# Retirement Plans for Employees of Tax-Exempt Organizations

By Dana Scott Fried

This article is intended to familiarize tax-exempt organizations and their advisors with the retirement plans available for employees. These include: tax-qualified retirement plans, tax-deferred annuities, simplified employee pensions, and nonqualified retirement plans.

In all cases, where annual dollar limitations are described below (which are typically cost-of-living-based and may change from year to year), the amount in effect for 2009 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. Obviously, this primary benefit is inapplicable to a tax-exempt organization. Perhaps the other most notable 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 or decades. (Contrast this to agreeing to pay a nonqualified pension in the future of, for example, \$3,500 per month. In such a case, the employer would only need to come up with the monthly pension 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 that 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 and the great majority of for-profit employers, with which tax-exempt organizations must compete for staff, provide them. Why do employees want them? The following tax-qualified retirement plan features are appealing to employees and prospective employees:

- No income taxes are due until the benefits are paid.
- The 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.
- Employee eligibility and benefits may not discriminate in favor of highly compensated employees.
- The maximum vesting period is three years (if all-or-nothing "cliff" vesting is utilized) or six 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 $\frac{1}{2}$) may be available.
- A variety of distribution options may be available, from which the employee can select after termination.
- Benefits can be rolled over to an IRA or another employer's tax-qualified retirement plan without the imposition of income tax.

The protection of assets from an employer's creditors is especially noteworthy, especially for companies and 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.

Another key aspect of tax-qualified retirement plans is that they may not provide benefits that discriminate in favor of highly compensated employees (HCE) or provide for discriminatory eligibility requirements that favor HCEs. (An HCE is defined as an employee with compensation in excess of \$110,000.) Therefore, a tax-qualified retirement plan cannot be used to provide benefits solely for an employer's executives; where this outcome is desired, a nonqualified plan will be required. For example, 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, a plan could 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, because the contribution formula is the same for all employees—10% of base salary.

Tax-qualified retirement plans (which must have a trustee) are subject to special required minimum distribution rules as well as nondiscrimination requirements with regard to the following:

- Eligibility for plan participation.
- Contributions and benefits.
- 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," special minimum employer contribution and vesting requirements. (Top-heavy means that the accounts under a defined contribution plan or the benefits under a defined benefit plan of "key employees"—officers with compensation in excess of \$160,000—exceed 60% of those for all employees.)
- Availability of plan benefits, rights, and features (e.g., hardship withdrawals, loans, or certain payments options) to all participants, not just HCEs.

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 an employer from moving all of its non-HCEs to a subsidiary with an inferior plan. For for-profit enterprises, the controlled group test is based on 80% ownership (e.g., stock for a corporation, profits, or capital interest for a partnership). For tax-exempt organizations, the test is based on commonality (80% test) of board members (or control over the right to select 80% of board members).

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

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., where the employer bears the investment risk and may be required to contribute additional amounts to fund the defined benefit), and 2) the annual contributions that may be allocated to an employee's individual account under a tax-qualified defined contribution plan (i.e., a plan where the employee bears the investment risk and the employee's account balance is the employee's benefit). The defined benefit plan limit is the lesser of \$195,000 or 100% of the employee's compensation for her three highest-earning years. The defined contribution plan limit is \$49,000 per year per employee. 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 (\$22,000 for employees who reach age 50 by the end of the year). This limit applies in the aggregate to tax-qualified 401(k) plans, tax-deferred annuities, and Savings Incentive Match Plan for Employees (SIMPLE) plans under IRC section 408(p).

Tax-qualified retirement plans are subject to myriad distribution, operational, and reporting and disclosure requirements, typically necessitating the services of a third-party administrator and other experts 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 investment of tax-qualified retirement plans are subject to the fiduciary requirements of the Employee Retirement Income Security Act (ERISA).

## Tax-Deferred Annuities

Funded typically through the use of annuity contracts issued by insurance companies (custodial accounts of noninsurance companies such as banks, credit unions, and trust companies can also be utilized), tax-deferred annuities (TDA) are contracts to provide retirement benefits to employees of public educational organizations, states, and organizations that are tax-exempt under IRC 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 the following:

- The plan must be in writing. (Effective for 2009, this requirement applies to non-ERISA TDAs—formerly, only ERISA TDAs were required to have a written plan document.)
- Nondiscrimination requirements must be in place, 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 must be in place.
- All contributions must be immediately and fully vested.
- Rollovers must be permitted.
- Contributions may be made by the employer, the employee (via salary reduction) or a combination of both.

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 number of factors, certain TDAs are 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 that are applicable to ERISA TDAs.) TDAs of government and church employers are generally not subject to ERISA. As to other tax-exempt organizations, a TDA will not be subject to ERISA where the following conditions are met:

- Participation is completely voluntary by employees.
- There are no employer contributions (employee contributions via payroll reduction are permitted).
- All rights under the annuity contract (or custodial account) are enforceable solely by the employee, the employee's beneficiary, or their authorized representatives.
- Most critically, the sole involvement of the employer must be limited to—
  - permitting or facilitating annuity contractors and service providers to meet with and distribute marketing information to employees;
  - summarizing or compiling information with respect to available products and services;
  - collecting employee contributions (via payroll reduction) and 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; and
  - 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 plans today, where all contributions are made by employees on a pretax basis via payroll reduction (i.e., salary deferral), are the 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 annual limitation on employee deferral contributions under both types of plans is $16,500 ($22,000 with the "catch-up" for those who reach 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 above, 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 must comply with ERISA's many fiduciary, disclosure, and reporting obligations. Furthermore, a 401(k) plan is subject to the actual deferral percentage test that 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 must receive back their excess deferrals (i.e., the amount that does not satisfy the average deferral percentage test requirements) on a fully taxable basis during the first quarter of the following year. Salary deferral TDAs are not subject to the average deferral percentage test (or any similar test). Consequently, where salary reduction employee contributions are intended to be the sole source of contributions, a salary deferral TDA may be preferable to a 401(k) plan. In addition, new for 2009, annual reports (in certain cases requiring audited plan financial statements) will be required for many TDAs subject to ERISA.

## Simplified Employee Pension Plans

A simplified employee pension (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—$245,000), or $49,000. As is the case under a tax-qualified retirement plan or TDA, the employee is not taxed on 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 must be fully vested, further minimizing the employer's administrative responsibilities—often a good choice for a smaller employer. Each employee selects his 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 possibly excluding those covered by a collective bargaining agreement) age 21 or older and who have performed services for the employer during at least three of the five 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 plan is top-heavy under the definition as stated above in the tax-qualified retirement plans section, 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 positives and negatives of a SEP as preferable to establishing a tax-qualified retirement plan or TDA. Recall, however, that employee salary reduction contributions are not permitted under a SEP. Consequently, an employer wishing to utilize a plan that 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., benefits only for particular executives or senior management) are desired such that a tax-qualified retirement plan or TDA cannot be utilized—or where a tax-exempt organization simply cannot or prefers not to fund the benefit in advance—IRC section 457 will apply. Section 457 is applicable to nonqualified deferred compensation plans of governmental and nongovernmental tax-exempt employers. There are essentially two types of 457 plans: eligible deferred compensation plans that 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 included within an employment agreement.

An eligible deferred compensation plan under IRC section 457(b) is an unfunded plan that provides for annual deferrals limited to the lesser of $16,500 (the additional catch-up is available to employees of governmental employers but is not available to employees of nongovernmental tax-exempt organizations; there is also another catch-up opportunity for the last three years preceding the year in which the plan's normal retirement age is reached, available to both governmental and nongovernmental 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. IRC section 457(b) plans must also satisfy specific distribution (including required minimum distribution) requirements. Hardship withdrawals and rollovers to other 457(b) plans are permitted.

To the extent a deferred compensation arrangement or plan provides contributions or benefit accruals that 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 and benefits under tax-qualified retirement plans pursuant to IRC section 415. A top-hat plan provides deferred compensation for a "select group of management or highly compensated employees." Although there is no bright-line test for this requirement, less than 20% or less than 10% are aggressive or conservative positions on selectivity.) Assuming that the plan qualifies as a top-hat plan, the key remaining aspect of IRC 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 current taxation 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 currently taxed. Upon elimination of the forfeiture risk, taxation is immediate, regardless of the (later) contractual time for payment.

Where an employee's own compensation is voluntarily deferred, the vesting requirement under IRC section 457(f) will generally be unacceptable; consequently, a voluntary deferral arrangement under a nonqualified plan will need to be a 457(b) plan, and the annual deferral opportunity will be limited to $16,500 (plus catch-up). Where no vesting requirement or typical vesting schedule is envisioned, a 457(b) plan should be used for the first $16,500 (plus catch-up). For 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. These approaches place additional cash-flow pressures upon the employer and fail to provide employees with much of a deferral. Another alternative is simply to subject the benefit to a substantial risk of forfeiture until a stated retirement age. Generally, the "substantial risk of forfeiture" requirement is satisfied where an employee forfeits her benefit upon resigning or being terminated for "cause" (not sufficient if forfeit solely upon a termination for cause) prior to vesting.

## Selecting the Right Plan

Tax-exempt organizations may have only a few employees or hundreds of employees. Depending upon their size and 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 employees the opportunity to fund their own retirement benefits. Larger organizations may have their own HR professionals available to administer their plan, 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 under the circumstances. ❑

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