401(k) vs. 403(b): What Is the Best Choice for My Non-Profit?

Facts

As the director of a not-for-profit organization, I'm looking at retirement plan options for our employees. The fiscal year ends June 30th and I'd love to implement something to benefit our employees beginning with the new year.

Question

How do I know if a 401(k) or 403(b) plan is the right plan for us?

Answer

Congratulations! Adding a retirement plan for your employees is an awesome benefit. The hard part can be making the decisions around the best plan design for your organization and the provisions that will be the easiest to maintain. To help you weigh the decision, 401(k) versus 403(b), let's take a look at two major considerations, eligibility and annual testing, and how these different plan types come into play.

Eligibility

One of the first things to contemplate when setting up your retirement plan is what the plan's eligibility will be. Would you like your employees to be able to begin contributing as soon as they're hired? Or would you prefer that they wait until they've worked for you for a certain amount of time, say a few months or even a year? The answer to this question will help you navigate the decision tree as the rules for 403(b) plans and 401(k) plans are very different.

403(b) plans are subject to something called universal availability. This means the ability to make deferrals must be universally available to all employees immediately. So, as of day one, a plan sponsor must allow an employee in a 403(b) plan to begin making deferrals. There are a few very specific exceptions to the universal availability rule but, generally speaking, in a 403(b) plan everyone is eligible to contribute as soon as they are hired. This rule may make administration easier (no need to determine who and when someone is eligible) but it can also mean the plan participant count can grow quite quickly.

If you choose to sponsor a 401(k) plan, you can implement a more restrictive eligibility schedule. 401(k) plan sponsors can set requirements of up to one year of service (requiring at least 1,000 hours of service during the period) and attainment of age 21. If your organization experiences quick turnover of employees, you may find that having the ability to set service requirements keeps the plan "cleaner" with fewer terminated participant balances remaining in the plan over time.

Both 403(b) and 401(k) plans can implement eligibility requirements for employer contributions, including matching and nonelective contributions. Meaning, if your organization decides to provide a contribution on behalf of plan participants, you can establish service requirements like what's available for 401(k) plan deferral provisions. This optional feature for both plan types allows your organization to focus these discretionary employer contributions on your longer-tenured staff.

Testing

The next thing to consider is the type of participants you'll have in the plan and whether it is subject to the ADP nondiscrimination test, which can limit the contributions any highly compensated employees can make based on the average contribution rate of the non-HCEs. If the average deferral rate of the HCEs exceeds the limit set by the deferral rates of the NHCEs, the HCEs may be required to take corrective refunds from the plan.

Typically, a 401(k) plan is subject to this test, whereas a 403(b) plan is not. While there are ways for 401(k) plans to avoid this annual testing, a 403(b) plan may offer the better opportunity for maximizing deferrals if your organization has HCEs looking to contribute. *Wondering about what makes a participant an HCE, we have that info for you here.*

While it wasn't always the case, despite the factors above, 403(b) and 401(k) plans offer many similar participant experiences. Annual contribution limits, withdrawal restrictions and access, as well as the ability to self-direct investments are generally the same across both plan designs. In addition, the plan sponsor requirements like maintaining a plan document and filing a Form 5500, are the same for ERISA-covered 403(b) plans and 401(k) plans. Fiduciary responsibilities apply to sponsors of either plan type.

Granted, not all employers have the option to implement a 403(b) plan. They are only available to 501(c)(3) non-profit organizations as well as certain governmental entities. If you're unsure whether a 403(b) plan may be available to you or you'd like to drill down to the nitty-gritty on 403(b) plans, we've got you covered here. Even if a 403(b) plan isn't an option for your business or organization, there are still numerous other plan types and provisions to consider. If you're curious about those, we've put together a quick reference comparison chart that will help you review the different plan types that might be right for you. And, we know, reading this alone isn't going to get you to the perfect plan; our DWC team is eager to review your business's retirement plan needs and help you design a plan that fits like a glove.