

**LOEB & LOEB LLP WEBINAR: RETIREMENT PLANS FOR EMPLOYEES OF  
TAX-EXEMPT ORGANIZATIONS**

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**Introduction**

This presentation is intended to familiarize tax-exempt organizations with the retirement plans such organizations can provide for their employees. This presentation is organized into the following sections:

- Tax-qualified retirement plans
- Tax-deferred annuities
- Simplified employee pensions
- Nonqualified retirement plans

In all cases, where annual dollar limitations are described below (which are typically COLA-based and may change from year-to-year), the amount in effect for 2010 is indicated.

**Tax-Qualified Retirement Plans**

The hallmark of a tax-qualified retirement plan is that it provides the contributing entity with an immediate tax deduction for its contributions. Obviously, this primary benefit is inapplicable to a tax-exempt organization. Perhaps the other most fundamental aspect of tax-qualified retirement plans is that the contribution is required to be made currently, even though the retirement benefit itself may not be payable for many years/decades. (Contrast this to agreeing to pay a non-qualified pension in the future of, e.g., \$3,500 per month, in which case the employer would only need to come up with the monthly amount, and perhaps not until well into the future). Thus, a tax-exempt organization appears to get a raw deal - it is required to make current contributions without the attendant benefit enjoyed by for-profit employers, namely the tax deductions, which serve to decrease the cost to the employer of maintaining the plan.

Then why would a tax-exempt organization sponsor a tax-qualified retirement plan? The answer is simple - - employees want them (“to attract and retain qualified employees”) and the

great majority of for-profit employers, with which tax-exempts must compete for employees, provide them. Why do employees want them? The following tax-qualified retirement plan features are appealing to employees/prospective employees:

No income tax until the benefits are paid.

Plan's assets are held in trust and are not subject to the claims of the employer's creditors.

Employees in defined contribution plans may be able to direct the investments of their plan accounts.

Eligibility/benefits may not discriminate in favor of highly compensated employees.

Maximum vesting period is 3 years (if all or nothing "cliff" vesting is utilized) or 6 years (if graded vesting is utilized).

Plan loans may be available.

Hardship withdrawals may be available.

For certain defined contribution plans other pre-termination withdrawals (e.g., age 59-½) may be available.

A variety of distribution options from which the employee need not select until his or her termination.

Can roll benefits over to an IRA or another employer's tax-qualified retirement plan without imposition of income tax.

The trust/protection from the employer's creditors is especially noteworthy, especially for companies/organizations experiencing or anticipating financial distress. Tax-qualified retirement plans are unique in that employees are not currently taxable on their benefits, even though the plan is funded, yet the plan's assets are not subject to claims of the employer's creditors.

The key aspect of tax-qualified retirement plans is that they may not provide benefits that discriminate in favor of highly compensated employees ("HCEs") or provide for discriminatory eligibility requirements which favor HCEs. (An HCE is an employee with compensation in excess of \$110,000). Therefore, a tax-qualified retirement plan cannot be used, e.g., to provide benefits solely for an employer's executives, or even for the CEO only - where this treatment is desired, a non-qualified plan will be required. For the sake of clarity, it would be discriminatory (and therefore impermissible) for a plan to provide a 20% of base salary employer contribution for HCEs but only 10% for non-HCEs; conversely, it would not be impermissible discrimination for a plan to provide a \$15,000 employer contribution for an HCE with a \$150,000 base salary and only a \$5,000 employer contribution for a non-HCE with a \$50,000 base salary, where the contribution

formula is the same for all employees, i.e., 10% of base salary. Tax-qualified retirement plans are subject to special required minimum distributions rules as well as to nondiscrimination requirements as to:

Eligibility for plan participation.

Contributions/benefits amounts.

Compensation eligible under the plan's formula (amount and type - no more than \$245,000 of an employee's compensation may be considered).

Amounts contributed to 401(k) plans by employees (via salary reduction) or by employers.

For any year that the plan is "top-heavy" (the accounts under a defined contribution plan/benefits under a defined benefit plan of "key employees" - officers with compensation in excess of \$160,000 - exceed 60% of those for all employees), special minimum employer contribution and vesting requirements will apply.

Availability of plan benefits, rights and features (e.g., hardship withdrawals, loans or certain payments options) cannot be available to HCEs only.

The nondiscrimination requirements are imposed on a "controlled group" basis - all members of a controlled group are deemed to be a single employer, to prevent, e.g., an employer from moving all of its non-HCEs to a subsidiary with an inferior plan. In the for-profit world, the controlled group test is based on 80% ownership (e.g., stock for a corporation, profits or capital interest for a partnership). In the tax-exempt world, the test is based on commonality (80% test) of board members (or control over the right to select 80% or more of the board members).

Contributions to a tax-qualified retirement plan may be made by the employer, the employee (typically via salary reduction) or a combination.

The tax-qualified retirement plan rules place limits on (1) the benefits that may be accrued under a tax-qualified "defined benefit plan" (i.e., a plan where the future benefit is defined (e.g., a \$3,000 monthly pension for life commencing at age 65), where the employer bears the investment risk - it may be required to contribute additional amounts to offset poor investment results to fund the defined benefit), and (2) the annual contributions that may be made to an employee's individual account under a tax-qualified "defined contribution plan" (i.e., a plan where only the contribution is defined (e.g., X% of base salary), and where the employee bears the investment risk - the employee's account balance (contributions plus or minus investment

experience) is the employee's benefit). The defined benefit plan limit is the lesser of \$195,000 or 100% of the employee's compensation for his or her high 3 years. The defined contribution plan limit is \$49,000. On account of these limitations, far greater retirement benefits can be provided under a defined benefit rather than a defined contribution plan.

With a tax-qualified defined contribution "401(k) plan," the maximum annual employee elective deferral amount is limited to \$16,500 (plus \$5,500 for employees who attain age 50 by the end of the year). This limit applies in the aggregate to tax-qualified 401(k) plans, tax-deferred annuities and "SIMPLE Plans" under IRC Section 408(p) (tax-deferred annuities are discussed below).

Tax-qualified retirement plans are subject to a myriad of distribution, operational, and reporting and disclosure requirements, typically necessitating the services of a third party administrator and other expert(s) to assist the employer sponsoring the plan. In the case of a defined benefit plan, a consulting actuary is needed to assist the plan sponsor with the many applicable funding rules, requirements and calculations. The sanctions for failing to comply with the tax-qualified retirement plan requirements can be severe. Finally, the administration and investments of tax-qualified retirement plans are subject to the fiduciary requirements of ERISA.

### **Tax-Deferred Annuities**

Funded typically through the use of annuity contracts issued by insurance companies (custodial accounts of non-insurance companies such as banks, credit unions and trust companies can also be utilized), tax-deferred annuities ("TDAs") are contracts to provide retirement benefits to employees of public educational organizations, states and organizations which are tax-exempt under Internal Revenue Code Section 501(c)(3) (i.e., religious, charitable, scientific, educational and public interest organizations). TDAs, like tax-qualified retirement plans, are subject to a host of technical rules and requirements, including:

Plan must be in writing. (Effective for 2010, this requirement applies to both ERISA and non-ERISA TDAs - formerly, solely ERISA TDAs were required to have a written plan document.)

Nondiscrimination requirements including a “universal availability” requirement (i.e., virtually all employees must be permitted to make salary reduction contributions if any are permitted to do so).

Distribution requirements.

All contributions must be immediately and fully vested.

Rollovers are permitted.

Contributions may be made by the employer, the employee (via salary reduction) or a combination.

Why would a tax-exempt organization opt to maintain a TDA rather than a tax-qualified retirement plan? One important reason is that, depending on a member of factors, even though a TDA is a plan or program used to provide retirement benefits, certain TDAs are nonetheless not subject to ERISA. (Not being subject to ERISA avoids numerous government and participant reporting and disclosure requirements as well as fiduciary requirements and obligations which are applicable to TDAs which are subject to ERISA.) TDAs of governmental and church employers are generally not subject to ERISA. As to the remaining tax-exempt world, a TDA will not be subject to ERISA where:

Participation is completely voluntary by employees.

No employer contributions (employee contributions only - via payroll reduction is OK).

All rights under the annuity contract (or custodial account) are enforceable solely by the employee, the employee’s beneficiary or their authorized representatives.

Most critical, the sole involvement of the employer must be limited to:

Permitting/facilitating annuity contractors/service providers to meet with/distribute marketing information to employees.

Summarizing or compiling information with respect to available products/services.

Collecting employee contributions (via payroll reduction), remitting those contributions to the contractors and maintaining employee contribution records.

Holding one or more group annuity contracts covering its employees in the employer’s name.

Limiting the funding media or products available to employees, or the annuity contractors who may approach employees, to a number and selection designed to afford employees with a reasonable choice.

In addition, the employer may receive no compensation or other consideration in connection with the TDA (other than reasonable amounts to cover expenses incurred in the performance of its duties under a salary reduction agreement).

Perhaps the most popular tax-qualified retirement plan of the day, where all contributions are made by employees on a pre-tax basis via payroll reduction (i.e., salary deferral), is known as a “401(k) plan,” and in the TDA arena, a “salary deferral TDA”. Many of the limitations and requirements applicable to these plans are the same (e.g., contribution limits). For example, the federal law annual limitation on employee deferral contributions under both types of plans is \$16,500 (\$22,000 for those who attain age 50 by the end of the year) (the \$16,500 amount is aggregated with tax-qualified 401(k) plan and “SIMPLE Plans” under IRC Section 408(p)). As mentioned previously, a TDA can be operated in a fashion so as not to be subject to ERISA. Such is not the case, however, for a 401(k) plan, which, as subject to ERISA, would be required to comply with ERISA’s many fiduciary, disclosure and reporting obligations. Further, a 401(k) plan is subject to the “Actual Deferral Percentage” test which limits the difference between contributions made by HCEs as a group and those made by non-HCEs as a group, often with the result that participants who are HCEs being required to receive back their excess deferrals (i.e., the amount that does not satisfy the ADP test requirements) on a fully taxable basis during the first quarter of the following year. Salary deferral TDAs are not subject to the ADP test (or any similar test). Consequently, where salary reduction employee contributions are the sole source of intended contributions, a salary deferral TDA may be preferable to a 401(k) plan.

### **Simplified Employee Pension Plans**

A simplified employee pension or “SEP” is essentially a series of IRAs established by an employer for its employees to receive employer contributions. Under a SEP, an employer can contribute far more each year on behalf of its employees than each employee would be able to contribute under a traditional IRA. The maximum annual SEP contribution is equal to the lesser of 25% of the employee’s compensation (for this purpose, only a specified portion of an employee’s compensation may be considered - this amount is \$245,000), or \$49,000. As is the

case under a tax-qualified retirement plan or TDA, the employee is not taxable for the amounts of the employer's contributions when they are made - taxation does not arise until receipt of the SEP benefits.

SEPs are simpler to establish and maintain than tax-qualified retirement plans and TDAs. No trust or annuity contract is required. All contributions are required to be fully vested, further minimizing the employer's administrative responsibilities - often a good choice for a smaller employer. Each employee selects his or her own investment and SEPs are not subject to ERISA, thereby relieving the employer from ERISA's fiduciary obligations regarding investments. No IRS Annual Report is required. IRA rollovers are permitted.

On the negative side, employee salary reduction contributions are not permissible, loans cannot be provided, all contributions must be fully vested when made (i.e., no forfeitures by short-service employees upon their termination of employment) and employees must be entitled to withdraw the employer contributions at any time. In addition, SEPs are subject to special required minimum distribution rules as well as the following nondiscrimination requirements:

All employees (including part-time and seasonal but can exclude if covered by a collective bargaining agreement) age 21 or older and who have performed services for the employer during at least 3 of the 5 immediately preceding years must be covered.

Contributions may not discriminate in favor of HCEs.

Only the first \$245,000 of an employee's compensation may be considered.

The "top-heavy" plan rules are applicable - if the sum of the IRA balances of "key employees" (officers having annual compensation in excess of \$160,000 exceeds 60% of the total IRA balances of all employees, the employer is obligated to contribute for each non-key employee the lesser of 3% of the employee's compensation or the percentage allocated to the IRA of the best-treated key employee.

Smaller employers may consider the above mix of positives and negatives as preferable to establishing a tax-qualified retirement plan or TDA. However, as mentioned previously, employee salary reduction contributions are not permitted under a SEP. Consequently, an employer wishing to utilize a plan which offers solely salary reduction contributions or a combination including such contributions will not be able to do so with a SEP.

### **Nonqualified Retirement Plans**

Where discriminatory retirement benefits (e.g., CEO only, senior management only) are desired and consequently, a tax-qualified retirement plan, TDA, etc., cannot be utilized, or even where a tax-exempt organization simply cannot or prefers not to fund the benefit in advance, Internal Revenue Code Section 457 will apply. Section 457 is applicable to non-qualified deferred compensation plans of governmental and tax-exempt employers. There are essentially two types of 457 plans - “eligible deferred compensation plans,” which meet the requirements of Section 457(b), or “ineligible deferred compensation plans” under Section 457(f), which do not satisfy the requirements under Section 457(b). A 457(b) plan typically requires a separate plan document whereas a 457(f) plan can be a paragraph within an employment agreement.

An “eligible deferred compensation plan” under Section 457(b) is an unfunded plan that provides for annual deferrals limited to the lesser of \$16,500 (an additional \$5,500 “catch-up” applies for employees of governmental employers who attain age 50 by the end of the year - the “catch-up” is not available to employees of non-governmental tax-exempt organizations), or 100% of the employee’s compensation. (This limit is aggregated for all 457(b) plans.) For this purpose, “unfunded” means that all amounts under the plan remain (until paid out) solely the property of the employer and subject to the claims of the employer’s creditors. 457(b) plans must also satisfy specific distribution (including required minimum distributions) requirements. Hardship withdrawals and rollovers to other 457(b) plans are permitted.

To the extent a deferred compensation arrangement or plan provides contributions/benefit accruals which exceed the annual \$16,500 limit under Section 457(b), or less likely, where such an arrangement or plan cannot satisfy some other requirement under Section 457(b), Section 457(f) will apply. To satisfy the Section 457(b) “unfunded” requirement, the plan must be exempt from ERISA’s funding requirement - namely, the plan must qualify as an “excess benefit plan” or a “top-hat” plan. (An “excess benefit plan” solely provides benefits in excess of the limitations on annual contributions/benefits under tax-qualified retirement plans pursuant to Internal Revenue Code Section 415. A “top-hat plan” is an unfunded plan to provide

deferred compensation for a “select group of management or highly compensated employees.” Although there is no bright line test for the “select group” requirement, conservatively viewed, less than 10% of all employees (on a controlled group basis) should be covered - more aggressively, less than 20% should be covered.) Assuming that the plan qualifies as a top-hat plan, the key remaining aspect of Section 457(f) relates to the timing of participant taxation. Essentially, Section 457(f) provides that the employee will be taxable upon becoming vested (rather than upon payment - which could lead to the result of being taxed currently on an amount not to be received for many years). Conversely, to the extent the benefit is subject to a “substantial risk of forfeiture,” the employee is not yet taxed. However, upon elimination of the forfeiture risk, taxation is immediate, regardless of the (later) contractual time for payment.

Where an employee’s own compensation is to be voluntarily deferred, the vesting requirement under Section 457(f) will obviously be unacceptable; consequently, a voluntary deferral arrangement under a non-qualified plan will need to be a 457(b) plan, and the annual deferral opportunity will be limited to \$16,500 plus catch-up, if applicable. Where no vesting requirement, or even a typical 2, 3, 4 or 5-year vesting schedule is envisioned, a 457(b) plan should be used for the first \$16,500/\$22,000. As to the amounts in excess of the limitation, a 457(f) plan would be required.

Because full taxability occurs under a 457(f) plan upon vesting, the plan may provide for full payment upon vesting or payment of the lesser amount necessary to meet the tax liability generated by vesting. However, these approaches place additional cash flow pressures upon the employer and fail to provide the employee with much deferral. Another alternative is simply to subject the benefit to a substantial risk of forfeiture until retirement age, e.g., attainment of age 65. Generally, the “substantial risk of forfeiture” requirement is satisfied where the employee forfeits his or her benefit upon resigning or being terminated for “cause” (not sufficient if forfeit solely upon a termination for cause) prior to vesting.

(The special deferred compensation requirements of Section 409A of the Internal Revenue Code apply to a 457(f) plan (but not to a 457(b) plan, tax-qualified retirement plan, TDA or SEP) - however, this is a topic for a different presentation.)

### **Conclusion**

Tax-exempt organizations may have only a few employees or hundreds of employees. On the basis of factors such as the number of employees and the organization's financial condition (both current and future), certain organizations may be in a position to offer greater employer contributions (matching or nonelective), while others will not be able to make any employer contributions but may wish to permit their employees the opportunity to fund their own retirement benefits. Larger organizations may have their own HR professionals available to administer their plan/arrangements whereas smaller organizations may need to avoid additional administrative responsibilities to the extent possible. In this regard, the management of tax-exempt organizations should obtain expert advice to select the most appropriate plan/arrangement under the circumstances for their employees.