

# 401(k) vs. 403(b): Who Wins the Title Match?

There are some distinct advantages to taking a long hard look at adopting or sticking with a 403(b) plan rather than jumping ship in favor of a 401(k) plan.

BY SUSAN D. DIEHL

**T**ax-exempt organizations have the choice of setting up either a 403(b) or a 401(k) plan. Ensuing questions posed by the employer will revolve around the question, "Which is better?" The real answer is: it depends!

It has become a pet peeve of mine to hear stories of employers who were convinced to leave their 403(b) and set up a 401(k) plan instead. While there are a few instances where the 401(k) may be more beneficial, in my opinion there are *only* a few.

Some of the factors commonly cited in favor the 401(k) plan are:

- Better investments (true)
- Easier and cheaper to administer (not true)
- 403(b) plans cannot accept employer contributions (not true)

Unfortunately, I could share some horror stories about marketing 401(k) plans to employers that were much better suited for a 403(b) plan, but those are stories for another day.

So which type of plan is better? Since this is more of a professional bout than an amateur boxing match, we are going to go 10 rounds (unless there is a TKO) and declare the winner. Put on your boxing gloves and let's get started.

## ROUND 1: NONDISCRIMINATION TESTING FOR ELECTIVE DEFERRALS

**401(k) plan:** The ADP test is used to determine whether HCEs defer proportionally more than the NHCEs. When this test fails, the employer must either distribute the excesses to the HCEs or contribute more to the NHCEs to satisfy the ADP test. In small to mid-sized non-profit organizations there may not be many employees who are HCEs, and churches and certain church-related organizations are exempt from the ADP test.

**403(b) plan:** The ADP test does not apply. This is replaced by the Universal Availability rule, which is much easier to satisfy than the ADP test. An

employer either permits all employees to defer into the plan or it has the option to exclude certain employees. No testing after that.

**Winner:** 403(b) plan.

## ROUND 2:

### LATE DEFERRALS IN AN ERISA 403(b)/401(k)

**401(k) plan:** Generally under a 401(k) plan, if deferrals are made later than (1) as soon as they can be reasonably segregated from the employer's general assets, or (2) after the 15th day after the month in which they are taken from payroll, then penalties and filings apply. The employer must file a Form 5330 paying the excise tax on the amount of the late deferrals.

**403(b) plan:** The excise tax does not apply to 403(b) plans, which means the Form 5330 does not apply either. Of course, the employer still must make the employee whole by putting the lost earnings into the plan, as is the case in a 401(k) plan.

**Winner:** 403(b) plan.



GEO. A. HAYES

### ROUND 3: TOP-HEAVY TESTING

**401(k) plan:** Generally, under a non-safe harbor 401(k) plan the employer must satisfy the top-heavy testing rules. In small to mid-sized non-profits, there may not be many employees who are key employees, but the testing still must be performed.

**403(b) plan:** The top-heavy rule does not apply.

**Winner:** 403(b) plan.

### ROUND 4: ELIGIBILITY FOR ELECTIVE DEFERRALS

**401(k) plan:** The maximum eligibility for permitting elective deferrals by employees can be structured to require one year of service. In this case, if an employer has a high turnover in employees, it may have fewer employees than are eligible

under the plan. This would reduce the amount of participants and prevent the employer from having more than 100 participants for purposes of a Form 5500 required audit.

**403(b) plan:** There is no age or service eligibility that can be used under a 403(b) for elective deferrals. The Universal Availability rule applies in lieu of service eligibility. A 403(b) plan may exclude employees who are expected to work less than 20 hours per week, but if that exclusion doesn't work for the employer, it may result in a larger number of employees who must be offered the deferral option.

**Winner:** 401(k) plan.

### ROUND 5: POST-EMPLOYMENT EMPLOYER CONTRIBUTIONS

**401(k) plan:** The only option under a 401(k) plan would be in the year of

separation, and only with respect to the compensation received through the later of either 2½ months after separation from service or the end of the limitation year.

**403(b) plan:** A post-employment employer contribution rule is very common in 403(b) plans. It is typically used for the CEO or director and other key employees of a non-profit employer. This permits an employer to contribute on behalf of an employee for the year in which he or she separates from service plus the next 5 years.

The contribution is based on the most recent compensation earned in the last 12 months of employment. This compensation amount is then used to determine what the Section 415 limitation would be for the next 5 years. For example, an employee could have an employment agreement which states that the individual will

## A 403(b) plan sponsor will typically have the choice to make employer contributions based on employment agreements.”

receive an employer contribution of \$10,000 per year for the 5-year period following termination of employment. Another example: Upon separation from service, accrued sick or vacation may be contributed as an employer contribution.

The advantage of contributing over a 5-year period is that it allows the employer to continue to contribute if the total amount of the accruals exceeds the Section 415 limit for the year.

Keep in mind that the employer will need to perform the nondiscrimination test on these contributions if there is an HCE in the plan. In small to mid-sized non-profit organizations there may not be any HCEs. Churches and certain church-related organizations, however, are exempt from the nondiscrimination requirements.

**Winner (close but not a TKO!):**  
403(b) plan.

### ROUND 6: ELECTIVE DEFERRAL MAXIMUM

**401(k) plan:** The maximum elective contribution for 2018 is \$18,500, plus \$6,000 as an age 50 catch-up contribution, for a total of \$24,500.

**403(b) plan:** In addition to the above limits, under a 403(b) there are special rules that include:

- Long-term service deferrals — Employees who work at least 15 years for the same employer can (pursuant to a calculation) potentially contribute up to an additional \$3,000 each year, subject to a maximum under this rule of \$15,000 in the aggregate. This brings the total for the year to \$27,500.
- Special rules for church employees — Regardless of compensation,

a church employee may receive contributions up to \$10,000 per year, with a lifetime limit of \$40,000. In addition, church employees working outside of the U.S. (typically foreign missionaries) may receive a contribution of up to \$3,000 without violating Section 415 if the employee's compensation does not exceed \$17,000.

**Winner:** 403(b) plan.

### ROUND 7: INVESTMENTS

**401(k) plan:** A 401(k) plan can offer any investment that the employer or its advisor selects (subject to the prohibited transaction rules). Some employers may be conservative, while others may add very aggressive investments as a choice.

**403(b) plan:** With the exception of church plans under Section 403(b) (9), investments may only be made in annuity contracts or mutual funds under a custodial agreement. In addition, amounts held in a custodial account are subject to stricter in-service distributions rules with respect to nonelective contributions and regular matching contributions (generally these amounts are subject to the same distribution rules as qualified nonelective contributions). In a 403(b) (9) plan, which is a retirement income account that may only be used by churches, there are no exclusions for investment types. In fact, churches are not subject to the prohibited transaction rules under Section 4975, so investments can even include collectibles!

**Winner:** 401(k) plan.

### ROUND 8:

#### ADMINISTRATIVE COSTS

**401(k) plan:** This is not the case for all plans, of course, but typically 401(k) plans have higher administrative fees than 403(b) plans. Some TPAs charge the same price to administer either plan type.

**403(b) plans:** For many of the reasons stated above, being exempt from certain administrative processes can cause the cost to administer a 403(b) plan to be lower than cause the cost to administer a 401(k) plan.

**Winner:** 403(b) plan.

### ROUND 9:

#### REQUIRED MINIMUM DISTRIBUTIONS

**401(k) plan:** Both plans will fall under the basic rule that participants must begin to receive their required minimum distribution (RMD) no later than the April 1 following the later of



attainment of age 70½ or separation from service. However, 403(b)s have one small advantage...

**403(b) plan:** If the custodian or issuer tracks the pre-1987 balance in the plan, then the age for distributing the pre-1987 balance is age 75. Also, 403(b)s can take advantage of the aggregation rule that applies to IRAs whereby participants can calculate the RMD separately for each 403(b) they own, but take the distribution from any one or any combination of their 403(b) accounts.

**Winner:** Slight advantage to the 403(b) plan.

#### ROUND 10: OVERALL CONTRIBUTION LIMITS VS. LAYERING THE BENEFITS

**401(k) plan:** If the employer has adopted a 401(k) in lieu of a 403(b), the plan will generally be designed to accept all types of contributions into a single plan. For example, the plan may permit elective deferrals and in addition the employer has the option to contribute a profit-sharing contribution and/or matching contribution. In any event, the maximum annual addition per employee cannot exceed \$55,000 for 2018.

**403(b) plan:** Here we call it “layering on the benefits.” A 403(b) plan is not aggregated with a 401(a) plan under the Section 415 limitations, so if the employer were to establish a 403(b) and pair it with a 401(a) plan for the matching contributions (i.e., a 401(m) plan), each plan would have a separate Section 415 limitation for each employee — in essence doubling the amount that can be contributed. Instead of the aggregation rule that applies to a 401(k) plan, there is a special 403(b) aggregation rule where a participant in a 403(b) must aggregate contributions in the 403(b) plan with contributions made to a plan maintained by a business controlled by that individual (some refer to this

as the “doctor rule”). This generally does not outweigh the benefits of the general aggregation rule described above which permits layering, but it may be a concern for certain individuals.

**Winner (definitely by a knockout!):** 403(b) plan.

As you can see, there are some distinct advantages to taking a long hard look at adopting or sticking with a 403(b) plan rather than jumping ship in favor of a 401(k) plan. Employers must be sure to consult with a trusted advisor or firm that actually specializes in 403(b) plans; otherwise they may not receive a truly objective comparison between the plans that have their best interests in mind.

As highlighted above — and in a useful chart that has been posted on the ASPPA Net website (see sidebar) — there are areas in both types of plans that will vary. The answer to the question, “Which plan is better?” will depend on several factors, including the type of employer, employee turnover and the desired contribution types. So put on your gloves, take a few jabs, and see if your plan makes it to your corner of the ring. **PC**



Susan D. Diehl, QKA, CPC, ERPA, is the President of PenServ, a nationally recognized pension consulting firm in Horsham, PA. She has served as chairperson of the Department of Labor's ERISA Advisory Council, as vice chair of the IRS' Information Reporting Program Advisory Committee (IRPAC), on the IRS' Advisory Committee on Tax Exempt and Government Entities (ACT), and as President of the National Tax-Deferred Savings Association (NTSA).

## 401(k)/ 403(b) Comparison Chart

PenServ has created a detailed four-page chart comparing the features of 401(k) plans and 403(b) plans. A pdf of the chart has been posted for ASPPA members on the ASPPA Net website — just enter <https://bit.ly/2HNSze> in your browser.

Comparison of ERISA 403(b) Plans to ERISA 401(k) Plans		
FEATURE OF	ERISA 403(b)	ERISA 401(k)
Which Types of Businesses may Establish	Educational organizations, nonprofit organizations under 501(c)(3)(C), and other church organizations.	See Proprietary Partnership, S-Corporation, C-Corporation, and all other businesses including partnerships.
Conferred Existence of Plan	Permanency must be intended.	Permanency must be intended.
Information Sharing Agreements	Typically required, unless there is one vendor or TPA is a platform.	Not required. Investments are selected by the Employer or Advisor to the Plan.
Annual Contribution	Not required.	Not required.
Maximum Annual Contribution	Up to 10% of each participant's compensation (subject to a minimum \$10,000 for 2018).	Up to 25% of total eligible participants' compensation (subject to a minimum \$5,000 for 2018).
What is Compensation?	If you are an employee, compensation is generally based on your pay as shown on your Form W-2. If you are a self-employed professional, compensation is based on your net self-employed "earned income."	If you are an employee, compensation is generally based on your pay as shown on your Form W-2. If you are a self-employed professional, compensation is based on your net self-employed "earned income."
Do Deferrals Effect Compensation?	No. Starting in 2002, deferrals do not affect compensation for purposes of compensation for being an ERISA plan participant.	Yes. The plan may allow Employer to make contributions based on compensation for being an ERISA plan participant.
Eligibility for Elective Deferrals	There are no age and service rules. See available exclusions below.	All employees who are age 21 and have completed 1 year of service must be eligible for elective deferrals.
Exclusions from Deferrals	ERIA, director, officer, employee, 403(b) 401(k), 401(k), Nonresident Alien, partner, and spouse, who work less than 20 hrs per week (1000 hours per year).	ERIA that have not completed the eligibility requirements set above, unless the employee is a spouse, parent, or becomes employee as a result of a transfer, or becomes a spouse or becomes a parent for greater than 2 years post-transfer.
Subject to Penalty for Late Deferrals	No	Yes
Eligibility for Employer Contributions	May use the same as 401(k).	All employees who are age 21 and have completed 1 year of service must be eligible for employer contributions.

\*Informational comparisons are provided governmental and are never subject to ERISA or nondiscrimination laws. Church organizations are not subject to ERISA. Proprietary Partnership includes sole proprietorships, limited liability companies, and other partnerships. See Note 403(b) Non-Qualified Plan (Excluded Organizations).

Copyright 2018 PenServ Plan Services (Formerly Penn Mutual Retirement Plan Services) All rights reserved. ERISA 403(b) Comparison Chart Version 1.0 (01/18).

Page 1