rev. Rul. 66-110, to ensure their trustworthiness for use as a substitute for the PS 58 rates.

For arrangements entered into (or modified) after January 28, 2002, carrier rates must meet an even higher standard.[10] These rates must “be available to all standard risks who apply for term insurance unless (i) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, and (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer’s normal distribution channels.”[11] There is currently no guidance on how frequently term insurance must be sold to qualify as being sold "regularly," but the intent of the term "regularly" was preventing taxpayers from using favorably low rates than were not regularly sold. An informal survey of rates promoted by carriers to measure split-dollar economic benefit showed these rates to average 43 percent of Table 2001 rates for ages older than age 65.

FICA Taxation

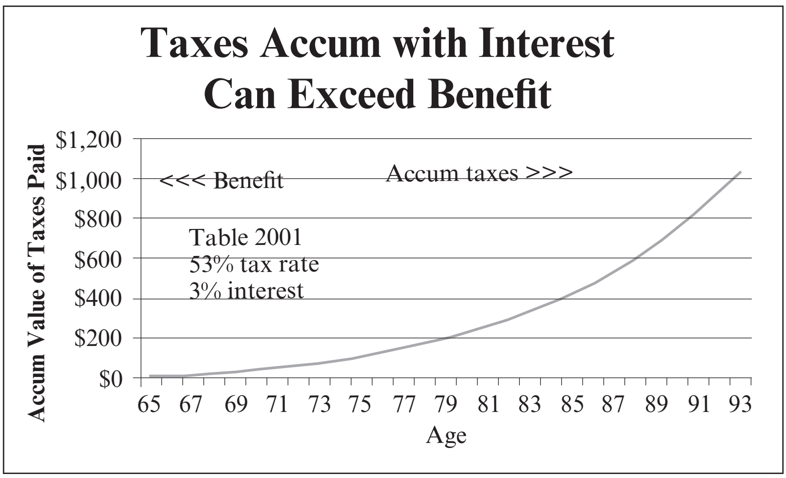
Imputed term costs are generally treated as FICA wages, and FICA taxes increase the tax cost significantly. Because postretirement imputed term costs are usually a retired executive's only FICA wages, the FICA tax rate includes both the Social Security tax rate of 6.2 percent on FICA wages up to the wage base ($118,500 for 2016) and the Medicare rate of 1.45 percent. In the rare event that annual postretirement imputed term costs exceed $200,000, employers must withhold the 0.90 percent Additional Medicare Tax on FICA wages in excess of $200,000.[12] The 7.65 percent combined rate is in addition to federal and any state income taxes paid by the employee, and the 7.65 percent paid by the employer.

Inclusion of imputed term costs in FICA wages is not obvious. IRC Section 3121(a) states that wages taxable for FICA purposes include all forms of remuneration unless a specific exclusion applies. IRC Section 3121(a)(2) does exclude life insurance premiums from the definition of FICA wages (an exception), but IRC Section 3121(a)(2)(C) includes imputed income from group term life arrangements (the exception to the exception) without mentioning split-dollar. Treasury Regulations Section 1.61-22 clarifies the FICA treatment for imputed term costs by specifically including them in FICA wages. Arrangements exempt from Treasury Regulations Section 1.61-22 (because they were entered into before September 17, 2003, and not materially modified thereafter) and IRC Section 79 (because they are not group term) may have some basis for excluding imputed term costs from FICA wages under the IRC Section 3121(a)(2) exception from FICA wages.

Besides being costly, FICA taxation of imputed term costs increases administrative costs. Employers must withhold FICA taxes[13] or pay the FICA taxes on the employee's behalf (as additional FICA wages). Unlike postretirement group term life insurance,[14] there is no exemption from FICA withholding rules for split-dollar. The tax rules for group term life on retired employees allow employers to report imputed term costs as FICA wages without withholding the FICA tax. Instead of withholding, employers add codes M and N to Form W-2 Box 12.[15] This exception to withholding rules for postretirement group term life does not apply to split-dollar arrangements in spite of the similarity of the two arrangements.

Taxes Can Exceed Benefit

The 7.65 percent FICA rate increases the tax burden of a federal tax rate of up to 39.60 percent[16] and a state rate of up to 13.30 percent.[17] Even after reflecting the federal tax deduction for state income taxes, the combination of marginal federal income rates, state income rates, and FICA rates can exceed 50 percent. Accumulated with interest, these taxes add up. For example, if an age 65 participant withdraws from the plan and invests the taxes he would have paid on $1,000,000 of coverage (at a 53 percent rate) and earns 3 percent, those invested amounts will exceed the $1,000,000 benefit after age 93.



OTHER RISKS TO EXECUTIVES

Living too long isn't the only risk that executives face in split-dollar plans. There are other tax risks. For example, executives who benefit from artificially low grandfathered term rates risk losing the ability to continue using the rates, either because the carrier discontinues the sale of the product at specified ages or because the rates fail to meet the criteria set by the IRS. Executives insured under second-to-die policies face the risk that one spouse dies prematurely and the other spouse lives a long time.[18] Second-to-die policies tend to have significantly higher death benefits than single life policies. Although the economic benefit on the high death benefit is affordable when both spouses are alive, the economic benefit can skyrocket after one spouse dies. Risks are not limited to tax risks. Executives often bear the risk that the policy will perform worse than projected at policy issue. Unless the employer agrees to bear this risk, an underperforming policy can lapse before the executive's death, resulting in no coverage at the time of death.

Gross-Ups

Some employers agree to gross-up for the increasing tax costs. Gross-ups are taxable wages intended to indemnify employees for out of pocket costs (*e.g.*, taxes on imputed term costs). Employers that decide to gross-up for taxes on imputed income (or employee term contributions) often create arrangements that are subject to IRC Section 409A. Whereas nonequity split-dollar arrangements generally fall under the welfare benefits exception to 409A,[19] gross-ups do not. However, other IRC Section 409A exceptions can apply. For example, gross-ups that vested before 2005 are grandfathered under 409A.[20] In addition, gross-ups that can be unilaterally cancelled by the employer avoid 409A by not creating a legally binding right.[21] When employers do create a non-grandfathered legally binding right to gross-ups, the gross-up creates a 409A arrangement that limits the employer's options on settlement. Absent bankruptcy or a change in control, settlement of a gross-up arrangement cannot be "proximate to a financial downturn," meaning that settlement is not a means to accelerate benefits that are reasonably expected to be otherwise lost.[22] Such a settlement requires a 12-month delay in payment and settling all other plans of the same 409A category, including plans with no participants common to the gross-up arrangement. Another complicating factor is that identifying the relevant 409A category is not obvious.[23] Reimbursement arrangements and split-dollar are two possibilities.

Accounting

Employer costs are not limited to gross-up arrangements. US GAAP has required employers to accrue benefit obligations for most postretirement split-dollar arrangements since 2008, even when no more premiums will be paid.[24] FASB's decision to require accrual of the benefit was controversial because the split-dollar industry had a difficult time understanding how employers could be forced to accrue for an arrangement in which all future cash flows were receipts (*e.g.*, recovery of premiums at death). Properly recorded split-dollar benefit obligations are at least equal to an obligation to pay the same benefit in cash (*i.e.*, a death benefit only arrangement). Some recourse collateral assignment arrangements qualify for accounting as discounted receivables, but these are rare. For a more complete discussion of split-dollar accounting, read the four-part series published in 2012 and 2013 in the *Journal of Pension Planning & Compliance*.

Other Corporate Concerns

Besides the concerns over imputed income, FICA withholding, IRC Section 409A, and accounting, employers have special concerns in the context of mergers and acquisitions. Companies being acquired wonder about split-dollar arrangements in the hands of the purchaser. The purchaser has its own concerns, such as benefit harmonization, accounting, and 409A's 12-month window for plan liquidation after a change in control.[25]

SUMMARY

Postretirement split-dollar arrangements taxed under the economic benefit regime face significant challenges. Executives who endure the ever-increasing tax burden evoke the metaphor of boiling frogs. FICA withholding, potential 409A issues, and accounting issues add to the concerns of employers. Part two of this two-part series addresses potential alternatives to continuing these types of arrangements.

The authors acknowledge the assistance of Howard D. Stern, FSA, Senior VP and Actuary of the Pangburn Group.

NOTES

1. Treas. Reg. § 1.61-22 for arrangements entered into, or materially modified after September 17, 2003, or IRS Notice 2002-8 for grandfathered arrangements.
2. Treas. Reg. § 1.7872-15 for arrangements entered into, or materially modified after September 17, 2003, or IRS Notice 2002-8 for grandfathered arrangements.
3. IRS Notice 2002-8.
4. Section 13 of the Securities and Exchange Act of 1934, as amended by Section 402 of the Sarbanes-Oxley Act.
5. FASB Emerging Issue Task Force Issues 06-4 and 06-10, now codified in ASC 715-60.
6. *See* Table 2001 on the final page of IRS Notice 2001-10 for example.
7. The American Taxpayer Relief Act of 2012 made permanent the estate and gift tax laws that were in effect in 2012, but increased the top estate and gift tax rate to 40 percent. Estate and gift taxes are now unified with an exemption amount that is indexed for inflation (from $5 million in 2011). For 2016, the inflation-indexed exemption amount is $5.45 million.
8. Notice 2001-10, Section IV B 2, "Table 2001 is based on the mortality experience reflected in the table of uniform premiums promulgated under section 79(c) of the Code (see § 1.79–3(d)(2) of the regulations), with extensions for ages below 25 and above 70, and the elimination of the five-year age brackets."
9. *https://www.irs.gov/Businesses/Corporations/Split-Dollar-Life-Insurance-Audit-Technique-Guide-03-2005.*
10. IRS Notice 2002-8, Section III, paragraph 3.
11. IRS Notice 2002-8.

12. IRC § 3102(f)(1), which pertains only to withholding. The actual tax depends on filing status and FICA wages of the spouse on a joint return. *See* IRC § 3101(b)(2) for the actual thresholds by filing status. *Also see https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax.*
13. IRC § 3102.
14. IRC § 3102(d).
15. *See* the IRS instructions for Form W-2, Box 12.
16. IRC § 1.
17. California maximum individual tax rate of 12.30 percent, plus the Mental Health Services Tax Rate of 1 percent for taxable income in excess of $1,000,000. *See https://www.ftb.ca.gov/forms/2015_California_Tax_Rates_and_Exemptions.shtml#itr.*
18. *See* Private Letter Ruling 200910002, for example.
19. Treas. Reg. § 1.409A-1(a)(5).
20. Treas. Reg. § 1.409A-6(a)(1)(i).
21. Treas. Reg. § 1.409A-1.409A-1(b)(1).
22. Treas. Reg. § 1.409A-1.409A-3(j)(4)(ix)(C).
23. Treas. Reg. § 1.409A-1.409A-1(c)(2).
24. FASB Emerging Task Force Issues 06-4 and 06-10, now codified in ASC 715-60.
25. Treas. Reg. § 1.409A-1.409A-3(j)(4)(ix)(B).

A Few 403(b) Compliance Quirks

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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.*