# Retirement and Compensation Planning Considerations for Nonprofit Organizations

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The primary body of law governing retirement planning for all employers, including nonprofit organizations, is contained in the Employee Retirement Income Security Act of 1974, as amended (ERISA),[1] and the Internal Revenue Code of 1986, as amended.[2] As a general rule, nonprofit organizations, including those which are tax-exempt under the code, may maintain the same types of retirement plans and other employee benefit arrangements as private sector, for-profit employers. However, there are certain types of retirement plans and special limitations and considerations which apply only to various nonprofit organizations.

The focus of this article is on those retirement plans and other compensation considerations which are unique to nonprofit organizations. This article also provides a brief discussion of the various types of retirement plans which may be maintained by tax-exempt as well as for-profit employers.

## Qualified Retirement Plans

Attorneys providing general representation to organizations in the nonprofit as well as in the private sectors should be at least generally familiar with retirement planning and other benefit issues affecting their clients and their clients' employees. The types of retirement plans which are most commonly maintained by nonprofit as well as by for-profit employers are "tax-qualified" retirement plans. The three basic tax advantages provided under the code for such qualified plans are summarized as follows:

1. Contributions made by the employer each year currently are income tax deductible, even though the contributions are not taxable to the participating employees when made. (This deduction would not be of consequence to many nonprofit employers.)

2. Any earnings on the amounts contributed under the plan may accumulate without the earnings being taxed currently to the employer or the plan.

3. Distributions from the plan may qualify for favorable tax treatment, and a participating employee often may further defer the tax on his or her receipt of a distribution by rolling it over into another tax-qualified retirement plan or individual retirement account.

Retirement plans maintained by employers also are generally subject to ERISA, whether or not they provide the favorable benefits of tax-qualified retirement plans. ERISA imposes many requirements on retirement plans which are substantially identical to those imposed under the code on tax-qualified retirement plans, including those concerning participation, vesting, mandatory distributions, funding and non-discrimination. However, there are additional code provisions tax-qualified plans must comply with which do not have parallel ERISA provisions, including those concerning required minimum distributions, annual limits on contributions which may be made on behalf of a participant, and minimum coverage rules. In addition, ERISA imposes certain requirements which are independent of any imposed under the code, including those relating to fiduciary responsibility and reporting and disclosure.

## Pension and Profit-Sharing Plans

The two types of tax-qualified retirement plans that are most commonly maintained by nonprofit as well as by for-profit employers are pension plans and profit-sharing plans. Pension plans include both defined benefit and defined contribution plans.

### *Pension Plans*

In general, a defined benefit plan provides a determinable retirement benefit based upon a formula contained in the plan. The formula provides for a benefit each month which is calculated based upon the participant's years of service with and compensation from his or her employer. Each year, the employer contributes an amount which is actuarially determined to be appropriate to fund the projected retirement benefits of all plan participants. Several assumptions are utilized in calculating the annual contributions, including interest rate, mortality, and future salary increases of the participants.

In contrast, under a defined contribution plan the contribution, rather than the benefit, is fixed. Each year, the employer must contribute on behalf of each eligible participant an amount determined under the plan's contribution formula. It is common for the contribution to be stated as a fixed percentage of each participant's compensation. Contributions also may take certain other factors into account, including a participant's age and the contributions made into the Social Security system by the employer on the employee's behalf.

Each participant in a defined contribution plan has an account into which the contributions made on his or her behalf are allocated. The amount a participant ultimately is entitled to receive is determined by reference to his or her account, and is dependent upon the plan's investment performance as well as any forfeitures allocated and expenses charged against the account.

### *Profit-Sharing Plans*

A profit-sharing plan is similar to a defined contribution plan except that the employer is not required to contribute an amount calculated under the plan's contribution formula each year. Instead, within certain limits, the employer retains discretion over the amount, if any, which will be contributed each year. Any amounts contributed must be allocated to the accounts of the eligible participants in accordance with the plan's contribution formula.

The position of the Internal Revenue Service (IRS) is that a nonprofit organization may maintain a tax-qualified profit-sharing plan without jeopardizing its tax-exempt status even though the organization does not have a profit motive.[3] However, the plan must have appropriate safeguards and limits in place to protect against prohibited inurement to the benefit of any private individuals.

For plan years beginning after December 31, 1985, the code provides that a plan's status as a profit-sharing plan is determined without regard to the employer's current or accumulated profits and without regard to whether the employer is a tax-exempt organization.[4]

In order for all types of retirement plans to be tax-qualified and provide favorable tax treatment, they must satisfy an extensive list of requirements contained in the code. These include eligibility to participate, vesting, required distributions and prohibitions on contributions being made or benefits being provided in a discriminatory manner in favor of the employer's highly compensated employees.[5]

## Other Types of Retirement Plans

### *401(k) Plans*

The other common type of qualified retirement plans, which prior to plan years beginning in 1997 could not be maintained by most tax-exempt nonprofit organizations, are those plans containing cash or deferred arrangements, commonly known as 401(k) plans. Under such plans, employees may elect to have a portion of their compensation withheld from their wages and contributed by their employer on a pre-tax basis to a trust.

401(k) plans are subject to the general qualification requirements contained in the code, and also are subject to certain additional special qualification rules. Such rules include those designed to ensure that the eligible highly compensated employees do not elect to contribute a disproportionately large percentage of their salary, as compared to the non-highly compensated employees, and that the plan is

not used as a tax-advantaged pre-retirement savings account.[6]

#### *Code Section 403(b) Plans for Nonprofit Organizations*

Tax-sheltered annuities under Code Section 403(b) are a type of deferred compensation arrangement commonly maintained by nonprofit organizations. They may be maintained only by employees of organizations exempt from taxation under Section 501(c)(3) of the code, or by employees of public educational systems. Tax-sheltered annuities are similar to 401(k) plans in many respects. However, 403(b) arrangements have several unique characteristics which should be kept in mind.

1. Participants in 403(b) arrangements are generally subject to the same $9,500 per year limit (as adjusted for cost-of-living) on their elective deferrals as are participants in 401(k) plans. However, a special catch-up election is available to participants with 15 years of service with certain employers, including certain hospitals and educational organizations, enabling them to increase their annual elective deferrals by up to $3,000, subject to a $15,000 lifetime maximum catch-up election increase.

2. The investment options which may be offered under a 403(b) arrangement are more limited than those which may be offered under a 401(k) plan. In general, they consist of annuity contracts issued by insurance companies and custodial accounts investing exclusively in shares of regulated investment companies.

3. If only employee elective deferral contributions will be made under the arrangement, it will satisfy all nondiscrimination requirements provided that all of the employer's employees may participate, and subject only to the requirement that if they elect to participate, they must agree to defer more than $200 annually. This is a significantly easier test to satisfy than the actual deferred percentage test applicable to elective deferrals made under a 401(k) plan.

4. Is the 403(b) arrangement an "employee benefit pension plan" subject to ERISA? This is an important question, as many nonprofit organizations mistakenly assume that the arrangement in which their employees participate is not an ERISA plan and that they have no responsibility over or liability exposure under it. A 403(b) arrangement will not be an ERISA plan if:

a. Participation is completely voluntary;

b. All rights under the annuity contracts or custodial accounts are enforceable solely by the employee (or a beneficiary or authorized representative);

c. There are no matching or other non-elective employer contributions;

d. The involvement of the employer is limited to:

- permitting agents or brokers to publicize their offered investment products to employees,
- requesting information concerning the products,
- summarizing or otherwise compiling that information to facilitate review and analysis by employees,
- collecting and remitting salary reduction contributions to the carriers,
- holding a group annuity contract in the employer's name, and
- limiting the investment options to a number and selection that is designed to afford employees a reasonable choice while easing administrative burdens and costs and minimizing the interference with employee performance that could result from direct solicitations by the carriers; and

e. The employer receives no direct or indirect consideration or compensation except to cover expenses properly and actually incurred in performing its duties under the salary reduction agreements.[7]

If the 403(b) arrangement does not satisfy the above requirements, it will be an ERISA plan unless it is maintained by a governmental entity otherwise exempt from ERISA, including a public educational organization. As in ERISA plan, the nonprofit organization will be required to maintain a plan document and also will be subject to other ERISA requirements, including certain reporting and disclosure requirements which may impose responsibilities and liability on the nonprofit organization and certain of its employees who may be classified as fiduciaries under the arrangement.

In view of these concerns, nonprofit organizations which make 403(b) arrangements available to their employees, and which do not intend to make any matching or other non-employee elective contributions, should carefully attempt to satisfy the above requirements. They also should consider entering into a "hold harmless" agreement with the investment sponsors whose products are offered to their employees.

#### *401(k) Plans for Nonprofit Organizations*

As previously mentioned, for plan years beginning after December 31, 1996, non-governmental, tax-exempt organizations may sponsor 401(k) plans.[8] Accordingly, many nonprofit organizations which previously maintained 403(b) arrangements for their employees should consider whether to freeze or terminate their 403(b) arrangements and replace them with a 401(k) plan. Attorneys representing nonprofit organizations should be aware of the basic workings of 403(b) arrangements so that they can provide useful guidance to their clients in this area.

#### *Section 457 Plans*

Section 457 of the code contains the rules governing deferred compensation plans of state and local governments and tax-exempt organizations.[9] Section 457 contains rules governing both "eligible" and "ineligible" plans.

In very general terms, eligible plans may be preferred by participants over ineligible plans, as amounts deferred under an eligible plan will not be taxable to a participant until paid. However, the annual contribution under an eligible plan is generally limited to the lesser of

$7,500 or one-third of the participant's compensation per year, reduced by any amount deferred under a 403(b) arrangement. Thus, while an eligible Section 457 plan may be a useful way for a nonprofit organization to set aside additional retirement funds for select individuals, its application will be limited by the annual $7,500 ceiling. It also will be limited to the extent that such individuals also participate in 403(b) arrangements.

In addition to the annual contribution limit, other restrictions apply to eligible plans which do not apply to tax-qualified retirement plans or 403(b) arrangements. For example, the plan must be "unfunded." Thus, any amounts set aside by the nonprofit organization to pay benefits in the future must remain subject to the claims of the organization's creditors.

While the plan must be unfunded, assets may be held in a "rabbi trust" established for the benefit of the participants.[9]

In certain cases, an ineligible plan also may be an attractive compensation technique for nonprofit organizations. While ineligible plans are not subject to the dollar limits on annual contributions applicable to eligible plans, all contributions made on an employee's behalf will be immediately taxable to him or her when the contributions are no longer subject to a substantial risk of forfeiture. As a result, these plans generally work well when the nonprofit organization wants to condition a participant's receipt of any amounts under the plan on the performance of future services. Such a condition will delay both vesting and the recognition of income on the deferred amount, as well as the time when such amount will be payable to the participant.

## General Compensation and Incentive Compensation Issues for Nonprofits

While private sector and taxable nonprofit employers are subject to scrutiny and may lose an income tax deduction if they pay an employee an amount in excess of that which is reasonable for services rendered, nonprofit tax-exempt organizations must consider the doctrines of "private inurement" and "private benefit" when setting compensation for their employees.

The doctrine of private inurement requires that no part of a tax-exempt organization's net earnings benefit any private individual.[10] Private individuals are those who have a personal and private interest in the activities of the organization and insiders. The private benefit doctrine prohibits certain exempt organizations from serving private purposes.[11] Some degree of private benefit may be received by an individual so long as such benefit is incidental to the accomplishment of the organization's exempt activities.

The IRS may scrutinize compensation arrangements, including current cash compensation, retirement and incentive plans, to determine whether the aggregate of the benefits provided to any individual result in private inurement or a private benefit which could jeopardize the organization's tax-exempt status. Provided that an employee's total compensation package, including any incentives which may be available, are not a disguised attempt to distribute profits or to create a joint venture between the employee and the nonprofit organization, and further provided that the arrangement results from arm's length bargaining, the arrangement should be able to withstand scrutiny and not jeopardize the organization's tax-exempt status.

## The Effect of Participation in Multiple Plans for Employees of Nonprofit Organizations

The technical rules which should be considered when an individual participates in multiple retirement plans and other deferred compensation arrangements (including those maintained by both for-profit and nonprofit organizations) are beyond the scope of this article. However, at a minimum, certain basic concepts should be kept in mind by attorneys representing nonprofit organizations.

First, in the past few years, there have been many alliances formed between for-profit and nonprofit organizations. In addition, it has become increasingly common for employees to move between the public and private sectors or to work for both a for-profit and nonprofit organization at the same time. By way of example, this trend is frequently seen in the health care field where physicians may sell their practice to a nonprofit hospital or may maintain a private practice and at the same time be employed by a hospital or university and also be eligible to participate in its plans.

As a result, attorneys representing nonprofit organizations must not only be aware of the special retirement planning considerations applicable to such organizations but also generally must be aware of the rules applicable to for-profit organizations and their employees, and how such rules may impact their clients. They must also keep in mind that the contributions which may be made and the benefits which may be provided by a nonprofit organization could be impacted by the benefits being provided by a private sector employer who employs some of the same individuals.

Second, each of the plans and compensation arrangements discussed above should be viewed as part of an integrated benefit package, each component of which could impact upon any of the other components. For example, prior to responding to a client's request for advice concerning a 403(b) arrangement, you should familiarize yourself with any and all other benefit plans and arrangements currently maintained or available to the client.

As discussed above, you should consider whether such an arrangement is better suited for your client than a 401(k) plan which may be maintained or could be adopted by it. You also should review your client's overall involvement with its retirement plans and determine whether efforts should be made to avoid having ERISA apply to the 403(b) arrangement. In addition, you should consider how any amounts credited on behalf of the participants could impact the

amounts they are entitled to receive under an eligible Section 457 plan as well as any other plans maintained.

### Conclusion

All attorneys representing non-profit organizations should be generally familiar with the retirement plan and other employee benefit issues discussed in this article. In addition, in view of the alliances being formed between for-profit and nonprofit organizations with increasing frequency, such as those in the medical and related health care fields, these issues are likely to have increased significance to those employers and their advisors who traditionally only had to concern themselves with the retirement plan and benefit issues applicable to for-profit entities.

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#### Endnotes

1. 29 U.S.C. § 1001 *et seq.*
2. 26 U.S.C.
3. GCM 38283, issued Feb. 15, 1980.
4. Code § 401(a)(27)(A).
5. Code § 401(a).
6. Code § 401(k).
7. 29 C.F.R. § 2510.3-2(f).
8. Code § 401(k)(4)(B).
9. PLRs 9211037, 9212011, 9642038 and 9642046.
10. Code § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(2).
11. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

# FACTS:

- Alcohol is the most widely used and destructive drug in America.
- Cocaine use causes marked personality changes; users become impatient, suspicious and have difficulty concentrating.
- Marijuana affects memory, concentration, and ambition.
- Early intervention with alcoholic and drug problems most often leads to complete recovery.
- Attorneys can and do suffer from alcohol and other drug abuse problems.

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