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Defined Contribution Plans for Nonprofit Organizations

Understand how new 403(b) plan requirements compare to 401(k)s.

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When it comes to qualified retirement plans, the 403(b) has long been the default alternative for nonprofit organizations. The lack of nondiscrimination testing for elective deferrals and no plan audit requirement as well as the ability to avoid Employee Retirement Income Security Act (ERISA) regulations have traditionally been the biggest benefits associated with sponsoring a 403(b) plan. However, because of recent regulations, these key differentiators no longer apply to all 403(b) plans.

The challenge for nonprofit organizations and the CPAs who serve them is to understand how these new regulations affect 403(b) plans and when a 401(k) might be a better option. This article explores the new regulations and the key questions CPAs need to ask when discussing these options with their nonprofit employers or clients.

REGULATIONS

Established under a section of the Internal Revenue Code (IRC), a 403(b) plan is a defined contribution retirement plan for employees of private organizations that are tax-exempt under IRC § 501(c)(3), certain employees of public schools and certain ministers.

On July 23, 2007, the Treasury Department and the IRS finalized the first comprehensive 403(b) regulations since 1964. The intent of the regulations was clear: to move the regulatory framework of 403(b) plans closer to that of 401(k) plans. Highlights of the new regulations addressed: (1) plan documents, (2) contract exchange and transfer rules, (3) timing of deferral deposits, (4) universal availability rule and (5) plan termination.

Further, the Department of Labor issued regulations on Nov. 16, 2007, that require ERISA-covered 403(b) plans to be subject to the same reporting and audit requirements as 401(k) plans.

Like its cousin the 401(k), a 403(b) plan now must have a written plan document. A plan document is a road map that specifically defines how the plan operates, who can participate in the plan, and what services are provided to participants. Specific things that must be included in the plan document are:

- Participant eligibility
- Benefits provided
- Contribution limits
- Available investment options
- Distributions

A written plan must also include any optional features such as:

- Loan availability
- Hardship withdrawal criteria
- Fund transfers
- Rollovers (allowed or not allowed)

COMPLIANCE RESPONSIBILITIES

The initial regulations called for all 403(b) plans to have a plan document in place by January 2009. However, an extension allows plan sponsors until the end of 2009 to have this document in place.

ERISA-covered 403(b) plans with 100 or more participants generally will be required to file audited financial statements beginning with their 2009 Form 5500 filing. Plans with fewer than 100 participants may be eligible to use abbreviated reporting forms without audited financial statements.

The new regulations also require an open exchange of information between 403(b) sponsors and service providers. Since sponsors are now expected to be more proactive in the administration of their plans, the information exchange regulations require service providers to support the plan sponsor's efforts. Specifically, the regulations call for information sharing concerning the participants' employment status, loans, hardship distributions and other plan distributions. This information will enable the plan sponsor to ensure the participants are meeting sponsor and IRS guidelines.

For ERISA-compliant 403(b)s, the timing of deferral deposits have now been clearly defined. Like 401(k)s, deferrals into ERISA-compliant 403(b)s must be put into the participant's account as soon as they can reasonably be segregated from the general assets of the employer but no later than the 15th business day of the month following the month in which contributions are received or withheld by the employer. For non-ERISA 403(b)s, the rules are less specific. Deferrals must be deposited within a reasonable time period. The example in the regulations is 15 business days following the month in which the deferral amounts would otherwise have been paid to the participant, but the language is not as specific as it is for ERISA-compliant plans.

Another important aspect of the regulations around 403(b)s is the universal availability regulation. Sponsors of 403(b) plans must allow all employees to participate in the plan. Like most rules, there are some exclusions to the universal availability rule. These exclusions include:

- Employees who will contribute \$200 annually or less.
- Those employees who participate in a 401(k) or 457 plan, or in another 403(b) plan.
- Nonresident aliens.
- Employees who normally work less than 20 hours per week.
- Students performing services described in IRC § 3121(b)(10).

Additionally, plan sponsors will need to communicate employees' eligibility to participate in the plan regularly.

Plan sponsors now have the right to terminate a 403(b) plan. Should a plan sponsor terminate a 403(b), it must distribute the participants' assets in a reasonable amount of time. Once a 403(b) has been terminated, the plan sponsor cannot contribute to another 403(b) for 12 months.

AVOIDING ERISA

ERISA, enacted in 1974, sets minimum standards for most retirement plans and health plans in private industry and provides protection for individuals in these plans. The new 403(b) regulations include a stricter set of requirements that a plan sponsor must meet to avoid ERISA requirements. In order to avoid ERISA requirements, a 403(b) plan must meet the following three criteria:

- Can have no employer contributions;
- Must have minimal administrative involvement by the plan administrator;and
- Must be a voluntary plan.

The first and possibly most important aspect of avoiding ERISA within the 403(b) is the inability of employers to provide any contribution to plan participants. Nonprofit organizations will have to carefully weigh the value of being non-ERISA and the impact it may have on how employees and potential employees view the organization's retirement plan.

The most comprehensive of the requirements to maintain non-ERISA status lies in the "minimal" administrative requirement of plan sponsors. Like 401(k)s, 403(b)s have certain features that must be clearly defined in the plan document. To satisfy the "minimal" administrative involvement requirement, 403(b) sponsors cannot dictate many of these features. Instead, these features must be determined and managed by the vendor or third-party service provider. Specific features that the sponsor cannot determine include:

- Authorizing plan-to-plan transfers.

- Processing distributions.
- Establishing hardship withdrawal eligibility.
- Making qualified domestic relations order (QDRO) determinations.
- Determining loan eligibility.
- Enforcing loans.
- Negotiating with plan vendors as it relates to terms of their product.

These important features can have a significant impact on the operation and perceived value of the overall retirement plan. As with the decision as to whether to provide employer contributions, plan sponsors must carefully consider whether the lack of control over these features is worth the benefits of avoiding ERISA regulations.

Because it is rare with both 403(b)s and 401(k)s for sponsors to make participation mandatory, this particular requirement should have little influence on most sponsors' decision to be ERISA or non-ERISA compliant.

WHEN IS IT TIME TO TALK 401(k)?

When does a 401(k) become an attractive alternative to a 403(b) for a nonprofit organization? The answer depends on the organization's intentions for the plan. Most sponsors offer retirement plans for one of two reasons:

1. The benefit is seen as a must, but it provides little benefit to the organization (that is, it's a "feel good" benefit), or
2. It is a recruitment and retention tool that can differentiate the organization from the competition.

An organization's motives for sponsoring a retirement plan will ultimately determine whether it provides employer contributions.

TO CONTRIBUTE OR NOT TO CONTRIBUTE

Sponsors that simply offer a retirement plan as a feel-good benefit are less likely to provide employer contributions, such as a match. In these situations, the sponsor should feel comfortable going ahead with a 403(b). Provided it has no desire to further define the features inherent in the plan, the sponsor may take advantage of the less stringent non-ERISA compliance requirements.

However, if your organization views its retirement plan as a comprehensive piece of its recruitment and retention strategy, it most likely will provide an employer contribution. This will require ERISA regulatory compliance and ultimately warrant a comparison between the 403(b) and the 401(k). Nonprofit organizations operate in a highly competitive environment, especially when it comes to attracting top talent. The need to provide an attractive benefits package can outweigh the desire to avoid additional administrative liability. Providing an employer contribution immediately renders the No. 1 advantage of a 403(b) null and void.

Of course, the decision to provide an employer contribution just levels the playing field between 403(b)s and 401(k)s. Once this decision has been made, you need to educate your organization's management on the differences between the two types of plans and how those differences affect the sponsor and the participants.

INVESTMENT OPTIONS

For the plan sponsor looking to use the retirement plan as a recruitment and retention tool, a 401(k) has a decided advantage over the 403(b) when it comes to investment options.

A 403(b) plan can only offer annuity and mutual fund products as investment options for participants. A 401(k), however, can provide any combination of the following investment options, which include virtually any tradable security:

- Mutual funds
- Stocks
- Real estate investment trusts (REITs)
- Bonds
- CDs
- Self-directed brokerage accounts
- Structured notes
- Incidental insurance
- Annuities

COST AND COMPLEXITY OF ADMINISTRATION

The administration of 403(b) and 401(k) plans also presents significant differences for your organization to consider. A 403(b) contains separate individual accounts for each participant. Once an individual account has been created, the plan sponsor has little control over that plan and those assets. If the plan sponsor decides that it no longer wishes to support a particular vendor, it can only discontinue that vendor for future participants. It cannot require existing participants to stop using that vendor. The plan sponsor is required to maintain an open line of communication with the service provider to make sure it fulfills its fiduciary responsibility.

A 401(k) is set up under a single trust. If the employer decides to change plan service providers, it can simply pick up the entire plan and transfer the assets to the new service provider. As a 401(k) plan's assets grow, the plan sponsor can often negotiate better prices on its service as it realizes greater economies of scale.

MARKET FORCES

Only a handful of service providers have the expertise and resources to support the 403(b) market. Given the changing regulatory landscape, it is likely that fewer service providers will provide support for 403(b) plans. Even fewer financial advisers and consultants will continue supporting 403(b) plans because of the specialized knowledge required and new compliance requirements. Ultimately, fewer providers (less supply) in the market will likely drive plan costs up for participants and sponsors.

The opposite is true for 401(k)s. A growing number of vendors and providers are competing for 401(k) assets and administrative services. Insurance companies, mutual fund companies, brokerage houses and trading platforms are all continuing to develop their 401(k) plan capabilities. This increased supply and competition, combined with the 401(k) sponsor's structural ability to negotiate collectively on behalf of participants, is good for participants and plan sponsors and should result in better pricing and levels of service.

EXECUTIVE SUMMARY

- **Being subject to fewer regulations has traditionally been the biggest benefit** associated with sponsoring a 403(b) plan rather than the more common 401(k) plan.
- **New regulations have moved the regulatory framework of the 403(b) plan closer to that of 401(k) plans.** Sponsors of 403(b) plans have until the end of 2009 to have a written plan document in place; an open exchange of information (participants' employment status, loans, hardship distributions and other plan distributions) between 403(b) sponsors and service providers is also required.
- **Deferrals into ERISA-compliant 403(b)s** must now be put into the participant's account as soon as they can reasonably be segregated from the general assets of the employer but no later than the 15th business day of the month following the month in which contributions are withheld by the employer. For non-ERISA 403(b)s, the rules remain less specific; deferrals must be deposited within a reasonable time period.
- **Organizations that do not provide employer contributions** (and do not intend to in the future), should feel comfortable continuing with a 403(b) plan. Organizations that make employer contributions will be subject to ERISA regulatory compliance and should consider sponsoring a 401(k) plan because it allows them to offer participants more investment options, it is less complex to administer, and more 401(k) vendors are available.

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