

To 403(b) or Not to 403(b)?

Retirement Plan Options for Churches

BY DANNY MILLER

For churches, the choice between a 403(b) and a 401(k) plan can be daunting—but with your help, it doesn't have to be.

There are three basic types of retirement plans available to churches: Section 401(a) qualified plans, Section 403(b) tax sheltered annuities and nonqualified retirement plans. (For purposes of this article, the term “church” refers to local houses of worship of the various faiths and certain church-affiliated and supported organizations referred to in the Code as “qualified church-controlled organizations,” or QCCOs. It does not include non-QCCOs such as church-affiliated hospitals, colleges and universities, which are subject to different and more complex rules.) All three types of plan are exempt from the requirements of ERISA as “church plans”—and therefore do not have to file Form 5500s. However, each type of plan is subject to different rules under the tax code.

Section 401(k) plans are a type of Section 401(a) qualified plan. In the 403(b) arena, church 403(b) plans can be funded with 403(b)(1) annuity contracts or 403(b)(7) custodial accounts—or, if the plan document specifically so provides, they can be treated as 403(b)(9) retirement income accounts. Nonqualified plans aren't subject to the rules imposed on 401(k) or 403(b) plans. However, beginning in 2005, nonqualified plans became subject to the rules of Code Section 409A.

Coverage and Nondiscrimination Rules

So what's the best type of retirement plan for a church to maintain? What are the primary advantages and disadvantages of each? First of all, a 403(b) plan sponsored by a church is not subject to coverage and nondiscrimination rules. This means that a church can provide more retirement plan contributions for some employees, including its pastor, than for others; it can even make contributions for only one church worker and none for others. This flexibility can provide an advantage for a 403(b) plan over a 401(k) plan, because the latter is subject to both general and special coverage and nondiscrimination rules.

403(b) plans maintained by churches offer more flexibility than do 401(k) church plans, particularly if the church employs HCEs.

However (there always seems to be a “however” or a “but” when discussing tax rules), if a church doesn’t employ any highly compensated employees (HCEs) (for 2013, an employee has to make more than \$115,000 in taxable income to be an HCE—and, significantly, a minister’s excludable housing allowance isn’t counted for this purpose), then these nondiscrimination and coverage rules are not an issue. The rules only prohibit coverage and discrimination in favor of HCEs; if there are no HCEs, then a 401(k) plan has the same flexibility as a 403(b) plan and it can provide different contribution levels (including no contributions) for different employees.

Differences in Deferrals

Are there any other differences between church 401(k) plans and church 403(b) plans? The limits on elective deferrals are generally the same for both 401(k) and 403(b) plans. However, a participant in a church 403(b) plan who has 15 years of service with the church can contribute an extra \$3,000 per year to the plan, on top of the normal limits, up to a lifetime limit of \$15,000—not that much in extra contributions, but still more than can be made to a 401(k) plan.

Contribution Issues

A 403(b) plan can also be more useful than a 401(k) plan if a church wants to continue to make contributions after an employee terminates service. A special rule (only available to 403(b) plans) permits contributions to be made on behalf of former employees for up to five years following termination of employment. This means, for example, that a church could agree to continue to make contributions to its 403(b) plan for up to five years following its

senior pastor’s retirement, subject to the annual Code contribution limits (which, in 2013, could be as much as \$51,000 per year, if the senior pastor had that much taxable income in the last 12 months of his or her employment). Note, however, that only the church can make these post-employment contributions—the former employee cannot.

Church 403(b) plans also can permit contributions to be made on behalf of pastors who have no or very little taxable compensation due to their claiming an excludable housing allowance. A special contribution limit rule applicable to church 403(b) plans permits up to \$10,000 per year (subject to a lifetime limit of \$40,000) to be contributed in behalf of church workers, including clergy, even if they have no taxable compensation. This special contribution rule is not available under a 401(k) plan.

Making the Right Choice

With these differences in mind, is there any reason for a church to provide a 401(k) plan instead of a 403(b) plan? Currently, the process by which 401(k) plans are approved by the IRS is less expensive and time consuming than the process by which 403(b) plans receive an IRS blessing. However, the IRS is expected to adopt a prototype and volume submitter program for 403(b) providers, and the IRS has indicated the program will have special rules for church 403(b)s. Ultimately, a church may choose to provide its workers with a 401(k) plan simply because it feels that they may be more familiar with the 401(k) label, particularly if the church has no HCEs and can thus vary contribution levels. But the flexibility that a church 403(b) plan offers would seem to tilt the decision-making process in its favor.

The Nonqualified Plan Option

Nonqualified plans are not a very attractive option for churches due to the requirement that assets in such plans must be reachable by creditors of the church in order to avoid contributions under the plan being taxable to

participants. In addition, the relatively inflexible requirements of Section 409A apply to a nonqualified plan maintained by a church.

However, nonqualified plans are not subject to the Code’s contribution limits, so they can still have a place in retirement planning for churches, particularly in the case of pastors who have no or very little taxable compensation due to their claiming tax excludable housing allowance and who are therefore limited in their ability to make contributions to either a 403(b) plan or a 401(k) plan.

But the benefit security issue and the Section 409A restrictions probably mean that nonqualified plans will only be used by a church as a supplemental retirement arrangement (and even then normally will be used only if the five-year, “former employee” contribution rule available under 403(b) plans described above doesn’t accommodate the amount desired to be paid as additional retirement compensation).

Conclusion

In summary, 403(b) plans maintained by churches offer more flexibility than do 401(k) church plans, particularly if the church employs HCEs. Even if a church has no HCEs, a 403(b) plan offers slightly greater advantages in the areas of contribution limits and a church’s ability to make post-employment contributions. Church 403(b) and 401(k) plans both offer the benefit security that’s lacking in a nonqualified plan. This lack of benefit security and the restrictions imposed by the Section 409A rules mean that nonqualified plans should be used primarily to supplement a church 403(b) or 401(k) plan. **B**



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