The Rules Are: There are Some Rules - The IRS Code Requirements for Governmental Defined Contribution Plans

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There is a common phrase, “the rules are that there are no rules.” Indeed, some governmental plan sponsors often misinterpret the fact that their plans are not subject to ERISA and some of the Internal Revenue Code (IRC) to mean that they are not subject to any rules at all. Conversely, some public school districts and public higher education organizations misconstrue the retirement plan rules, by assuming those of their private school colleagues equally apply to them. This article provides an overview of the important sections of the Code that do and do not apply to governmental plans, so that plan sponsors can avoid confusion.

First and foremost, governmental plans are never, ever subject to ERISA (or specifically, Title I of ERISA, where most of the provisions that do not mirror IRC provisions reside). Even if a governmental plan sponsor wished to be subject to ERISA, it is not possible for such a plan to ERISA-fy itself (in contrast to church plans, which can elect ERISA coverage). Thus, as a governmental plan sponsor, if someone tells you that you need to file a 5500 for your plan, or that you are required to provide participant fee disclosures, that individual has no idea what they are talking about!

In addition, certain code provisions do not apply to certain types of plans, whether private or public. For example, the 401(k) provisions with respect to Average Deferral Percentage, or ADP testing, never apply to 403(b) or 457(b) plans. We still hear anecdotally of consultants who insist that 403(b) plans are subject to ADP testing. That is simply not true (although a full examination of such plan-specific Code provisions is beyond the scope of this article, if a Code provision is not applicable to either governmental or private plans of a certain type, I will note that fact below).

Finally, in the interest of clarity, note that the rules discussed below only relate to public defined contribution (403(b), 457(b), 401(a) and, to a lesser extent, grandfathered 401(k) plans). Although some of the same rules apply, the specific applicability of the rules to defined benefit plans, such as state retirement systems, is quite different in terms of scope and content.

Nondiscrimination

Governmental plans are not subject to most nondiscrimination rules. Specifically, the coverage test rules of 410(b), which relate to nondiscrimination in eligibility, and the general nondiscrimination rules of 401(a)(4), which relate to nondiscrimination in contribution amounts, as well as benefits, rights and features of a plan, do not apply at all to governmental plans. In addition, ADP testing does not apply to 401(k) grandfathered governmental plans (see Plan Design, below), and, as stated above, does not apply to 403(b) or 457(b) plans, private or public. In addition, Average Contribution Percentage, or ACP testing, under Code Section 401(m), which would normally apply to matching contributions (and, unlike ADP testing does apply generally to non-governmental 403(b) plans) is also not applicable to governmental plans. Finally, the top-heavy testing that would normally apply to 401(a) and (k) plans, but not to 403(b) and 457(b) plans, is not applicable to governmental plans.

Thus, since none of these rules apply, a plan established with an employer contribution exclusively for a single employee - such as a superintendent or a dean, or a specific class of employees - may not run afoul of any nondiscrimination rules. In other words, there are no rules of which a plan sponsor can run afoul! Providing larger amounts of employer contributions for some employees and smaller amounts for others may likewise not raise any concern over discrimination (but see Other Laws, below). Making this discrimination has been a source of great confusion among public plan sponsors, who are no doubt aware that their private counterparts are subject to nondiscrimination rules. But as the rules clearly do not apply to governmental plans, such plan sponsors can freely customize their plan contributions however they
see fit, to accomplish employee attraction/retention goals, or to achieve other plan objectives.
So what nondiscrimination rules do apply to governmental plans? The 401(a)(17) limit as to compensation that may be taken into account under a retirement plan ($265,000 in 2015) does indeed apply to governmental plans, which can restrict the amount of employer contributions to such plans. However, if the plan document permits, a higher grandfathered compensation limit may be used for any participants who were in the plan on July 1, 1993. For 2015, this compensation limit is $395,000.

In addition, governmental 403(b) plans are subject to the universal availability rules, which mean, with limited exceptions, that generally all employees of the plan sponsor must be provided with the right to make elective deferrals to a 403(b) plan.

PLAN DESIGN
There is one specific type of plan that may be utilized exclusively by governmental employers. It is a 415(m) plan, established by the addition of 415(m) to the Internal Revenue Code in 1996. This plan, known as a “governmental excess benefit arrangement”, is a nonqualified plan that allows contributions that would otherwise be payable to a defined benefit or a defined contribution plan, were it not for the application of the 415 limit. In the private tax-exempt marketplace, we often see a combination 401(a)/403(b) plan design; it allows for contributions in excess of the standard 415 limit, since separate 415 limits generally apply to the 401(a) and 403(b) plans. However, such a plan design is generally unnecessary in the governmental arena to accomplish this goal, due to the existence of the 415(m) plan.

We should also note that section 403(b) plans are available only to public educational institutions (K-14 and higher education). Other public entities, such as state and local governments, may not sponsor a 403(b) plan, although there have been instances of such entities erroneously sponsoring 403(b) plans. On a related note, governments can sponsor a 401(k) plan, but only if the plan was established prior to 1986, as so-called “grandfathered” 401(k) plans. Thus, in general, private tax-exempts, which may freely sponsor 401(a), 401(k), 403(b), and 457(b) plans (albeit the latter with limited eligibility—see below) have more flexibility with respect to plan choice than public entities.

With respect to employee eligibility, there is a special provision for 457(b) governmental plans as well as non-QCCO church plans, such those of church hospitals, that again differs from the 457(b) plans of private tax-exempts (it should be noted that steeple churches/QCCOs are not subject to 457(b) and cannot sponsor 457(b) plans at all). Generally, private 457(b) plans must limit participation to a group of “select management and highly compensated” employees, otherwise known as a “top-hat” group. However, government and church 457(b) plans are not subject to such restrictions; all employees can be eligible for the 457(b) plan at the governmental employer’s discretion.

457(b) plans of private tax-exempts can also allow independent contractors to participate, but governmental 457(b) plans will generally limit participation to actual employees, to avoid possible loss of status as a governmental plan (since ERISA 3(32) discusses the governmental plan exemption for plans for employees). To cover independent contractors, employers might establish a separate plan just for those independent contractors. This would avoid loss of governmental plan status, and loss of the ERISA exemption since there would be no employees in that plan.

Age/service requirements also do not apply to governmental plans. For example, a governmental plan sponsor can establish a provision where only employees age 30 or over with at least five years of service are eligible to receive employer contributions.

CONTRIBUTIONS
The limitations on contributions that apply to retirement plans, including the limitations of 402(g) and 415(m), generally apply to governmental plans. This can cause a problem for non-public education 457(b) plan sponsors who do not have access to a 401(k) plan, since the 457(b) limits are somewhat restrictive ($18,000 on combined employer contributions/elective deferrals in 2015). Thus, if a state/local governmental plan sponsor wishes to provide an employer contribution in a defined contribution plan, they will often pair a 401(a) plan with a 457(b) plan. This is occurring with increasing frequency as state retirement systems transition away from a pure defined benefit model. The 401(a) plan is used for employer contributions so that the employee may defer up to the full 457(b) plan limit. Some sponsors in this situation also provide for an employee pretax contribution to be made in the form of a “pick-up” contribution under 414(h), in order to allow for additional employee contributions. Such deferrals, however, are not elective, so the employee does not have the option to take the contribution as current compensation.
There is a special contribution limitation that applies to public, but not private, 457(b) plans. The age-50 catch-up election under 414(v), which permits deferrals in excess of otherwise applicable plan limits up to a certain dollar amount ($6,000 in 2015), is permitted in governmental 457(b) plans, but not in 457(b) plans of private tax-exempts. This is a significant advantage of governmental 457(b) plans when compared to private 457(b) plans. However, the age-50 catch-up cannot be used in addition to the special 3-year-prior-to-retirement limit increase under 457(b)(3).

With respect to contribution types, the rules that apply to private plans generally apply to public plans as well. Moreover, there is another advantage of governmental 457(b) plans over private tax-exempt 457(b) plans in this area: 457(b) Roth contributions are permitted in governmental, but not private, plans.

Finally, there are no requirements that contributions be vested after the completion of a certain number of years (Code Section 411, however, requires that certain pre-ERISA vesting rules apply under 401(a)(7), including vesting upon plan termination/cessation of contributions). Nevertheless, in reality, virtually all governmental plan sponsors require that employee contributions are 100% vested, and many, though not all sponsors also follow the minimum vesting requirements for private plans.

**DISTRIBUTIONS AND LOANS**

Most of the rules that apply to distributions and loans of private 403(b)/457(b) plans apply to governmental plans as well, including the rules under 401(a)(9) regarding minimum distributions. Although there were special rules for governmental plans prior to 2009, they no longer apply. The same is true for the rules that apply to loans under Code Section 72(p), in-service distribution restrictions (various Code Sections depending on plan type), the direct rollover rules of 401(a)(31), and the premature distribution penalty tax under 72(t) applicable to 403(b), but not 457(b) plans. Note that there is an exception to the 10% penalty for public safety employee (e.g., police/fire/ems), but only for defined benefit plans.

One distribution rule that does not apply to governmental plans is the Qualified Joint and Survivor Annuity Rule (QJSA) rule under Code Sections 401(a)(11) and 417. Thus, spousal consent is not required for loans and distributions from a governmental plan.

A special distribution rule also applies exclusively to governmental plans. In 2006, Section 402(l) was added to the Code. This section permits public safety employees to apply up to $3,000 in retirement plan distributions per year tax-free for payment of health or long-term care insurance premiums.

In addition, two special rules apply to governmental 457(b) plans, but not to private tax-exempt 457(b) plans. The first is the ability to roll over a distribution: rollovers are not permitted in a private 457(b) plan. The second is that governmental 457(b) plan assets are generally taxable only when actually paid out to a participant in the form of a distribution; by contrast, private 457(b) plan assets are taxable when distributed or made available to a participant for distribution. Also note that a difference in distribution tax reporting: public plans use 1099-Rs, while private plans use W-2s to report distributions. Thus, public 457(b) plans have some distinct advantages in terms of distribution flexibility, compared to private 457(b) plans.

Also, loans may be made available from governmental 457(b) plans, but loans are not permitted from private tax-exempt 457(b) plans.

Though not technically a distribution, the rule regarding transfers to purchase defined benefit plan service credit merits mention. A participant may transfer assets from his defined contribution retirement plan to purchase additional service in a governmental defined benefit plan without violating distribution restrictions.

**REPORTING AND DISCLOSURE**

All governmental plans, including 403(b) plans (as of 2009), are required to maintain a written plan document. According to ERISA, a Summary Plan Description is not required, however. Though it is not a legal requirement, many plan sponsors do provide a summary document as best practice. Summary Annual Reports (SARs) are also not required to be distributed to participants, since they would summarize an annual report (5500) that is nonexistent (see below).

Some public plan sponsors also provide fee disclosures to participants similar to those required under Section 404(a)(5) of ERISA, but, again, since governmental plans are never subject to ERISA, such disclosures are not a legal requirement. However, like private plans, governmental plans must provide 402(f) distribution rollover notices to participants. Rather shockingly, it is not obligatory to provide benefit statements to governmental plan participants, though public plan sponsors almost universally do provide those statements via their recordkeeper(s).
Unlike private plan sponsors, who have extensive reporting requirements related to their retirement plans (Form 5500, Form 8955-SSA, etc.), there are no reporting requirements for public plans, other than what may be required by state law, and federal reporting related to individual contributions and distributions (W-2, 1099-R). If a governmental entity wishes to receive a determination letter from the IRS for a 401(a) or 401(k) plan, a one-time filing would be required, as is the case with private plans of this type.

**MISCELLANY**

The concept of a Qualified Domestic Relations Order is unique to ERISA. This does not mean that governmental plans are prohibited from honoring/processing Domestic Relations Orders; it only means that an order need not be subject to the qualification requirements of ERISA. Though a governmental plan could fail to honor a DRO, governmental plans often do honor such orders. In addition, a state court could compel the plan sponsor to honor a DRO.

Another difference between private and public 457(b) plans is that governmental plan assets may be invested in a trust, while private tax-exempt 457(b) assets may not be.

Also, the Qualified Preretirement Survivor Annuity rules of Code Sections 401(a)(11) and 417 do not apply to governmental plans. Thus, no spousal consent is required for certain nonspouse beneficiary designations.

Finally, several lesser-known provisions of the Code do not apply to governmental plans. These include the anti-cutback provisions of 411(d)(6) and the related provisions of 401(a)(12) with respect to mergers and acquisitions, the anti-assignment rules of 401(a)(13) and the benefit commencement rules of 401(a)(14), also known as the "normal retirement date" rules. The exclusive benefit rule of 401(a)(2), however, does apply to governmental plans.

**OTHER LAWS**

Though ERISA may not pertain, other laws unrelated to the Internal Revenue Code would apply with less frequency. For example, assume a public higher education plan sponsor wants to take a “stick” approach to incentivizing faculty to retire in a timely fashion. To achieve such a goal, the plan sponsor wants to reduce the amount of its 403(b) plan employer contribution for faculty over 65 years of age. Though nondiscrimination rules do not apply here, the plan may run afoul of the Age Discrimination in Employment Act (ADEA), which protects older workers and applies to state and local governments, including K-14 school districts and higher education.

Of course, state law, as it relates to retirement plans, would apply as well. For private plans, such state law is generally disregarded, as ERISA preempts such laws. Although state law is occasionally written to specifically apply to the retirement plan in question, most is more general in nature. However, some state laws may mandate/prohibit certain types of conduct. This has been an issue, for example, in determining the degree to which governmental employers are/are not subject to fiduciary responsibilities, as well as with automatic contribution arrangements. Thus, plan sponsors should always consult with outside counsel well versed in such matters to determine state law applicability.

**CONCLUSION**

Clearly, governmental 403(b)/457(b) plan sponsors are not subject to as much regulation as their private 501(c)(3) counterparts. But they are subject to some regulations, so it is important for plan sponsors to understand the rules that do and do not apply to public entities.