"B" v. "K" PLANS: A COMPARISON OF BROAD-BASED PLANS UNDER SECTION 403(b) AND SECTION 401(k) AFTER JOPA

J. Edward Shillingburg*

The Small Business Job Protection Act of 1996 ("JOPA") amended the Internal Revenue Code to permit tax-exempt organizations (other than state and local government units)[1] to maintain § 401(k) plans ("K plans"), effective for plan years beginning after December 31, 1996.[2] This Article will assess the impact of this change, especially among the most numerous tax-exempt organizations, § 501(c)(3) organizations (charitable, educational, religious, and scientific organizations) that have been able for many years to sponsor § 403(b) plans ("B plans") and since 1986 have been able to sponsor eligible plans under § 457(b) ("E plans").[3]

As this Article will detail, all three types of plans have fundamental similarities: a participant has an account under the plan to which are credited employee pre-tax contributions and employer contributions; the participant acquires a nonforfeitable interest in employee contributions immediately and in the employer contributions either immediately or upon completing a designated period of employment with the plan sponsor; the participants can direct the investment of their accounts among several investment alternatives (usually, mutual funds and funds provided under a group annuity contract) and earnings are free from income tax while held in the

---

* Law Offices of J. Edward Shillingburg, Newark, New Jersey (http://www.exec-comp.com). Mr. Shillingburg is admitted to practice in New Jersey, New York, and the District of Columbia. Formerly, he headed the ERISA practice group of Lord Day & Lord, Barrett Smith, in New York, and served as of counsel to Morgan, Lewis & Bockius, in New York.

1. In this Article, state and local government units, while tax-exempt under § 115 of the Code, will be discussed separately from organizations that are exempt from tax under § 501(c).

2. *See* I.R.C. § 401(k)(4)(B), *amended by* Small Business Job Protection Act, Pub. L. No. 104-188, § 1426(a), 110 Stat. 1755, 1801 (1996) [hereinafter JOPA]. (All "I.R.C." references are to the Internal Revenue Code of 1986, as amended and as provided in the CCH Sept. 30, 1996 edition.)

3. *See* I.R.C. §§ 403(b), 457(a).

account; the account is distributable generally upon termination of employment with the plan sponsor, and certain portions of the account may be distributable earlier for hardship or made available through participant loans; and amounts distributed from the account (other than loans) are taxable income when received by the participant. However, E plans, other than those maintained by government units, may not be funded and thus are of limited use compared to K and B plans.

A. Situation Before JOPA

Most tax-qualified pension and profit sharing plans are organized under § 401(a).[4] The original legislation was adopted in the 1930s.[5]

In the mid-1950s, the IRS recognized that tax-qualified plans could be established under § 401(a) that permitted employees to elect to reduce their salary or wages and to have an equal amount contributed to a § 401(a) plan.[6] These arrangements were generally referred to as "cash or deferred arrangements."[7]

In 1958, Congress adopted § 403(b) to regulate retirement arrangements for employees of § 501(c)(3) organizations, and it was extended to educational units of state and local governments.[8] Later the IRS ruled that § 403(b) plans could be established for employees of separately organized non-school units of governmental bodies that could qualify as § 501(c)(3) organizations.[9] Under § 403(b), a tax-qualified arrangement could be established for a single highly com-

---

4. *See* I.R.C. § 401(a). For this purpose, § 401(a) includes plans organized with trusts and plans organized under group annuity contracts and custodial mutual fund agreements. *See* I.R.C. §§ 401(a), 401(f), 404(a)(2).

5. *See generally* 6 JACOB MARTENS, JR., THE LAW OF FEDERAL INCOME TAXATION § 25B.02 (Martin M. Weinstein et al. eds., 1988) (tracing the history of tax treatment of employee benefit plans).

6. *See* Rev. Rul. 68-89, 1968-1 C.B. 402; Rev. Rul. 63-180, 1963-2 C.B. 189; Rev. Rul. 56-497, 1956-2 C.B. 284. *But see* Hicks v. United States, 205 F. Supp. 343 (W.D. Va. 1962).

7. *See, e.g.*, IRS PUBLICATION 17, at 94 (1995).

8. *See* Pub. L. No. 87-370, § 7448, 75 Stat. 801 (1961); Technical Amendments Act of 1958, Pub. L. No. 85-866, § 23(a), 72 Stat. 1606, 1620. Deferred tax treatment of annuity contracts purchased by § 501(c)(3) organizations had previously been provided on a less regulated basis. *See* Treas. Reg. § 1.403(b)-1(a) (as amended in 1986).

9. *See* Rev. Rul. 80-384, 1980-2 C.B. 172 (providing that state and local governmental units that are the counterparts of § 501(c)(3) organizations); Rev. Rul. 74-15, 1974-1 C.B. 126 (allowing a county library to establish a B plan).

pensated employee, while a § 401(a) plan would be required to include non-highly compensated employees to meet the coverage and non-discrimination tests under § 401(a).[10] Expressly permitted were "salary reduction" (or cash or deferred) contributions by employees.[11] Section 403(b) plans are often referred to as "tax-sheltered annuities" or "TSAs."[12]

In the early 1970s, the Treasury Department became concerned about the growth of tax-deferred arrangements because the taxes on deferred compensation were deferred to a later period and thus reduced current tax receipts. In 1972 the Treasury Department proposed a regulation calling into question the tax treatment of employees covered by § 401(a) plans with cash and deferred arrangements, as well as arrangements under plans that were not intended to be tax-qualified.[13] Congress imposed a freeze on the regulation project, and the stay was extended several times until 1978.[14]

In 1978, Congress adopted two different approaches to deferred compensation. First, responding to taxable employers, it adopted § 401(k) and § 401(m), which added for § 401(a) plans an additional layer of non-discrimination tests in the form of the average deferral percentage test for salary-reduction contributions and the average contribution percentage test for employee post-tax contributions and employer matching contributions (the "ADP" and "ACP" tests).[15]

Congress also adopted in 1978 a proposal submitted by state and local governments to permit salary reduction arrangements within certain limits but free of the non-discrimination limitations customary under § 401(a).[16] The results were E plans,[17] which had the following features:

(a) Maximum amount limited to the lesser of $7500 (not in-

---

10. *Compare* I.R.C. § 401(a)(3) and (4) (discussing pre-ERISA coverage and nondiscrimination), *with* I.R.C. § 403(b) (before the addition of paragraph (12) in 1986), *and* Treas. Reg. § 1.403(b)-1(b) (as amended in 1986).

11. *See* Treas. Reg. § 1.403(b)-1(b)(3); Rev. Rul. 67-69, 1967-1 C.B. 93.

12. *See, e.g.*, IRS PUBLICATION 571, at 1 (1996).

13. *See* Prop. Treas. Reg. § 1.402(a)-1(i), 37 Fed. Reg. 25938 (1972); *see also* Prop. Treas. Reg. § 1.61-16, 43 Fed. Reg. 4638, 4639 (1978).

14. *See* Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406 § 2006, 88 Stat. 829, 992–93 [hereinafter ERISA].

15. *See* Revenue Act of 1978, Pub. L. No. 95-600 § 135(a), 92 Stat. 2763, 2785 (adding § 401(k) and (m)).

16. *See* I.R.C. §§ 401(a)(4), 410(b).

17. *See* Revenue Act of 1978 § 131(a) (adding § 457).

dexed) or one-third of taxable compensation. The $7500 limit was an individual limit coordinated under § 402(g) with contributions under K and B plans and other elective contributions. No non-discrimination tests were imposed, such as an ADP or ACP. A special "catch-up" limit was available in the last three years before normal retirement.

(b) Assets of the plan continued to be assets of the employer, subject to the claims of its general creditors, and were not separately trusteed.

(c) Distributions were not available to participants until the earlier of age 70½ or separation from service, subject to earlier distribution for an unforseen hardship.

(d) Distributions could be rolled over tax-free to another § 457 plan, but not to a § 401(a) plan, an individual retirement account or annuity (an "IRA") or a B plan.[18]

In the 1978 legislation, Congress barred tax-exempt organizations and state and local government units from access to K plans.[19] While § 501(c)(3) organizations could continue to use B plans and state and local government units now had access to E plans, other tax-exempt organizations, such as trade associations and labor unions, had no access to a tax-qualified salary reduction plan (although they continued to have access to qualified money purchase and defined benefit plans under § 401(a)).[20]

In 1986, Congress amended § 457 to allow tax-exempt organizations to establish E plans.[21] However, in combination with the general ERISA requirement that the assets of employee pension plans be trusteed[22] and the E plan requirement that such plans not be

18. JOPA improved eligible § 457 plans, as discussed *infra* text accompanying notes 31–33.

19. *See* I.R.C. § 401(k)(4)(B)(ii).

20. *See* I.R.C. § 401(a); Treas. Reg. § 1.401-1(b) (1976). The IRS initially took the position that a § 501(c)(3) organization could not maintain a profit-sharing plan under § 401(a) because it was barred from distributing profits under the prohibition of inurement to private persons in § 501(c)(3), but it later interpreted "profit" to mean an excess of revenues over expenses. *See Gen. Couns. Mem.* 38,283 (Feb. 15, 1980). The "profit" requirement for profit-sharing plans was completely eliminated in 1988. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1011(A)(j) 102 Stat. 3342, 3468 (adding I.R.C. § 401(a)(27)).

21. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1107(a), 100 Stat. 2085, 2426.

22. *See* ERISA, *supra* note 14, § 403, 29 U.S.C. § 1104 (1994).

trusteed,[23] only a government unit or a church could maintain an E plan with broad-based coverage (i.e., including non-highly compensated employees),[24] and a non-church exempt organization could only maintain an E plan for highly compensated employees.[25] Consequently, E plans were of limited utility for tax-exempt organizations compared to K and B plans.[26]

B. Non-§ 501(c)(3) Organizations After JOPA

JOPA permits trade associations or other non-§ 501(c)(3) tax-exempt organizations to adopt K plans for a broad-based group of employees.[27] While they may still maintain E plans for their highly compensated employees,[28] K plans have higher deferral limits (but with the ADP and other nondiscrimination limitations), separately trusteed assets, and rollovers to IRAs or other § 401(a) plans.[29] And there is little reason to maintain both types of plans since the $7500 deferral limits are coordinated, rather than cumulative.[30]

JOPA provided other E plan improvements. The dollar deferral limits have been indexed, although they begin at $7500, and not at the $9500 level that K plans reached in 1996 and that B plans had

---

23. *See* I.R.C. § 457(b)(6). For state and local government plans, the bar against trusteed E plans was changed in 1996 to require that they be trusteed. *See* I.R.C. § 457(g).

24. Government units and churches are exempt from ERISA. *See* ERISA, *supra* note 14, § 4(b)(1)–(2), 29 U.S.C. § 1003(b)(1)–(2) (1994).

25. Unfunded plans maintained by employers, other than government units and churches, for a select group of management or highly compensated employees are exempt from the participation, vesting, funding, trust, and fiduciary provisions of ERISA. *See id.* §§ 201(2), 301(a)(3), 401(a)(1), 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1) (1994). Such plans are subject to only a one-time notice to the Department of Labor in lieu of the normal disclosure and annual reporting requirements. *See* Department of Labor Reg., 29 C.F.R. § 2520.104-23 (1997).

26. The 1986 legislation also subjected amounts deferred under "non-eligible" § 457 plans maintained by tax-exempt organizations to taxation in the year that the employee's interest was not subject to a substantial risk of forfeiture. *See* I.R.C. § 457(f). This was unexpected and has had a substantial negative impact on compensation arrangements for executives of tax-exempt organizations.

27. *See* JOPA, *supra* note 2, § 1426(a) (amending I.R.C. § 401(k)(4)(B)). Such plans must meet the broad-based coverage and other nondiscrimination rules for qualified plans. *See* I.R.C. §§ 401(a)(4), 410(b).

28. While there are no coverage requirements in § 457(a), a tax-exempt organization may maintain an unfunded plan only for a select group of management or highly compensated employees. *See supra* note 25 and accompanying text.

29. *Compare* I.R.C. § 457(b), *with* I.R.C. §§ 401(a), 402(c), 402(g)(1).

30. *See* I.R.C. § 402(g).

enjoyed since 1978.[31] E plans may now automatically cash out accounts of $3500 or less.[32] And E plans maintained by government units must now be trusteed.[33] Thus, the extension of K plans to non-§ 501(c)(3) tax-exempt organizations permits them to maintain broad-based funded salary-deferral plans for the first time since 1978.

C. § 501(c)(3) Organizations After JOPA

A § 501(c)(3) organization now can have either a B plan or a K plan.[34] There are several situations in which a § 501(c)(3) organization has an obvious choice. First, in recent years, especially in the health service industry, § 501(c)(3) organizations have established taxable subsidiaries to conduct activities that would attract the unrelated business income tax if conducted by the parent; the taxable subsidiary cannot participate in the parent's B plan but the parent can now freeze its B plan and adopt the K plan to simplify administration. Second, some § 501(c)(3) organizations are paired with non-§ 501(c)(3) organizations, such as a social welfare organization (under § 501(c)(4)); while the non-§ 501(c)(3) organization cannot participate in the B plan, both organizations can now participate in a K plan to simplify administration. Finally, an organization that already has a B plan may simply choose to continue with its old plan in view of the disruptions in changing plans and perhaps the perceived lack of real improvement in a K plan. The rest of this Article will compare the two types of plans, technical issue by technical issue, with a summary at the end.

1. ERISA

---

31. *See* I.R.C. § 457(b)(2)(A), (e)(15) (added by JOPA, *supra* note 2, § 1447(b)); I.R.C. § 402(g)(1), (4), (5). The IRS annually issues a notice with the amounts, as adjusted for cost of living, that apply for the following year. *See, e.g.*, Notice 96-55, 1996-47 I.R.B. 7.

32. *See* I.R.C. § 457(e)(9) (as amended by JOPA, *supra* note 2, § 1447(a)). The amount has been increased to $5000 for years after 1997. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1071(a)(1), 111 Stat. 788, 948 (1997) [hereinafter Relief Act].

33. *See* I.R.C. § 457(g) (added by JOPA, *supra* note 2, § 1448).

34. *See* I.R.C. §§ 401(k)(4)(B), 403(b).

All of ERISA, including the disclosure, reporting, trust, funding, fiduciary, prohibited transaction, and bonding rules, applies to K plans.[35]

ERISA can be made not to apply to B plans that have only employee salary reduction contributions.[36] If a B plan has employer matching contributions or an employer contribution not dependent on employee contributions, it is subject to all of ERISA.[37] However, the reporting requirements for ERISA B plans are reduced to filing only a few portions of the Form 5500 Series reports. Two of the portions not required are the coverage information and the income statement and balance sheet information.[38] As a result, a B plan with more than 100 participants is not required to file a certified financial with the Form 5500,[39] and the summary annual report is quite modest.[40] However, the summary plan description, statement of material modifications, and other ERISA requirements apply.[41]

With respect to fiduciary issues, both B and K plans may use

---

35. A K plan is regarded as an "employee pension plan" and thus is subject to all of Title I of ERISA. *See* ERISA, *supra* note 14, § 3(2), 29 U.S.C. § 1002(2)(A) (1994).

36. *See* Department of Labor Reg., 29 C.F.R. § 2510.3-2(f) (1997); IRS INSTRUCTIONS FOR FORM 5500, at 3 (1996). The conditions of this exemption should be read carefully. The exemption applies to plans that (a) have only employee salary-reduction contributions, (b) provide employees with a choice of funding agent (i.e., the mutual fund family administrator or insurance company providing the group annuity or custodial contract), and (c) have minimal employer involvement in the plan. *See* 29 C.F.R. § 2510.3-2(f).

37. *See* ERISA, *supra* note 14, § 3(2), 29 U.S.C. § 1002(2)(A) (1994); Department of Labor Reg., 29 C.F.R. § 2510.3-2(f) (1997).

38. *See* IRS INSTRUCTIONS FOR FORM 5500, at 5 (1996).

39. Employee benefit plans with more than 100 participants are generally required to file a certified financial statement with their Form 5500 Series reports. *See* ERISA, *supra* note 14, § 103(a)(3). The Department of Labor has provided for abbreviated reporting for plans with less than 100 participants and has waived the certified financial statement requirement for such plans. *See* Department of Labor Reg., 29 C.F.R. §§ 2520.104-41, 2520.104-46 (1997).

40. *See* Department of Labor Reg., 29 C.F.R. § 2520.104b-10 (1997) (providing for the distribution to participants of a summary of the annual report). However, since no financial information is provided in the plan's Form 5500 Series report, there is no such information to provide in the summary annual report.

41. *See* ERISA, *supra* note 14, §§ 401-414, 501-514, 29 U.S.C. §§ 1101-1114, 1131-1134 (1994) (stating, respectively, the fiduciary duty and enforcement provisions); Department of Labor Reg., 29 C.F.R. § 2520.104a-3 (requiring the summary of plan description); Department of Labor Reg., 29 C.F.R. § 2520.104-104a-7 (requiring the statement of material modifications). The benefit insurance and plan termination program administered by the Pension Benefit Guaranty Corporation does not apply. *See* ERISA, *supra* note 14, § 4021(b)(1), 29 U.S.C. § 1102 (1994).

the procedures for participant investment direction to obtain some measure of protection.[42]

2. IRS Review and Assistance

For K plans, employers have access to the IRS voluntary determination letter process to obtain confirmation of the qualification of the plan language, coverage, and benefits.[43] The IRS also provides programs to assist employers in making corrections to plans without triggering disqualification and by paying a penalty.[44] The IRS has an active audit program for K plans.[45]

There is no determination letter program for B plans; employers may apply for a National Office private ruling on its plan,[46] which requires a more substantial application and a higher user fee.[47] The IRS provides the Tax Sheltered Annuity Voluntary Correction Program to assist employers with correcting defects in their plans, with a penalty payment.[48] The Department of Labor maintains the Delinquent Filer Voluntary Compliance Program to correct late filing or non-filing of Forms 5500 with a penalty.[49] The IRS has recently emphasized audits of B plans.[50]

3. Eligible Employers

K plans are available to taxable employers, tax-exempt employers (other than state and local government units), and certain rural cooperatives and mutual irrigation or ditch companies.[51]

---

42. *See* ERISA, *supra* note 14, § 404(c), 29 U.S.C. § 1104(c) (1994); Department of Labor Reg., 29 C.F.R. § 2550.404c-1 (1996).

43. *See* Rev. Proc. 97-6, 1997-1 I.R.B. 153 (describing the determination letter program). The user fee for a simple individually designed plan is presently $700. *See* Rev. Proc. 97-8, 1997-1 I.R.B. 187.

44. *See* Rev. Proc. 94-62, 1994-2 C.B. 778 (discussing the Voluntary Compliance Resolution Program).

45. *See* IRS Announcement 93-105, 1993-27 I.R.B. 15

46. *See, e.g.,* Priv. Ltr. Rul. 97-08-021 (Nov. 25, 1996).

47. *See* Rev. Proc. 97-4, 1997-1 I.R.B. 96. The user fee for a letter ruling is presently $2100. *See* Rev. Proc. 97-8, 1997-1 I.R.B. 187.

48. *See* Rev. Proc. 96-29, 1996-16 I.R.B. 24 (Closing Agreement Program and Voluntary Compliance Program). *See generally* Rev. Proc. 95-24, 1995-1 C.B. 694.

49. *See* 60 Fed. Reg. 20,874 (1995).

50. *See* IRS Announcement 95-33, 1995-19 I.R.B. 14 (discussing examination guidelines).

51. *See* I.R.C. § 401(k)(4)(B) (as amended by JOPA, *supra* note 2, § 1443(b)) (ex-

B plans are available to § 501(c)(3) organizations and state and local governmental units with respect to their educational employees.[52] Special rules apply to sponsors that are (i) churches and church-related employers ("church organizations") and (ii) to schools, hospitals, home health service agencies, health and welfare service agencies, and church organizations ("SHHWC organizations").[53] Church organizations,[54] schools,[55] hospitals,[56] and home health service agencies[57] are defined; health and welfare service agencies are not defined.

4. Funding Vehicles

K plans are funded with trusts, group annuity contracts, and custodial accounts with mutual funds.[58]

B plans are funded with individual and group annuity contracts, custodial accounts solely with mutual funds, and, for churches and related organizations, retirement income accounts.[59] There are some differences in the rules applicable to annuity contracts and to custodial accounts.[60] Church retirement accounts need not be held by a trustee or custodian.[61]

5. Minimum Age and Service and Entry Requirements

K plans, within the eligible group of employees, may hold employees out of the non-salary reduction portion of the plan until they are age twenty-one and have a year of service.[62] Alternatively, if the plan provides for 100% vesting on entry, the plan may require two

---

panding B plans to eligible rural cooperatives and related entities); *see also* I.R.C. § 401(k)(4)(B) (as amended by Taxpayer Relief Act of 1997, *supra* note 32, § 1525) (making certain mutual irrigation or ditch companies eligible notwithstanding that the cooperative or ditch company is a governmental unit).

52. *See* I.R.C. § 403(b)(1)(A).

53. *See id.* §§ 402(g)(8), 415(c)(4), 415(c)(7).

54. *See id.* § 414(e)(3)(B)(ii).

55. *See id.* § 170(b)(1)(A)(ii).

56. *See id.* § 170(b)(1)(A)(iii).

57. *See* Social Security Act, ch. 531, § 1861(o), 49 Stat. 620 (1935) (codified at 42 U.S.C. § 1395x(m), (o) (1994)).

58. *See* I.R.C. §§ 401(a), 401(f), 403(a).

59. *See id.* § 403(b)(1)(A), (b)(7)(A), (b)(9).

60. *Compare* I.R.C. § 403(b)(7)(A), *with* I.R.C. § 403(b)(10).

61. *See* I.R.C. § 403(b)(9)(B).

62. *See id.* § 410(a)(1)(A).

years of service before a participant may be eligible for non-salary reduction contributions.[63] Finally, if a school provides 100% vesting after a year of service, it may hold out employees from the non-salary reduction portion of the plan until age twenty-six and a year of service.[64] However, the waiting period to make salary-reduction contributions is limited to one year.[65] They must then be allowed to enter the plan within six months after qualifying.[66]

B plans have no comparable Code requirements, except that the waiting period for the salary reduction contribution portion of the plan must be the same for everyone.[67] If a B plan is subject to ERISA, the same minimum age and service and entry requirements outlined for K plans will apply to the B plan under ERISA.[68]

6. *Minimum Participation*

All defined contribution plans, such as K and B plans, are excluded from the 50 employee/40% of all employees minimum participation requirements.[69]

7. *Types of Contributions*

B and K plans may receive salary reduction contributions, employee post-tax contributions, employer matching contributions, and other employer contributions.[70] Salary reduction contributions may

---

63. *See id*. § 410(a)(1)(B)(i).
64. *See id*. § 410(a)(1)(2)(B)(ii).
65. *See id*. § 401(k)(2)(D).
66. *See id*. § 410(a)(4)(B).
67. *See* I.R.C. § 403(b)(12)(A)(ii).
68. *See* ERISA, *supra* note 14, § 202, 29 U.S.C. § 1052 (1994).
69. *See* JOPA, *supra* note 2, § 1422(a) (amending I.R.C. § 401(a)(26)).
70. The cash or deferred arrangement approved by § 401(k) is a feature attached to a defined contribution plan (e.g., profit-sharing plan, stock bonus plan, pre-ERISA money purchase plan or rural cooperative plan) that is intended to qualify under § 401(a). *See* I.R.C. § 401(k)(1). Thus, a K plan that has only salary reduction (e.g., pre-tax employee) contributions is the basic K plan. *See id*. § 401(k)(2). The plan sponsor may elect to add to the basic plan certain plan features permitted under § 401(a), such as a profit-sharing (e.g., employer non-matching) contribution, an employer contribution conditioned on employee pre-tax or post-tax contributions (e.g., an employer matching contribution), and employee post-tax contributions. *See* Rev. Rul. 69-627, 1969-2 C.B. 92 (permitting employee pre-tax contributions that are not required to obtain employer-funded benefits); Rev. Rul. 69-421, 1969-2 C.B. 59 (permitting employee pre-tax contributions required as a condition of employer-funded benefits). Since 1978, employer matching contributions and employee pre-tax contributions are subject to the limitations in § 401(m).

be extracted from salary, bonuses, and other taxable compensation not currently available to the employee.[71] Participants may make changes in their rates of salary reduction contributions at any time with respect to compensation not yet earned.[72] Certain one-time elections are not treated as salary reduction contributions.[73] No benefit, other than a matching contribution, may be conditioned upon the participant's salary reduction contributions to a K plan.[74] Matching contributions in B plans may also be conditioned upon salary reduction contributions; however, B plans may condition employer non-matching contributions on the participant's salary reduction contributions.[75]

8. FICA and FUTA

Salary reduction contributions to both B and K plans are subject to FICA and FUTA taxes when made to the plan.[76] Other employer contributions to B and K plans are exempt from FICA and FUTA taxes when made.[77] All distributions from B and K plans are exempt from FICA and FUTA taxes.[78]

A broad variety of contributions is allowed for B plans. *See, e.g.*, Priv. Ltr. Rul. 96-25-043 (June 21, 1996) (voluntary employee salary reduction contributions, mandatory employee contributions of 5% of pay over $6600 and employer non-matching contributions of 10% of pay); Priv. Ltr. Rul. 95-41-038 (Oct. 13, 1995) (permitting voluntary employee salary reduction and after-tax contributions and employer matching contributions based on both types of employee contributions); Priv. Ltr. Rul. 95-29-0006 (July 21, 1995) (allowing voluntary employee salary reduction and after-tax contributions, employer matching contributions and employer non-matching contributions).

71. *See* Treas. Reg. § 1.401(k)-1(a)(3)(i) (as amended in 1995); Treas. Reg. § 1.403(b)-1(b)(3) (as amended in 1986).

72. Prior to 1997, a B plan participant could not change salary-reduction contribution rates after the beginning of the year, except to reduce contributions to zero. *See* Treas. Reg. § 1.403(b)-1(b)(3) (as amended in 1986). After 1996, employees may change these rates as they may change K plan contribution rates. *See* JOPA, *supra* note 2, § 1450(a) (amending I.R.C. § 402(e)(3)).

73. *See* I.R.C. § 403(b)(12)(A)(ii); Treas. Reg. § 1.401(k)-1(a)(3)(iv) (as amended in 1995).

74. *See* I.R.C. § 401(k)(4)(A).

75. *See* DAVID L. RAISH, COMPENSATION AND BENEFITS OF KEY EMPLOYEES OF TAX-EXEMPT ORGANIZATIONS § 402 (1995).

76. *See* I.R.C. § 3121(a)(5)(D), (v) (including, respectively, B plans and K plans in the definition of wages subject to FICA taxes); *id*. § 3306(b)(5)(D), (r)(1)(A) (including, respectively, B plans and K plans in the definition of wages subject to FUTA taxes).

77. *See id*. §§ 3121(a)(5)(A), (D), 3306(b)(5)(A), (D).

78. *See id*.

9. Vesting

K plans have minimum vesting requirements.[79] Salary reduction and post-tax contributions are 100% vested when made.[80] However, matching contributions and other employer contributions must fully vest no later than at the end of five years or ratably over two to seven years (two to six years for top-heavy plans).[81]

B plans subject to ERISA are subject to the same vesting requirements (but not the top-heavy scale).[82] However, B plans typically provide that all contributions are 100% vested when made.[83] This results from the need to coordinate the 20% exclusion limit,[84] which applies when the contribution vests, with the § 415(c) limit,[85] which applies when the contribution is made.[86]

10. Nondiscrimination/Coverage — Control Groups

While the concept of not discriminating in favor of highly compensated employees is fundamental to much of § 401(a) and therefore to K plans,[87] the nondiscrimination concept did not apply to B plans before the 1986 legislation.[88] In the earlier period, B plans could be maintained for one executive, many executives, or all employees, and on different bases.[89] For B plans sponsored by government units, the IRS suspended enforcement of the non-discrimination rules for government plans in 1977.[90] The IRS extended the suspension for the purposes of § 401(k) and (m) until 1997 and for general purposes until 1999.[91] The 1997 tax legislation has made the

79. *See id*. §§ 401(a)(7), 401(k)(2)(C), 411(a)(2), 416(b)(1)(A)–(B).
80. *See id*.
81. *See id*.
82. *See* ERISA, *supra* note 14, § 203(a), 29 U.S.C. § 1053(a) (1994).
83. *See, e.g.*, Priv. Ltr. Rul. 96-25-043 (June 21, 1996); Priv. Ltr. Rul. 95-41-038 (Oct. 13, 1995); Priv. Ltr. Rul. 95-29-006 (July 21, 1995).
84. Discussed *infra* Paragraph 17(c).
85. Discussed *infra* Paragraph 17(b).
86. *See* I.R.C. § 415(c); Treas. Reg. § 1.403(b)-1(b)(2) (as amended in 1986).
87. *See* I.R.C. §§ 401(a)(4), 410(b).
88. *See id*. § 403(b)(12) (as added by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1120(b), 100 Stat. 2085, 2463–64).
89. *See* Treas. Reg. § 1.403(b)-1(b)(i), (iii) (as amended in 1986).
90. *See* IRS News Release IR-1869 (Aug. 10, 1977).
91. *See* Treas. Reg. § 1.401(a)(4)-13(b) (as amended in 1993); Treas. Reg. § 1.401(k)-1(h)(4) (as amended in 1995); Treas. Reg. § 1.402(a)-1(d)(3)(v) (as amended in 1994); IRS Announcement 95-48, 1995-23 I.R.B. 13.

suspension permanent.[92]

The "employer" for both B and K plans is defined as the plan sponsor and other entities controlled by it or under its common control.[93]

11. Nondiscrimination / Coverage — Aggregation of Plans

All B and K plans of the same employer may be aggregated for testing purposes.[94] However, special rules apply to plans covering collective bargaining units.[95]

12. Nondiscrimination / Coverage — Salary Reduction Contributions

(a) The salary reduction portion of a K plan generally must be available to a percentage of the employer's non-highly compensated employees ("NHCEs") that is at least 70% of the percentage of highly compensated employee ("HCEs") to whom the portion is available (the "ratio percentage test").[96] There is an alternate average benefits test.[97] Exclusions are provided for non-resident aliens, collectively bargained employees, and employees not meeting the minimum age and service requirements of the plan.[98] For this purpose, the plan is available to an employee if the employee is eligible to elect to have his or her employer make a salary reduction contribution; it does not require that the employee has made the election.[99] For this purpose, excluded employees are those in bargaining units, certain non-resident aliens, and employees not meeting the minimum eligibility requirements.

Additionally, salary reduction contributions must satisfy one of

---

92. *See* I.R.C. §§ 401(a)(5)(G), 401(k)(3)(G), 403(b)(12)(C), 410(c)(2) (added by Relief Act, *supra* note 32, § 1505(c)).

93. *See* I.R.C. § 414(b)–(c), (m)–(o); IRS Notice 96-64, 1996 I.R.B. 8; IRS Notice 89-23, 1989-1 C.B. 654.

94. *See* Treas. Reg. § 1.401(k)-1(g)(11)(i) (as amended in 1995); IRS Notice 89-23, 1989-1 C.B. 654.

95. *See* Treas. Reg. § 1.401(k)-1(g)(11)(ii)(B) (as amended in 1995); IRS Notice 89-23, 1989-1 C.B. 654.

96. *See* I.R.C. § 410(b)(1)(A)–(B); Treas. Reg. §§ 1.410(b)-2(b)(2), -7(c) (as amended in 1994).

97. *See* I.R.C. § 410(b)(1)(C).

98. *See id*. § 410(b)(3).

99. *See* Treas. Reg. § 1.410(b)-3(a)(2)(i) (as amended in 1993).

the actual deferral percentage ("ADP") tests:

- the ratio of salary reduction contributions for HCEs to their compensation ("ADP") is not more than the same ratio for NHCEs multiplied by 1.25%, or
- the excess of the ADP for HCEs over the ADP for NHCEs is not more than two percentage points and the ADP for HCEs is not more than the ADP for NHCEs multiplied by 200%.[100]

JOPA has simplified the determination of HCEs; after 1996 they are (i) employees who own more than 5% of the employer, and (ii) employees with compensation from the employer in excess of $80,000 and who, at the employer's election, were in the top 20% of employees by compensation.[101] Additionally, two safe harbors have been provided and NHCE data for the prior year may be used for the tests.[102]

(b) B plans must provide all employees an equal opportunity to make salary reduction contributions of more than $200 annually if the plan permits any employee to make such contributions.[103] Exclusions are provided for non-resident aliens, collectively bargained employees, employees not meeting the age and service requirements of the plan, students performing services for a school in which they are enrolled, employees normally working less than twenty hours a week, employees who made a one-time election to participate on a pick-up basis in a government plan, certain professors on temporary service with another educational organization, and certain employees with a vow of poverty.[104] Units of the same employer (as defined in I.R.C. § 414(b), (c), (m), (o), etc.) historically treated as separate units may be tested separately unless they are in the same metropolitan area.[105] No ADP testing is required.[106]

---

100. *See id*. §§ 1.401(a)(4)-1(b)(2)(i)(B) (as amended in 1993), 1.401(k)-1(b)(2) (as amended in 1995).

101. *See* JOPA, *supra* note 2, § 1431(a), 110 Stat. 1755, 1802-03 (1996) (amending I.R.C. § 414(q)).

102. *See* I.R.C. §§ 401(k)(3)(A)(ii), 401(k)(12), 401(m)(2)(A), 401(m)(11).

103. *See id*. § 403(b)(12)(A)(ii); IRS Notice 89-23, 1989-1 C.B. 654.

104. *See* IRS Notice 89-23, 1989-1 C.B. 654.

105. *See id*.

106. *See* I.R.C. § 403(b)(12)(A)(ii).

13. Nondiscrimination / Coverage — Matching Contributions and Post-tax Contributions

Under a K plan the participants eligible for the matching contribution and employee post-tax contribution portion of a K plan generally must satisfy the ratio percentage test.[107] Additionally, the matching contribution and employee post-tax contribution portion must also satisfy one of the maximum contribution percentage ("ACP") tests under § 401(m):

- the ratio of matching contributions and employee post-tax contributions for HCEs to their compensation ("ACP") does not exceed the same ratio for the NHCEs multiplied by 1.25%, or
- the excess of the ACP for HCEs over the ACP for NHCEs is not greater than two percentage points and the ACP for HCEs is not greater than the ACP for NHCEs multiplied by 200%.[108] However, the regulations limit multiple uses of the 2%/200% alternative limit under both the ADP and ACP tests.[109]

B plans, other than church plans, must satisfy the same tests with respect to matching and employee post-tax contributions.[110] However, under a B plan, with no ADP test applying to the salary reduction contributions, the ACP test produces better results because it has full use of the 2%/200% alternative limitation.[111]

14. Nondiscrimination / Coverage — Employer "Profit-Sharing" Contributions

The participants actually receiving contributions to their accounts in the profit-sharing portion of a K plan generally must sat-

---

107. *See* Treas. Reg. §§ 1.410(b)-2(b)(2), -7(c) (as amended in 1995) (discussed *supra* Paragraph 12(a)).

108. *See* Treas. Reg. § 1.401(a)(4)-1(b)(2)(B) (as amended in 1993); Treas. Reg. § 1.401(m)-1(b)(1) (as amended in 1995).

109. *See* Treas. Reg. § 1.401(m)-2 (as amended in 1994).

110. *See* I.R.C. § 403(b)(12); IRS Notice 89-23, 1989-1 C.B. 654.

111. The 2%/200% alternative limitations may be applied to § 403(b) plans. *See* Treas. Reg. § 1.401(m)-1 (as amended in 1995); Treas. Reg. § 1.401(m)-2 (as amended in 1994). "For purposes of applying the regulations under § 401(m), contributions made pursuant to a salary reduction agreement to a 403(b) annuity plan may not be considered." IRS Notice 89-23, 1989-1 C.B. 654.

isfy the "ratio percentage test."[112] The allocation of such contributions must meet certain nondiscrimination requirements. For example, plans that allocate contributions based on the same percentage of compensation will satisfy one of the safe harbors.[113] Other safe harbors are provided for formulas using age and service[114] or taking into account Social Security benefits.[115] Finally, the ratio percentage test can be satisfied on a rate grouping basis.[116]

The employer contribution portion of a B plan is subject to the same rules.[117] However, pending issuance of regulations, the sponsor of a B "program" may satisfy these requirements by operating the program under a good faith, reasonable interpretation of these requirements, taking into account the legislative history of the 1986 and 1988 legislation, or by meeting one of the safe harbors in I.R.S. Notice 89-23.[118] The employer's B "program" consists of all B plans to which it makes contributions and the employer may elect to aggregate its § 401(a) and § 403(a) plans with the program under certain conditions.[119] The I.R.S. Notice provides the following safe harbors:

- *Maximum disparity*: (a) The highest percentage of compensation for a year contributed under the program for any HCE is not more than 180% of the lowest percentage of compensation contributed under the program for any NHCE, (b) at least 50% of the NHCEs are currently accruing benefits under the program, and (c) the percentage of employees currently accruing benefits under the program who are NHCEs is at least 70% of all NHCEs.[120]
- *Lesser disparity*: (a) The highest percentage of compensation for a year contributed for any HCE under the program is not more than 140% of the lowest percentage of compen-

112. *See* Treas. Reg. §§ 1.410(b)-2(b)(2), -7(c) (as amended in 1994) (discussed *supra* text accompanying note 94); *see also* Appendix B (comparing the contributions permitted for a K plan under the ADP and ACP tests with those permitted for a B plan under the ACP test only).

113. *See id*. § 1.401(a)(4)-2(b)(1)-(2) (as amended in 1993).

114. *See id*. § 1.401(a)(4)-2(b)(3).

115. *See id*. § 1.401(a)(4)-2(b)(2)(ii).

116. *See id*. § 1.401(a)(4)-2(c).

117. *See* I.R.C. § 403(b)(12)(A)(i).

118. *See* IRS Notice 89-23, 1989-1 C.B. 654.

119. *See id*.

120. *See id*.

sation contributed under the program for any NHCE, (b) at least 30% of the NHCEs are currently accruing benefits under the program, and (c) the percentage of employees currently accruing benefits under the program who are NHCEs is at least 50% of all NHCEs.[121]

- *No disparity*: (a) The highest percentage of compensation for a year contributed for any HCE under the program is not higher than the lowest percentage of compensation contributed for any NHCE under the program, and (b) either (i) at least 20% of the NHCEs are currently accruing benefits under the program, and the percentage of employees currently accruing benefits under the program who are NHCEs is at least 70% of all NHCEs, or (ii) at least 80% of the NHCEs are currently accruing benefits under the program and the percentage of NHCEs in the program are at least 30% of all NHCES.[122]

15. Nondiscrimination — Penalties

Failure of a K plan to comply with the coverage and other nondiscrimination rules will result in loss of tax-free treatment for contributions and earnings of *all HCEs* in the K plan,[123] while such failure under the B plan will trigger the loss of tax-free treatment for *all participants* in the B plan.[124]

The 10% excise tax on an employer maintaining a K plan that has excess salary reduction contributions[125] does not apply to a B plan because the ADP test is inapplicable to B plans.[126] Failure to withdraw excess from the K plan will adversely affect the qualified status of the K plan,[127] but it will only affect the tax-free treatment of the offending B contract, not the entire B plan.[128]

The 10% excise tax on an employer maintaining a K plan that has excess matching and post-tax contributions, unless timely with-

121. *See id*.
122. *See id*.
123. *See* I.R.C. § 402(b)(4)(A).
124. *See id*. § 403(b)(1).
125. *See id*. § 4979(a), (c).
126. *See id*. § 403(b)(12)(A)(ii).
127. *See id*. § 401(a)(30).
128. *See* I.R.C. § 403(b)(1)(E).

drawn with earnings,[129] also applies to such excess contributions in a B plan because § 401(m) applies to B plans.[130] If they are not timely withdrawn, both the K plan and the B plan lose their tax-free treatment.[131]

16. Nondiscrimination — Other Rules

The $150,000 indexed compensation limit for K plans applies to B plans.[132] The integration with Social Security rules for K plans applies to B plans.[133] However, the top-heavy provisions (shorter vesting, minimum contributions and lower § 415 combined plan limits) applicable to K plans do not apply to B plans.[134]

17. Additional Limitations on Annual Contributions

There are additional limitations on the annual contributions to K and B plans. One limitation applies only to salary reduction contributions, but it takes into account all such contributions made by the individual to all B, K, and E plans and SEPs during the year.[135] Two limitations apply to all annual contributions made for the employee by his employer during the year.[136] The fourth limitation (§ 415(e)) applies in certain situations where an employer maintains both a defined benefit plan and a K or B plan.[137] The limitations are simply coordinated; the lowest controls.

(a) *Salary reduction contribution limit (§ 402(g))*. The annual contribution limit for both K and B plans is $9500 in 1997, and that number will increase for both types of plans with cost of living adjustments.[138] This is a per-person limit, not a per-plan or per-employer limit; the limit applies to all contributions in the aggregate made for an individual under a K, B, E, or other deferral plan for

---

129. *See id*. § 4979(d), (e).
130. *See id*. § 403(b)(12)(A)(i).
131. *See id*. §§ 401(m)(1), 403(b)(1)(D).
132. *See id*. §§ 401(a)(17), 403(b)(12).
133. *See* I.R.C. §§ 401(a)(5), (l), 403(b)(12).
134. *See id*. §§ 401(a)(10), 416.
135. *See id.* § 402(g).
136. *See id*. §§ 403(b), 415(c).
137. *See id*. § 415(e). This section expires at the end of 1999. *See infra* note 177 and accompanying text.
138. *See* I.R.C. § 402(g)(1), (4), (5); IRS Notice 96-55, 1996-47 I.R.B. 7.

the year.[139] However, employees of SHHWC organizations[140] may make "catch-up" contributions to a B plan in excess of $9500 annually.[141]

(b) *Overall defined contribution plan limit (§ 415(c))*. The 25% of compensation/$30,000 limit on annual contributions applies to both K and B plans.[142] The limit is on all contributions made to such plans by the same employer for the employee.[143] The 25% limit is presently applied to compensation after the salary reduction contribution but, effective after 1997, the percentage limit will be applied to pre-salary reduction contributions.[144] Thus, in 1997 for an employee with compensation of $35,000, the maximum amount of all contributions is $7000 (.25 x $35,000/1.25), but after 1997 it will be $8750 (.25 x $35,000).

However, SHHWC organization employees are provided with three special catch-up elections for B plans:

(1) In the year of separation only, the employee may substitute his § 403(b) 20% exclusion allowance[145] for the 25% of compensation portion of the § 415(c) limit, taking into account only his last ten years of employment with the organization.[146]

(2) The employee may replace the $30,000 portion of the § 415(c) limit with the least of (i) 25% of compensation plus $4000, (ii) his 20% exclusion allowance, and (iii) $15,000.[147]

(3) The employee may elect to have his 20% exclusion limit not apply.[148]

A SHHWC election is made simply by making the excess contributions.[149] Once made, the employee may not subsequently make either of the other elections.[150] Also, the "A" election may only be used once by an employee in his or her lifetime.[151]

---

139. *See* I.R.C. §§ 401(a)(30), 402(g)(1), (3).
140. *See supra* text accompanying note 53.
141. *See id*. § 402(g)(8); *see also supra* note 53 and accompanying text.
142. *See* I.R.C. § 415(c).
143. *See id*.; Treas. Reg. § 1.415-6(e)(1) (as amended in 1994).
144. *See* JOPA, *supra* note 2, § 1434 (amending I.R.C. § 415(c)(3)).
145. *See infra* Paragraph 17(d).
146. *See* I.R.C. § 415(c)(4)(A).
147. *See id*. § 415(c)(4)(B).
148. *See id*. § 415(c)(4)(C).
149. *See* Treas. Reg. § 1.415-6(e)(6) (as amended in 1994).
150. *See* I.R.C. § 415(c)(4)(D); Treas. Reg. § 1.415-6(e)(2)(ii) (as amended in 1994).
151. *See* Treas. Reg. § 1.415-6(e)(2)(iii) (as amended in 1994).

Church employees are provided with special elections. Employees with incomes less than $17,000 may elect to make larger contributions than those permitted under the 20% exclusion allowance, and such contributions are deemed not to exceed the 25%/$30,000 limit.[152] A church employee may elect to replace the 25% of compensation/$30,000 limit with $10,000, subject to a lifetime limit of $40,000 of such contributions and not in combination with the "A" election.[153]

Contributions in excess of the § 415(c) limits for a K plan are taxable to the employee and adversely affect its qualified status.[154] Excess contributions are taxable to the employee under a B plan; they do not affect its plan status; and in the case of a custody account (but not an annuity contract or a retirement income contract), they attract a 6% penalty tax.[155]

(c) *Exclusion allowance (§ 403(b)(2))*. This limit applies only to B plans. The allowance is the excess of (i) 20% times the employee's "includible compensation" times his or her "years of service" over (ii) "excludible contributions" made by the employer in prior years.[156] The allowance applies to all salary reduction contributions and employer contributions made for the employee by the employer for the year.[157] Contributions to the B plan are taken into account when they become vested, not when paid to the plan.[158] The exclusion allowance has several important elements that are not common to K plans:

(1) "Years of service" means the employee's cumulative years of service with the employer through the close of the year for which the allowance is being determined.[159] For full-time employees, years of service means the participant's years of employment, with one year of service being credited for the usual annual work period of individuals employed full-time in that general type of work.[160] For example, if the regular annual work period for a university professor is the

152. *See* I.R.C. §§ 403(b)(2)(D), 415(c)(7)(A).
153. *See id*. § 415(c)(7).
154. *See id*. § 401(a)(16).
155. *See id*. §§ 415(a)(2), 4973(a)(3).
156. *See id*. § 403(b)(2)(A)(i)–(ii).
157. *See* I.R.C. § 403(b)(2)(A).
158. *See id*.
159. *See id*. § 403(b)(4); Treas. Reg. § 1.403(b)-1(f)(1) (as amended in 1986).
160. *See* Treas. Reg. § 1.403(b)-1(f)(1), (4)(i) (as amended in 1986).

fall and spring semesters, the professor has a year of service if he or she works full-time for both the spring and fall semesters in a calendar year.[161] Special rules apply to determine years of service for both part-time employees and full-time employees working a portion of the year.[162] For example, if the professor works full-time only the spring semester in a given calendar year, he or she has one-half of a year of service; if the professor carried only a 50% load for that semester, he or she has one-quarter of a year of service.[163] However, an employee's years of service will never be less than one.[164] This concept is quite different from the year of service, based on 1000 hours of service in a twelve-month period, that is used in K plans for eligibility and vesting purposes.[165]

(2) "Includible compensation" is the employee's taxable compensation for the most recent year of service.[166] Special rules apply to determine includable compensation for part-time employees and for full-time employees working a portion of the year.[167] For example, if a full-time professor in his or her first calendar year (Year One) with the college works the fall semester, but only works the spring semester in the following year (Year Two), the professor has, for Year One, a year of service under the minimum one year rule and the includable compensation for Year One is the compensation earned for the fall semester.[168] For Year Two, the professor has one year of service (based on the fall and spring semesters) and the includible compensation for Year Two is the sum of the amounts earned for both semesters.[169]

Includible compensation is presently determined after reduction for the employee's salary contribution for the year, but effective after 1997, it will be determined before such contributions, and therefore is placed on the same basis as the § 415(c) limitation.[170]

---

161. *See id*. § 1.403(b)-1(f)(4)(iii).

162. *See id*. § 1.403(b)-1(f)(5).

163. *See id*. § 1.403(b)-1(f)(5)(i)–(iv).

164. *See id*.

165. *See* I.R.C. §§ 410(a)(5), 411(a)(5); Treas. Reg. § 1.410(a)-1(b)(5) (as amended in 1980); § 1.411(a)-1(b)(6) (1977). For detailed rules on the determination of years of service, see Department of Labor Reg., 29 C.F.R. § 2530.200A-1 to .210 (1997).

166. *See* I.R.C. § 403(b)(3); Treas. Reg. § 1.403(b)-1(e) (as amended in 1986).

167. *See* Treas. Reg. § 1.403(b)-1(e)(3), -1(g) (as amended in 1986).

168. *See id*.

169. *See id*.

170. *See* I.R.C. § 403(b)(3) (as amended by Relief Act, *supra* note 32, § 1504(a)(1)(B));

Thus, for an employee with one year of service, current compensation of $35,000, and no previous contributions, the 1997 exclusion allowance is $5833 (.20 x $35,000/1.2), but after 1997 it will be $7000 (.20 x $35,000).[171]

(3) "Excludible contributions in prior years" means the total of all salary reduction and employer contributions made to the plan for the employee since the employee commenced employment.[172] In addition, it includes the amounts contributed by the employer for the employee under another § 403(b) plan and a qualified plan that includes a defined benefit plan.[173] The regulations provide procedures to determine the contributions made for an employee's defined benefit plan.[174] There is no similar K plan concept.

Church employees with income of less than $17,000 may elect larger contributions.[175]

Contributions in excess of the exclusion allowance are currently taxable to the employee (and non-taxable when paid from the B plan).[176] Excess contributions to a custodial account (but not an annuity contract or a retirement income account) also attract a 6% excise tax.[177]

Appendix C shows how the exclusion allowance is developed over a participant's career and compares it to the annual § 415(c) limit.

(d) *Combined plan limit (§ 415(e))*. If an employee participates in both a K plan and a defined benefit plan of his employer, the employee's benefits are subject to the combined plan limits.[178] However, an employee participating in both a B plan and a defined benefit plan of his employer will *not* be subject to the combined plan limit, except where the employee controls the employer maintaining

---

Treas. Reg. § 1.403(b)-1(e)(1)(ii) (as amended in 1986). See *supra* note 82 and accompanying text for the test used to determine compensation under § 415(c).

171. While these amounts are lower than those permitted under the § 415(c) limit for a first year participant, *see, e.g.*, *supra* note 137 and accompanying text, the limitations will reverse as the participant has additional years of service and increasing compensation. Thus, the § 415(c) limit will become the lower, defining, limit of the two.

172. *See* I.R.C. § 403(b)(2)(A)(ii); Treas. Reg. § 1.403(b)-1(d)(i)–(ii) (as amended in 1986).

173. *See* Treas. Reg. § 1.403(b)-1(d)(3) (as amended in 1986).

174. *See id*. § 1.403(b)-1(d)(4).

175. *See supra* note 145 and accompanying text.

176. *See* I.R.C. §§ 403(b)(1)(A)(i)–(ii), 72.

177. *See id*. § 4973(a), (c)(1)–(2).

178. I.R.C. § 415(e); Treas. Reg. § 1.415-7(a) (1981).

the B plan, or the employee makes the "C" election.[179] However, the combined plan limit is scheduled to expire at the end of 1999.[180]

(e) *Combining the limits*. As expected, for a salary reduction-only K or B plan, the maximum contribution is the lowest limit provided in this item. In the case of a K plan, the maximum contribution may be lower under the ADP test. For a plan with both salary reduction and employer contributions, (i) the salary reduction contributions are initially controlled by the § 402(g) $9500 limit and, in the case of a K plan by the ADP limit; (ii) the matching contributions and post-tax employee contributions are controlled initially by the ACP limit; and (iii) all contributions are subject to the § 415(c) limit, the exclusion allowance limit, and, until it expires, the § 415(e) combined plan limit.

18. Distributions

Salary reduction contributions can be withdrawn from K and B plans only after age 59½, death, disability or separation from service, or in the event of hardship (without earnings).[181] K plans may permit in-service withdrawals of matching contributions and other employer contributions as profit-sharing plans.[182] Custodial account B plans may not make in-service withdrawals.[183] While annuity contract B plans are not subject to that limitation, typically they provide for distributions only on such events.[184]

The same rules for participant loans apply to both K and B plans.[185]

The sixty-day commencement of benefits rule applicable to a K plan[186] is applicable to ERISA B plans.[187] The rules requiring distributions to commence on the later of retirement or age 70½ apply to

179. I.R.C. § 415(e)(5); Treas. Reg. § 1.415-7(h) (1981).

180. *See* JOPA, *supra* note 2, § 1452(a); Relief Act, *supra* note 32, § 1504(b).

181. *See* I.R.C. §§ 401(k)(2)(B), 403(b)(11).

182. *See* Treas. Reg. § 1.401-1(b)(ii) (as amended in 1976).

183. *See* I.R.C. § 403(b)(7)(A)(ii).

184. *See, e.g.*, Priv. Ltr. Rul. 96-25-043 (June 21, 1996); Priv. Ltr. Rul. 95-41-038 (Oct. 13, 1995); Priv. Ltr. Rul. 95-29-006 (July 21, 1995).

185. *See* I.R.C. § 72(p); Department of Labor Reg. 29 C.F.R. § 2550.403b-1(a)(3) (1997).

186. *See* I.R.C. § 401(a)(14).

187. *See* ERISA, *supra* note 14, § 206(a).

both K and B plans.[188] The mandatory cash-out rule of accounts not exceeding $3500 ($5000 for plan years beginning after August 1997) applies to K plans and to ERISA B plans.[189]

The more favorable treatment of lump sum distributions under five-year averaging is not available to B plan participants.[190] However, at the end of 1999, this alternative is scheduled to expire for all K and other qualified plans.[191]

The rules for direct rollovers are parallel, but distributions from a K plan and a B plan can be combined only in an IRA. B plan distributions cannot be rolled over to a K plan (or other § 401(a) plan) or vice versa.[192] Sixty-day rollovers are subject to the same rules, and rollovers from an IRA to a B plan can only be made from an IRA having only B plan funds (and vice versa).[193] The rules for trustee-to-trustee transfers are parallel, but do not permit transfers from a K plan to a B plan (and vice versa).[194]

Employees, such as educators, whose careers are likely to be with employers that maintain B plans, have benefitted from the account portability available to them by often continuing to have the new employer make contributions to the participant's account with his or her existing funding agent because B plans may have several funding agents, similar to plans that make contributions to IRAs.[195] K plans generally have a relationship with a single trustee, insurance company, or mutual fund family that is not duplicated by the new employer. On termination of employment the participant's ac-

188. *See* I.R.C. §§ 401(a)(9), 403(b)(10); JOPA, *supra* note 2, § 1401(a).

189. *See* I.R.C. § 411(a)(11)(A) (as amended by Relief Act, *supra* note 32, § 1071); ERISA, *supra* note 14, § 203(e) (as amended by Relief Act, *supra* note 32, § 1071).

190. *See* I.R.C. § 402(e).

191. *See* JOPA, *supra* note 2, § 1401(a).

192. *See* I.R.C. §§ 401(a)(31), 402(e)(6), 403(b)(10).

193. *See* I.R.C. §§ 402(c), 403(b)(8), 408(d)(3)(A).

194. *Compare* Rev. Rul. 90-24, 1990-1 C.B. 97 (providing that in the transfer of annuity contracts or custodial accounts, it is irrelevant whether a complete or partial interest is transferred), *with* Rev. Rul. 67-213, 1967-2 C.B. 149 (providing that no income is realized on a trustee-to-trustee transfer), *and* Rev. Rul. 68-160, 1968-1 C.B. 167 (deciding that an annuity contract transfer from one trustee to another is not a premature distribution).

195. *See* I.R.C. § 403(b)(1)(A) (discussing annuity contracts purchased for employees); I.R.C. § 403(b)(7) (stating that a custodial contract shall be treated as an annuity contract purchased for the employee); Treas. Reg. § 1.403(b)-1(b)(4) (as amended in 1986) (illustrating multiple annuity contacts purchased by the employer for the same employee).

count is typically converted to cash and transferred to the participant's IRA sponsor or to the new K plan, neither of which may be maintained at the old K plan's funding agent. However, with the broad growth of mutual funds available to rollover IRAs, this may not be a substantial issue. Additionally, an individual moving from a tax-exempt employer to a taxable employer will have to rely on an IRA to pool accounts earned with previous employers.[196]

Unless the participant elects a life annuity, K plans are typically not subject to the qualified joint and survivor and spousal consent rules, because K plans are typically designated as "profit sharing plans."[197] B plans are typically regarded as money purchase pension plans, and those subject to ERISA are subject to these rules as money purchase plans.[198]

Distributions from both K and B plans are taxable at ordinary income tax rates when received.[199] Distributions are subject to mandatory 20% withholding unless an exception applies.[200] The 10% early distribution penalty applies to both K and B plan early distributions.[201] The excess distribution excise tax and excess accumulations estate tax addition, while applicable to both K and B plans,[202] were repealed effective in 1997.[203]

19. Anti-dilution

The anti-dilution rule on a merger or consolidation of a K plan applies to B plans subject to ERISA.[204]

20. Anti-alienation

196. *See* I.R.C. § 408(d)(3)(A).
197. *See id*. §§ 401(a)(11), 401(a)(27), 417(a)(1)(A).
198. *See* ERISA, *supra* note 14, § 205; Treas. Reg. § 1.401(a)-20, A-3(d) (as amended in 1988).
199. *See* I.R.C. §§ 72, 402(a), 403(a), 403(b)(1).
200. *See id*. § 3405(d).
201. *See id*. § 72(t).
202. *See id*. § 4980A(a), (d), (e)(1)(A), (e)(2)(A), (e)(2)(C).
203. *See* Relief Act, *supra* note 32, § 1073.
204. *See* I.R.C. § 401(a)(12); ERISA, *supra* note 14, § 208.

The anti-alienation rules applicable to K plans are basically applicable to all B plans under a similar provision or under ERISA.[205]

D. An Evaluation for Section 501(c)(3) Organizations after JOPA

As indicated by the schedule in Appendix A, which is keyed to the Paragraph numbers in Part C, above, many technical provisions are substantially the same for both K and B plans. However, significant differences remain in the applicability of ERISA, the extent of reporting, the interplay in the contributions limits, testing requirements, and availability of safe havens for nondiscrimination purposes.

1. Salary Reduction-Only B Plans

A § 501(c)(3) organization may sponsor a salary reduction-only B plan and avoid all ERISA responsibilities, including disclosure, reporting, fiduciary, and bonding,[206] as well as any ADP testing.[207] Employees of SHHWC organizations can elect the "catch-up" limit only in a B plan.[208] This is a clear advantage of B plans.

2. Taxable Affiliates

To ease administration, a § 501(c)(3) organization with a taxable subsidiary that maintains a K plan may now freeze its B plan and extend the K plan to employees of the parent.[209] The subsidiary has had experience with K plan administration, including ADP and ACP testing. And, with JOPA's simplification of the "highly compensated employees" definition and the adoption of modifications in the ADP and ACP testing under JOPA, testing is less onerous.[210] However, the parent may elect to continue with its B plan because of the B plan's advantages.

3. Other Situations

---

205. *See* I.R.C. § 401(a)(13), (g); ERISA, *supra* note 14, § 206(d).
206. *See supra* note 35 and accompanying text.
207. *See supra* notes 98–100 and accompanying text.
208. *See supra* notes 138, 142–48 and accompanying text.
209. *See* I.R.C. § 401(k)(4)(B) (as amended by JOPA, *supra* note 2, § 1426).
210. *See supra* notes 91–97 and accompanying text.

(a) An employer sponsoring a B plan subject to ERISA files an abbreviated Form 5500 Series annual report; it does not include financial and coverage information.[211] Since the abbreviated Form 5500 relieves a B plan sponsor with more than 100 plan participants from answering certain questions relating to certified financials, the practice is that B plan sponsors do not obtain certified financials.[212] And, the sponsor will have only an abbreviated summary report to distribute annually.[213]

(b) B plans will have no ADP testing for their salary reduction contributions.[214] The requirement that such contributions in B plans be made available to all employees[215] is not onerous. Finally, employees of SHHWC organizations have a “catch-up” election under which they may contribute more than $9500.[216]

(c) For those plans that provide for employer matching contributions, there is ACP testing under both K and B plans.[217] While B plans have no ADP testing,[218] this is only a modest gain for the B plan, because much of the information required for ACP testing — employee compensation and identification of HCEs — is carried over to the ADP test.[219]

(d) Now, let's turn to the interplay of the § 403(b) exclusion allowance and the § 415(c) limit, both applicable to all employer and employee contributions.

(i) Generally, the § 403(b) 20% exclusion allowance will allow greater contributions than the § 415(c) 25%/$30,000 limit — with the result that the 25%/$30,000 limit will be the effective limit in both K plans and B plans. The 20% exclusion allowance permits a current contribution based on current compensation for *prior* years of service (a “catch-up” feature) and, of significance for higher paid participants, it has no dollar limit.[220] The 25%/$30,000 limit is based on current compensation — albeit with a higher percentage — and

211. *See supra* note 39 and accompanying text.
212. *See supra* note 39 and accompanying text.
213. *See supra* note 39 and accompanying text.
214. *See supra* notes 98–100 and accompanying text.
215. *See supra* notes 98–100 and accompanying text.
216. *See supra* notes 138 and accompanying text.
217. *See supra* notes 108–09 and accompanying text.
218. *See supra* notes 98–100 and accompanying text.
219. *See supra* notes 98–100, 106–07 and accompanying text.
220. *See supra* notes 139–41, 153–71 and accompanying text.

has a dollar limit that impacts higher paid participants.[221] In such cases, the interplay is neutral, and the plan sponsor will probably favor a B plan to be free of ADP testing,[222] although the issue is closer if the plan will have matching contributions and thus require ACP testing.[223]

(ii) However, a SHHWC organization[224] will favor a B plan because participants can use the "A" and "B" elections to increase the annual contribution above the regular 25%/$30,000 limit.[225] Under the "B" election, a participant can substitute the least of (i) $4000 plus 25% of "includible compensation," (ii) the exclusion allowance, or (iii) $15,000 for the 25% portion of the 25%/$30,000 limit.[226] But note that the $30,000 limit continues to apply.[227] Thus, employees of these organizations have an opportunity for higher contributions than a K plan permits, without ADP testing.

(iii) Employees of church organizations have special benefits under B plans that are not available under K plans.[228]

(e) The non-discrimination safe harbors provided in Notice 89-23 are easily understood and applied.[229]

Even with K plans now available to them, the B plan is likely to be the plan of choice by § 501(c)(3) organizations.

221. *See supra* notes 139–41, 153–71 and accompanying text.
222. *See supra* notes 98–100.
223. *See supra* notes 106–07 and accompanying text.
224. *See supra* notes 53–57 and accompanying text.
225. *See supra* notes 142–45 and accompanying text.
226. *See supra* notes 142–45 and accompanying text.
227. *See supra* notes 142–45 and accompanying text.
228. *See supra* notes 53–57, 138, 149–50 and accompanying text.
229. *See supra* notes 111, 118 and accompanying text.

APPENDIX A

APPENDIX B

APPENDIX C