THE ADVISOR'S GUIDE TO 401(k) PLANS

(2018 Edition)

B · E · S · T

BROKER EDUCATIONAL SALES & TRAINING, INC

"Knowledge Is *Your* BEST Investment."

Researched and Written by:

Edward J. Barrett

CFP®, ChFC®, CLU, CEBS®, RPA, CPFA, CRPS®, CRPC®

This page left blank intentionally

DISCLAIMER

This course is designed as an educational program for financial advisors and insurance professionals. EJB Financial Press is not engaged in rendering legal or other professional advice and the reader should consult legal counsel as appropriate.

We have tried to provide you with the most accurate and useful information possible. However, one thing is certain and that is change. The content of this publication may be affected by changes in law and in industry practice, and as a result, information contained in this publication may become outdated. This material should in no way be used as an original source of authority on legal and/or tax matters.

Any laws and regulations cited in this publication have been edited and summarized for the sake of clarity.

Any names used in this publication are fictional and have no relationship to any person living or dead.

This presentation is for educational purposes only. The information contained within this presentation is for internal use only and is not intended for you to discuss or share with clients or prospects. Financial advisors are reminded that they cannot provide clients with tax advice and should have clients consult their tax advisor before making tax-related investment decisions.

EJB Financial Press, Inc.
7137 Congress St.
New Port Richey, FL 34653
(800) 345-5669
www.EJBfinpress.com

This book is manufactured in the United States of America

© 2018 EJB Financial Press Inc., Printed in U.S.A. All rights reserved

This page left blank intentionally

ABOUT THE AUTHOR

Edward J. Barrett CFP®, ChFC®, CLU, CEBS®, RPA, CPFA, CRPC®, CRPS®, began his career in the financial and insurance services back in 1978 with IDS Financial Services, becoming a leading financial advisor and top district sales manager in Boston, Massachusetts. In 1986, Mr. Barrett joined Merrill Lynch in Boston as an estate and business-planning specialist working with over 400 financial advisors and their clients throughout the New England region.

In 1992, after leaving Merrill Lynch and moving to Florida, Mr. Barrett founded The Barrett Companies Inc. and Broker Educational Sales & Training Inc., Wealth Preservation Planning Associates and The Life Settlement Advisory Group Inc.

Mr. Barrett was a qualifying member of the Million Dollar Round Table, Qualifying Member Court of the Table® and Top of the Table® producer. He holds the Certified Financial Planner designation CFP®, Chartered Financial Consultant (ChFC), Chartered Life Underwriter (CLU), Certified Employee Benefit Specialist (CEBS), Retirement Planning Associate (RPA), Certified Plan Fiduciary Advisor (CPFA), Chartered Retirement Planning Counselor (CRPC) and the Chartered Retirement Plans Specialist (CRPS) professional designations.

EJB Financial Press

EJB Financial Press, Inc. (ejbfinpress.com) was founded in 2004, by Mr. Barrett to provide advanced educational and training manuals approved for correspondence continuing education credits for insurance agents, financial advisors, accountants and attorneys throughout the country.

Broker Educational Sales & Training Inc.

Broker Educational Sales & Training Inc. (BEST) is a nationally approved provider of continuing education and advanced training programs to the mutual fund, insurance, financial services industry and an approved sponsor of CPE courses with the National Association of State Boards of Accountancy and Quality Assurance Service (QAS).

For more information visit our website at selfstudyce.brokered.net or call us at 800-345-5669.

This page left blank intentionally

TABLE OF CONTENTS

CHAPTER 1

INTRODUCTION

Overview

401(k) plans have only been part of the investment landscape for four decades, but they have grown to be the most widespread private-sector employer-sponsored retirement plan in the United States. With $5.3 trillion in assets at the end of the third quarter of 2017, 401(k) plans have become one of the largest components of U.S. retirement assets, accounting for 19.5 percent of all U.S. retirement assets, according to the Investment Company Institute (ICI).

This chapter will begin with an examination of the historical background of the 401(k) plan, its legislative history, and the advantages and disadvantages for setting up a 401(k) plan, for both the employer and employees. At the end of the chapter, it will examine the future of 401(k) plans.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Relate the history and evolution of 401(k) plans;
- Identify the legislative history of 401(k) plans; and
- Recognize the growth and the role of 401(k) plans in the future.

The Evolution of 401(K) Plans

Today's 401(k) plan has its origin in defined contribution (DC) plans created well before the passage of the Employee Retirement Income Security Act (ERISA) of 1974 or the addition of Section 401(k) to the Internal Revenue Code (IRC) in 1978. In years before ERISA, many employers offered "*thrift-savings plans*," which allowed employees to make contributions to a plan—but only on an after-tax basis—and modern 401(k) plans copied the idea of participant contributions. At the same time, many employers made before-tax employer contributions to tax-qualified profit-sharing plans, which allowed employers to contribute part of their profits to a trust and to allocate the monies to the accounts of eligible employees. Dating back almost to the introduction of the federal income tax code in 1913, tax rules allowed employees to defer taxation of employer profit-sharing contributions. In addition, taxation on investment earnings on employer and employee contributions were deferred until distributed from the plans.

In the mid-1950s, a number of companies, particularly banks, added to their profit-sharing plans a new feature that came to be called a "*cash or deferred arrangement*," or CODA. Each year, when employees were awarded profit-sharing bonuses, they were given the option to deposit some or the entire bonus into the plan instead of receiving the bonus in cash. Even though the employee had the right to receive the bonus in cash, which would trigger immediate income tax (under the *constructive receipt doctrine*—see below), a CODA sought to treat any amount the employee contributed to the plan as if it were an employer contribution, and therefore tax-deferred.

Note: Employer contributions, which are deductible as an expense to the employer and are not included in the income of the employee until distributed from the plan.

Principle of Constructive Receipt

Under the principle of "*constructive receipt*," a taxpayer must pay income tax on income earned in a tax year even if the income is not actually received in that year, so long as the income is available to the taxpayer without substantial restriction [Treas. Reg. § 1.451-2]. Accordingly, if an employee is given a choice between receiving compensation now or deferring it until a later tax year, the constructive receipt rule requires immediate taxation regardless of the choice made. A 401(k) plan is at its heart an exception to this rule, because it allows an employee to choose to contribute compensation right before the compensation would otherwise have been paid in cash.

The IRS was somewhat wary of this arrangement but did issue some guidance in 1956. The IRS allowed for this arrangement if two requirements were met:

- The participant made an irrevocable election to defer the profit sharing contribution before the close of the plan year for which the profit sharing contributions were made; and
- More than half of the participants in the plan (who elected to defer) were among the lowest two thirds of all eligible employees.

The IRS later reaffirmed that this type of arrangement could be a qualified plan. Subsequently, the IRS ruled that if such a plan met the nondiscrimination rules of Revenue Ruling 56-497, the deferred contribution would be exempt from the IRS doctrine of constructive receipt [Rev. Rul. 63-180, 1963-2 C.B. 189]. Further clarification of this position was issued in another IRS revenue ruling in 1968 [Rev. Rul. 68-89, 1968-1C.B. 402]. Despite these positive rules, CODAs never became wildly popular. By the early 1970s, there were fewer than 1,000 plans in existence.

Then in 1972, the IRS issued proposed regulations that would dramatically change its previous position. Under the proposed regulations, salary reduction contributions would have been treated, for tax purposes, as if they had been received by the employee in cash. Although the regulations did not deal directly with the profit sharing deferral arrangements, they cast doubt on these arrangements.

However, Congress was concerned about the IRS stance and when it passed *The Employee Retirement Income Security Act* (ERISA) of 1974 it contained a provision that froze the existing tax status of CODAs until the end of 1976. Any such arrangements in existence on June 27, 1974, retained their tax-favored status. The moratorium was deferred twice, the last time until the end of 1979.

Employee Retirement Income Security Act of 1974

The Employee Retirement Income Security Act of 1974 (ERISA) contained sweeping changes in the regulation of pension plans, and created rules regarding reporting and disclosure, funding, vesting, and fiduciary duties. Although ERISA was aimed mostly at "assuring the equitable character" and "financial soundness" of Defined Benefit (DB) pension plans, the Act contained numerous provisions impacting Defined Contribution (DC) plans (like profit-sharing plans, and eventually 401(k) plans). For example, ERISA contained a provision that allowed DC plans to delegate investment responsibility to participants and thereby relieve the plan sponsor from investment responsibility, which today is the basis for participant-directed 401(k) plans. Also included in ERISA was a provision Congress described as a "*freeze of the status quo*," which stated that the IRS could not disqualify any CODA plan adopted before June 27, 1974, but that no new plans could be created unless employee contributions were made solely on an after-tax basis.

The Revenue Act of 1978

In 1978, Congress, unhappy with the uncertainty surrounding CODAs, passed the *Revenue Act of 1978*, which contained a new Subsection (k) to Section 401 of the Internal Revenue Code (IRC). Subsection (k) allowed profit-sharing plans to adopt CODAs, subject to certain requirements, including:

- Restrictions on distributions during employment;
- A requirement that an employee's contributions be fully vested; and
- A numerical nondiscrimination test.

At the same time, Congress added IRC § 402(a)(8) (now located at IRC § 402(e)(3)), which provided that an employee would not be taxed on compensation contributed to the plan pursuant to a CODA, it provided that amounts an employee elects to have contributed to a 401(k) account are not treated as amounts paid or made available to the employee, thereby explicitly trumping the constructive receipt rule (discussed above). This prevents the employee from being taxed on the contributions under the constructive receipt doctrine. The section after various amendments, is now IRC § 402(e)(3). It also treats the amounts an employee elects to have contributed to the plan as employer, rather than employee, contributions to the plan. These new provisions were effective for tax years beginning in 1979. Likely under the impression that very few employers would add a 401(k) feature to their retirement plans, Congress estimated in 1978 that the loss in tax revenue would be "negligible."

On November 10, 1981, the IRS proposed regulations under the new Section 401(k): Internal Revenue Service, "*Certain Cash or Deferred Arrangements Under Employee Plans*," 46 Fed.

Reg. 55544. The regulation made it clear that 401(k) contributions could be made from an employee's ordinary wages and salary, not just from a profit-sharing bonus, as long as the employee agreed in advance to have funds taken from his or her pay and contributed to the plan. Because the proposed regulations essentially opened up 401(k) plans to ordinary wages and salary, November 10, 1981 marks the birth of the modern 401(k) plan. After that date, companies began to add 401(k) contributions to their profit-sharing plans, convert after-tax thrift-savings plans to 401(k) plans, or create new 401(k)-type DC plans.

At the 401(k) plan inception, employee before-tax contributions were also exempt from payroll, or Federal Insurance Contributions Act (FICA), taxes. Total employee and employer contributions were subject to an annual limit ($45,475 in 1982), but there was not a separate limit for employee contributions. The original 401(k) rules also imposed limits based on nondiscrimination tests and permitted loans and withdrawals.

Tax Equity and Fiscal Responsibility Act of 1982

In 1982, the unfavorable regulatory climate of 401(k) plans continued with the passing of the Tax Equity and Fiscal Responsibility (TEFRA) in which Congress reduced the maximum allowable annual contribution to a DC plan to $30,000. In 1983, furthermore, Congress removed the payroll tax exemption, requiring all employee pre-tax contributions be subject to FICA taxes.

Tax Reform Act of 1984

In 1984, the Treasury Department proposed to eliminate Section 401(k) from the Internal Revenue Code. Although this proposal was never implemented, the Tax Reform Act (TRA) of 1984 modified rules for 401(k) plans in elusive ways. It eliminated the possibility of integrating 401(k) plans with Social Security nondiscrimination tests (which previously had been safe harbors). Instead an alternative of testing under the general qualified plan nondiscrimination rules became mandatory. Congress changed the rules because it thought that these plans did not provide adequately for rank-and-file employees and that these plans should be secondary, not primary retirement plans. In addition, certain money purchase pension plans that allowed for salary reductions and were in existence before the passage of ERISA were grandfathered under the law.

Tax Reform Act of 1986

One of the new rules that Congress enacted with the Tax Reform Act (TRA) of 1986 effectively froze the $30,000 maximum annual amount of total contributions (employee and employer) to any type of DC plan, and this freeze was effective for 17 years. Another TRA of 1986 provision added a new, more restrictive annual limit that specifically applied to employee deferrals: an employee could contribute no more than $7,000 pre-tax to 401(k) plans. This rule was a significant restriction on employee contributions in two ways. Previously, any combination of employee and employer contributions could be used to reach the $30,000 contribution limit; now only a portion of the limit could be funded with employee pre-tax contributions. Also, whereas essentially all other restrictions on retirement plans are at the employer level, this new participant deferral limit was levied at the individual level. TRA of 1986 also tightened further the nondiscrimination rules that applied specifically to 401(k) plans.

Small Business Job Protection Act of 1996

It wasn't until the late 1990s that the regulatory climate began to change for 401(k) plans. In 1996, as part of a package of reforms aimed at bolstering small businesses—the Small Business Job Protection Act (SBJPA) of 1996—Congress acted to encourage employers to offer retirement plans, including 401(k) plans. The SBJPA simplified nondiscrimination tests and repealed rules imposing limits on the contribution that could be made to a retirement plan by an employee that also participated in a DB plan. In addition, starting in the late 1990s, the IRS issued a series of rulings allowing automatic enrollment.

Economic Growth Tax Relief Reconciliation Act of 2001

In 2001, the Economic Growth Tax Relief Reconciliation Act (EGTRRA) of 2001 took another step to spur saving through 401(k) and other DC plans. EGTRRA increased the annual DC plan contribution limit, albeit not higher than the $45,475 limit in place in 1982. In addition, the restrictions placed on employee deferrals were loosened as the limit on pre-tax contributions was increased and additional "catch-up" contributions were allowed for employees age 50 and older. With the goal of preserving retirement account even when job changes occur, EGTRRA increased the opportunities for rollovers among various savings vehicles (401(k) plans, 403(b) plans, 457 plans, and IRAs). In addition, EGTRRA permitted 401(k) plans to offer a "*Roth*" feature for after-tax contributions, aka Designated Roth Accounts (DRAC) (see Chapter 7 for a full discussion of the Roth 401(k)). Because of Congressional budget rules, these changes were set to expire after 2010.

Pension Protection Act of 2006

Legislation passed in August 2006, the Pension Protection Act (PPA) of 2006, also aims to foster retirement savings and 401(k) plan participation. Among its many provisions, the PPA makes the EGTRRA pension rule changes permanent and additionally makes some of the rules governing roles pension plan more flexible. For example, the PPA encourages employers to automatically enroll employees in their 401(k) plans and allows employers to offer appropriate default investments (see Chapter 10 for a full discussion of default investments). These measures seek to increase participation in 401(k) plans and facilitate the best use of these plan options by workers.

The American Taxpayer Relief Act of 2012

On January 2, 2013, President Obama signed into law the *American Taxpayer Relief Act of 2012 (ATRA)*. The new law permits 401(k) (as well as 403(b) and governmental 457(b)) plan sponsors to amend their 401(k) plans to permit *any* amount under the plan to be converted to a Designated Roth Account (DRAC) within the plan, even if the amount is not otherwise distributable. Converted amounts are treated as distributions and taxable in the year of conversion. The new law was effective January 1, 2013, but permits conversions of balances accumulated before 2013.

Prior to the new law, 401(k), 403(b) and governmental 457(b) plan sponsors could amend their plans to permit vested account balances to be converted to Roth amounts within the plan, but only if those amounts were otherwise distributable under the terms of the plan and qualified as eligible rollover distributions. This generally meant amounts were convertible only upon the participant's severance from employment, death, disability or attainment of age 59½ or, in the case of profit sharing or matching contributions, upon a stated age, stated event or fixed number of years, although traditional after-tax and rollover contributions and their earnings are generally freely distributable at any time. As under the new law, converted amounts were generally treated as distributions and taxable in the year of conversion.

The Tax Cuts and Jobs Act of 2017

On December 22, 2017, President Trump signed H.R. 1, the "*Tax Cuts and Jobs Act*" into law. Among the provisions of Title 1, Subtitle F there were a couple of changes that impact retirement plans involving: Hardship Distributions and Plan Loans.

The Growth of 401(k) Plans

Despite the legislative and regulatory measures aimed at restricting 401(k) plans in their early years, the number of firms offering 401(k) plans has grown dramatically since their formal introduction in 1981. Since 1984, we have seen the number of plans grow from 17,303 to 533,739 plans in 2014 (see Table 1.1). The growth in participation rates among workers at employers sponsoring plans also has grown considerably, from 7.5 million active participants to over 63 million active participants in 2014 (latest data available), according to Form 5500 filings with the U.S. Department of Labor (see Table 1.1).

Table 1.1
Number of 401(k) Type Plans, Active Participants, Assets, Contributions, and Benefits, 1984-2014

Year	Number of Plans	Active Participants (thousands)	Total Assets	Total Contributions(millions)	Total Benefits (millions)
1984	17,303	7,526	$91,754	$16,291	$10,617
1990	97,614	19,466	384,854	48,998	32,028
1995	200,813	27,759	863,918	87,416	62,163
2000	348,053	39,847	1,724,549	169,238	172,211
2005	436,207	54,623	2,395,792	223,533	189,822
2006	465,653	58,351	2,768,242	251,233	229,217
2007	490,917	59,566	2,981,522	273,235	262,108

Year	Number of Plans	Active Participants (thousands)	Total Assets	Total Contributions(millions)	Total Benefits (millions)
2008	511,583	59,976	2,230,188	285,773	233,452
2009	512,464	60,285	2,734,064	258,357	208,467
2010	518,675	60,510	3,142,141	267,584	245,474
2011	513,496	61,371	3,146,851	285,679	252,692
2012	516,293	63,088	3,530,122	306,092	284,677
2013	527,047	64,495	4,179,351	327,886	328,680
2014	533,739	62,651	4,399,891	349,216	365,657

Source: Form 5500 filings with the U.S. Department of Labor. http://www.dol.gov/ebsa/pdf/historicaltables.pdf

Future of 401(k) Plans

The 401(k) retirement plan has come a long way since its humble beginnings in the early 1980s. However, there are certainly a number of things that need to be fixed to provide today's workers with a retirement income that can protect their lifestyles in retirement.

In recent years, a number of changes have been made in an effort to encourage workers to save more in their 401(k) plans (automatic enrollment), to simplify the process of deciding how to invest their contributions (target date funds), and requirements to have participant statements that clearly show how much monthly or annual income that the person's 401(k) sum is capable of generating.

But, probably the most important change that is taking place and will change the future of 401(k) plans is the demand for more fee transparency. Most 401(k) plans are riddled with so many hidden fees that the typical 401(k) participant isn't aware they're even paying them. And while 401(k) sponsors (employers) have a fiduciary duty to protect their employees against newfangled retirement plan fees, most employers themselves are pretty clueless. Even worse, some employers are acting in collusion with 401(k) providers to obscure the true cost of their company's 401(k) plan. A recent study by the U.S. Government Accountability Office (GAO) proves this. The GAO study revealed that revenue sharing, whereby a mutual fund company shares its fee income with the 401(k) plan's administrator, is a common practice. The actual compensation can range from 0.05 percent to 1.25 percent. Why is it a problem? Because it creates a hidden incentive for the 401(k) service provider to recommend investment choices with higher fees, some of which may even include proprietary funds with substandard performance.

The bottom line: 401(k) plans of the future will need to be shaped by innovation and be able to provide the participant with smartly designed systems that use multiple investment products, with genuine diversification, offer 100% fee transparency, and provide the participant with statements that clearly show how much monthly or annual income that the person's 401(k) sum is capable of generating.

Table 1.2
Time Line for 401(k) Plans

1913	16th Amendment to Constitution Allows Personal Income Tax
1935	Social Security Act Creates Social Security
1942	Revenue Act Introduces Nondiscrimination Rules
1950s	Employers Introduce Cash or Deferred Arrangements (CODAs)
1956	IRS Revenue Ruling First Approves CODAs
1972	IRS Proposes Regulations to Eliminate CODAs
1974	Employee Retirement Income Security Act (ERISA) Grandfathers Existing CODAs Until 1/1/1977; Prohibits Creation of New CODAs; Allows Plan Sponsors to Delegate Investment Responsibility to Participants; Creates Formal Pension Plan Contribution Limits
1976	Tax Reform Act of 1976 Extends Moratorium on CODAs
1978	Revenue Act of 1978 Creates New Section 401(k); Foreign Earned Income Act of 1978 Extends CODA Moratorium Again
1981	IRS Proposes Regulations for 401(k)
1982	Tax Equity and Fiscal Responsibility Act Reduces Total DC Plan Contribution Limit and Imposes Required Minimum Distribution Rules on All Retirement Plans
1983	Social Security Amendments of 1983 Makes 401(k) Participant Contributions Subject to Employment Taxes
1984	Department of Treasury Proposes Repeal of 401(k)
1986	Tax Reform Act of 1986 Effectively Freezes Total DC Plan Contribution Limit; Places Additional Restrictions on Participant Contributions; Tightens Nondiscrimination Tests
1992	Department of Labor Releases Final 404(c) Regulations on Investments in Participant-Directed Plans
1996	401(k) Plan Assets Top $1.0 Trillion
1996	Small Business Job Protection Act (SBJPA) Simplifies Rules to Encourage Employer Adoption of Plans
2001	Economic Growth and Tax Relief Reconciliation Act (EGTRRA) Loosens Restrictions on Participant Contributions; Creates Catch-Up Contributions; Increases Rollover Opportunities Between Plans; Creates Roth 401(k)
2005	401(k) Plan Assets Reach $2.4 Trillion
2006	Pension Protection Act (PPA) Makes Permanent EGTRRA's Higher Contribution Limits; Encourages Automatic Enrollment
2012	The American Taxpayer Relief Act of 2012, enacted at the beginning of 2013, broadened participant's ability to convert their pre-tax account to a DRAC by removing the requirement that the employee must be eligible for an in-service distribution, effective for conversions after December 31, 2012.
2017	Tax Cuts and Jobs Act, Title 1, Subtitle F amended several provisions that impact 401(k) plans:

Sources: Investment Company Institute, Joint Committee on Taxation,
Employee Benefit Research Institute

Chapter 1
Review Questions

1. Prior to the enactment of ERISA, many employers offered what type of savings that allowed employees to make contributions to a retirement plan—but only on an after-tax basis?

( ) A. Thrift-savings plans
( ) B. Employee Stock Option Plans
( ) C. Money Purchase plans
( ) D. Target benefit plans

2. According to ICI, at the third quarter of 2017, 401(k) plans accounted for what percent of all U.S. retirement assets?

( ) A. 19.5 %
( ) B. 33.0%
( ) C. 22.5%
( ) D. 50.0%

3. Which of the following Acts enacted by Congress contained a new Subsection (k) to Section 401 of the Internal Revenue Code (IRC)?

( ) A. Tax Reform Act of 1986
( ) B. Employee Retirement Income Security Act of 1974
( ) C. The Revenue Act of 1978
( ) D. The Pension Protection Act of 2006

4. Which of the following Acts enacted by Congress now requires all employee pre-tax contributions to be subject to FICA taxes?

( ) A. Tax Reform Act of 1986
( ) B. Employee Retirement Income Security Act of 1974
( ) C. The Tax Equity and Fiscal Responsibility Act of 1982
( ) D. The Pension Protection Act of 2006

5. Which of the following Acts enacted by Congress permitted 401(k) plans to offer a "Roth" feature for after-tax contributions, aka the Designated Roth Account (DRAC)?

( ) A. Small Business Job Protection Act of 1996
( ) B. Economic Growth Tax Relief Reconciliation Act of 2001
( ) C. The Deficit Reduction Act of 2005
( ) D. The Pension Protection Act of 2006

This page left blank intentionally

CHAPTER 2

401(k) GENERAL QUALIFICATION REQUIREMENTS

Overview

In order to for a 401(k) plan to qualify for the tax benefits—deductible employer contributions, pre-tax employer contributions, and tax-deferred growth—it must both contain language that meets certain requirements of the tax law and it must be operated in accordance with the plan's provisions.

This chapter will examine the general qualification requirements for setting up and operating a 401(k) plan. It will then examine the eligible employers who can set up a 401(k) plan, the employees who can participate in the plan, as well as the advantages and disadvantages for both the employer and employee. And finally, at the end of the chapter, we will examine the employer costs for setting up a 401(k) plan and the tax credit available for certain employers (plan sponsors).

Learning Objectives

Upon completion of this chapter, you will be able to:

- Describe the general requirements for establishing a 401(k) plan;
- Identify the various elements in operating a 401(k) plan;
- List the entities that are eligible to set up a 401(k) plan;
- Relate the advantages and disadvantage for both the employer and the employee for setting up and participating in a 401(k) plan;
- Determine the costs of setting up a 401(k) plan; and
- Describe the benefits and amount of the small business tax credit.

General Requirements for Establishing a 401(k) Plan

When an employer (plan sponsor), is looking to establish a 401(k) plan, the employer must take certain basic actions. One of the employer's first decisions will be whether to set up the plan themselves or to consult a professional or financial institution—such as a bank, mutual fund provider, or insurance company—to help with establishing and maintaining the plan.

In addition, there are four basic qualification rules necessary to have a tax-advantaged 401(k) plan. They are:

- Adopt a written plan;
- Arrange a trust fund for the plan assets;
- Develop a record keeping system; and
- Provide plan information to participants.

Let's review each of these basic qualification requirements in greater detail.

Adopt a Written Plan Document

ERISA requires that the 401(k) plan be established and maintained pursuant to a written plan document that serves as the foundation for day-to-day plan operations. If the employer has hired someone to help with their plan, that provider may provide the written document (prototype) approved by the IRS.

A prototype plan is one that provides standardized language that is normally used in plans that are routinely approved by the Internal Revenue Service (IRS). Many major financial institutions that participate in the 401(k) business make available IRS-approved prototype plans.

In order to adopt such a plan, the employer (plan sponsor) executes an adoption agreement and selects various plan options. Some organizations offer what is called a flexible pre-approved prototype document, which allows the plan sponsor to select various options in the design phase of the plan with the knowledge that the IRS has already approved the plan for use by the clients of the financial institution. In other words, the plan does not have to obtain separate IRS approval. In an adopting employer, it is the responsibility of the financial institution that maintains the prototype document to keep the plan updated and current with any changes in pension law that might affect it.

This can provide a huge savings in legal costs to the employer (plan sponsor) because the registration fee is nominal. This is particularly true if there are 401(k) plans where the plan options are relatively limited and standardized. But it is important to remember: it is only as good as the entity that uses it.

Alternatively, employers (plan sponsors) have the choice to design their own custom-made plan. The benefit of course, is that the employer will be allowed to custom-design their document that will allow options that are more flexible and provide for easier amendment. Under the IRS's "*volume submitter*" program, a practitioner can gain blanket approval for the standard language used in all of its plan documents and request IRS approval only on the language of the plan that varies from the pre-approved language [Rev. Proc. 2000-20]. This may be the best solution to the prototype – versus – custom plan for many employers (plan sponsors), because it provides the convenience and cost savings of a prototype document, the ability to provide specific customized language provisions appropriate for their individual company requirements, and a competent advisor.

Whether the employer (plan sponsor) uses a prototype or customized document or something in between the most important element is the person or people who are advising the client with respect to the design features to become part of the plan. Here, the level of experience and depth of knowledge of the individual organization involved is the most relevant inquiry.

If an employer (plan sponsor) decides not to use a pre-approved prototype document, the sponsor has the option to seek advance determination about the qualified status of its retirement plan by the IRS. This written application procedure results in the issuance of a determination letter. A favorable response from the IRS indicates that in its opinion, the plan meets all of the criteria needed for it to be deemed qualified under the Internal Revenue Code (IRC), if the plan complies, in operation, with applicable rules [IRC§ 401(a)].

Note: The receipt of a determination letter is not an absolute requirement under the IRC regulations. However, as a practical matter it makes inherent good sense to undergo this procedure because it will provide the employer (plan sponsor) some assurance that its 401(k) plan is qualified under current law, and that it will remain so unless there are plan amendments or changes in the law (or if the plan does not comply in operation-discussed below). Further, if the IRS examines (audits) the plan in absence of a determination letter, the IRS may suspect that the plan is not in compliance and would subject it to intense scrutiny and penalties.

There is no significant filing and procedural requirements associated with obtaining a determination letter. Employers (plan sponsors) who are looking to set up a new 401(k) should definitely seek good legal assistance.

Arrange a Trust for the Plan Assets

With limited exception, under Section 403 of ERISA all assets of the 401(k) plan must be held in trust by one or more trustees to assure that assets are used solely to benefit the participants and their beneficiaries. Under Treas. Reg. § 1.401-1(a)(3) the following tests must be met in order to constitute a qualified trust under IRC § 401:

- It must be part of a pension, profit-sharing, or stock bonus plan established by an employer for the exclusive benefit of his employees or their beneficiaries:
    - It must be formed or availed of for the purpose of distributing to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan. And, in the case of a plan which covers any self-employed individual, the time and method of such distribution must satisfy the requirements of IRC § 401(a)(9) with respect to each employee covered by the plan;
    - It must be impossible under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries:

    - The trust instrument must be part of a plan which satisfies the requirements of IRC § 410 (relating to minimum participations standards); and
    - The contributions and benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of IRC § 414 (q).
- The trust shall not constitute a qualified trust unless the plan satisfies the requirements of IRC § 411 (relating to minimum vesting standards);
- It must, if the plan benefits any self-employed individual who is an owner-employee, satisfy the additional requirements for qualification contained in IRC § 401(a)(10) and (d); and
- For taxable years beginning after December 31, 1962, self-employed individuals may be included in qualified plans.

In addition to the above requirements, the trust must have at least one trustee to handle contributions, plan investments, and distributions. Since the financial integrity of the plan depends on the trustee, selecting a trustee is one of the most important decisions an employer will make in establishing a 401(k) plan. The trustees need to be named in the trust document or plan document, or at least be appointed by the named fiduciary in the plan. The named fiduciary refers to one or more representatives designated in the plan instrument by name or by title responsible for the plan operation. The named fiduciary requirement provides participants of the plan or other interested parties with the ability to identify the person responsible for plan operations.

Note: If an employer sets up a 401(k) plan through insurance contracts, the contracts do not need to be held in trust.

Develop a Recordkeeping System

An accurate recordkeeping system will track and properly attribute contributions, earnings and losses, plan investments, expenses, and benefit distributions. If a contract administrator or financial institution assists in managing the plan, that entity typically will help keep the required records. In addition, a recordkeeping system will help the employer (plan sponsor), plan administrator, or financial provider prepare the plan's annual return/report that must be filed with the federal government (discussed below).

Provide Plan Information to Participants of the Plan

Treas. Reg. 401.1(a)(2), requires that plan information be communicated to employees. In addition, the Department of Labor has regulations that also contain this requirement and detail the content and method for this communication.

These regulations require the employer (plan sponsor) to notify employees who are eligible to participate in the plan about certain benefits, rights, and features. In addition, a summary plan description (SPD) must be provided to all participants. The SPD is the primary vehicle to inform participants and beneficiaries about the plan and how it operates. The SPD typically is created with the plan document.

Operating a 401(k) Plan

Once an employer (plan sponsor) decides to establish a 401(k) plan, the employer (plan sponsor) assumes certain responsibilities in operating it. If the employer hired someone to help in setting up their plan, that arrangement also may have included help in operating the plan. If not, the employer will have to make another important decision whether to manage the plan themselves or to hire a professional or financial institution – such as a bank, mutual fund provider, or insurance company–to take care of some or most aspects of operating the plan.

Elements of operating 401(k) plans include:

- Participation;
- Contributions and Vesting;
- Coverage and Nondiscrimination Rules;
- Investing 401(k) plan monies;
- Fiduciary responsibilities;
- Disclosing plan information to participants and Reporting to government agencies; and
- Distributing plan benefits.

Eligible Entities to Setup a 401(k) Plan

Virtually all organizations, with the exception of state and local governments, can establish 401(k) plans:

- *Sole Proprietors.* The sole proprietor, or self-employed person, is treated as his or her own employee. The calculations involved are more difficult, since the compensation of the self-employed individual (either a sole proprietor) is reduced by the contributions made on behalf of common-law employees. Also, the self-employed individual's compensation must be reduced by one-half of the Social Security contribution (SECA deduction);
- *Partnerships.* If the self-employed individual is a partner, he or she is treated as an employee of the partnership. Special rules apply to a partnership's profit sharing plan if it includes a CODA. A partnership may maintain a CODA, and individual partners may make cash-or-deferred elections with respect to compensation attributable to services rendered to the partnership. Generally, the same qualification rules apply to a partnership CODA as apply to other CODA. A partner's compensation is deemed currently available on the last day of the partnership taxable year. Accordingly, an individual partner may not make a cash-or-deferred election with respect to compensation for a partnership taxable year after the last day of that year;

- *Corporations.* Regular (or C), S, and limited liability corporations (LLC) are eligible;
- *Tax-exempt organizations.* Tax-exempt organizations were prevented from adopting 401(k) plans from 1987 to 1997 until the Small Business Job Protection Act of 1996 repealed earlier legislation. (Plans that were in effect prior to 1987 with tax-exempt organizations and state and local governments were grandfathered and allowed to continue); and
- *Indian Tribal governments.*

It is important to remember that under IRC § 401 (k)(1), the 401(k) plan must be part of a profit sharing plan, a stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan, meaning the employer must be eligible to offer one of those plans.

401(k) Plan Advantages

From the perspective of the employer (plan sponsor), there are a number of advantages to offer a 401(k) plan to employees. Let's examine some of those advantages:

- *Lower costs.* Compared to other types of qualified retirement plans, such as defined benefit (DB) plans, the cost of contributing to a 401(k) are relatively small, especially if most of the 401(k) contributions are employee elective contributions;
- *Higher tax deductions.* Total annual employer and employee elective contributions can exceed 25% and are deductible by the employer. Employer deductions for employer and employee elective plan contributions can exceed 25% of plan participant's compensation;
- *Limited fiduciary responsibility and minimizes risk exposure*. Most 401(k) plans give participants the option to choose how to invest the money in their plan accounts. By offering participants the right to direct their investments and complying with the other requirements of ERISA Section 404(c), the employer helps to protect itself from fiduciary liability and minimizes its exposure to investment risk;
- *Credit for 401(k) elective deferrals.* The tax credit may increase the amount of elective deferrals made by non-highly compensated employees (NHCE). If this happens, it will permit larger elective deferrals by highly compensated employees (HCE) and make it easier for 401(k) plans to pass the ADP test; and
- *Optional profit sharing features.* An employer can use the discretionary profit sharing features of a 401(k) profit sharing plan to implement an age-weighted or cross-tested allocation formula that favors shareholders or key employees.

From the employee's perspective, the 401(k) plan offers the following advantages:

- *Pretax contributions.* The 401(k) plan allows participants to contribute before-tax dollars to the plan, thereby reducing their W-2 taxable incomes;
- *Investment choices.* In "*participant directed*" plans, employees allocate their contributions among the range of choices offered through their particular plans. This range of choices can be very broad;

- *Credit for 401(k) elective deferrals.* Low income employees may receive a tax credit. This provides a strong monetary incentive for low income employees to participate in a 401(k) plan;
- *Hardship withdrawals.* In-service withdrawals by employees for certain hardships are permitted. However, hardship withdrawals are taxable and subject to potential penalties under certain circumstances; and
- *Loans.* A plan generally may permit participants to borrow against their plan accounts. However, both the IRS and U.S. Department of Labor have rules governing the operation of the loan program (as previously discussed with profit sharing plans above).

401(k) Plan Disadvantages

There are several disadvantages to establishing a 401(k) plan for both the employer and the employee. Let's first examine the disadvantages of a 401(k) plan from the perspective of the employer, they include:

- *Administration of the plan can be costly and complex*. Employers are required to maintain ongoing administrative costs, intensive communication throughout its lifecycle;
- *Fiduciary responsibilities*. Employers are required to maintain fiduciary responsibility of the plan and follow all ERISA requirements; and
- *Nondiscrimination funding and contribution requirements.* The government imposes special nondiscrimination requirements on all 401(k) plans. The purpose of these requirements is to maintain a reasonable balance between amounts deferred by highly compensated employees (HCEs) and those deferred by non-highly compensated employees (NHCEs). These requirements can be costly and difficult to administer.

Next, let's examine the disadvantages from the perspective of the employee, they are:

- *Inadequate retirement balance.* Unless the employer also offers another plan such as a combination plan, employees who enter the plan later in life may have account balances at retirement that will not satisfy their retirement income needs;
- *Investment risk*. If employees direct their investment choices, they run the risk of picking poor investments; and
- *Lack of security of* employees contributions.

Costs of Setting up a 401(k) Plan

An employer who considers the adoption of a 401(k) plan must take its financial impact into account. The biggest portion of the cost of a 401(k) plan is employer contributions to the plan. The employer needs to measure the level of its contributions on both an initial and ongoing basis. In addition, the employer will also incur other costs as a result of adopting a 401(k) plan, including:

- Installation Costs. The installation of a 401(k) plan can be a significant cost in itself, involving a consultant to design the plan, an attorney to draft the plan and other related documents, and programmers to make changes to the payroll system, or website. Installation costs can be reduced, if a master or prototype plan or volume submitter plan is used;

- *Enrollment Costs*. Enrollment costs can also be a factor. Although the cost of enrollment materials and a consultant's time may be nominal, the cost to the employer (plan sponsor) of meetings for all employees could be substantial. Enrollment costs are highest at the time the plan is installed but will be ongoing as new employees become eligible for the plan. In some cases, re-enrollment meetings will be held to increase the participation of existing participants. Many employers have found that existing participants in the 401(k) plan do an excellent job of "selling" the plan to their fellow employees;
- *Administration Costs.* Ongoing administrative costs should be factored in as well. The cost of participant recordkeeping can vary, ranging from as little as $10 per head to close to $50 or more per head, depending on the size of the employer, the investment choices allowed the participants, and the frequency of reports. The trustees' fees for trust recordkeeping may be nominal or substantial, depending on the types of investment used in the plan. In some cases, the administrative costs will be deducted from plan assets, thus minimizing the employer's direct costs. However, caution should be used in this approach, as this could have a significant impact of the rate of return realized by employees in a new 401(k) plan. On the other hand, the impact of deducting costs from plan assets in an existing 401(k) plan with substantial assets should be minimal. If the employer chooses to pay fees directly, such costs will be tax deductible:
    - One way to compute costs for administrative expenses, divide the net expenses (for instance, $12,000) by the total value of the plan (let's say $1.5 million). Multiply that percentage—which is 0.8% (.008) in this example – by the total account balance. That will give the plan sponsor a figure of the total plan expenses that are deducted from 401(k) plan; and
  - Compliance costs. Estimating these costs will require decisions regarding the design, funding, and reporting frequency of the plan. It is also important to remember that the U.S. Department of Labor (DOL) has issued new regulations to disclose more detailed information about fees and expenses to plan sponsors. It may not lead to fees going down, but at least plan sponsors may be a little less in the dark about these costs.

Tax Credit for Startup Costs for Small Businesses

As was discussed above, the startup costs for a 401(k) plan have always been a major hurdle, especially to small businesses who want to offer a 401(k) plan. However, a provision of The Economic Growth and Tax Relief and Reconciliation Act (EGTRRA) of 2001 was set up to help small businesses scale this barrier and to give their employees a saving opportunity. EGTRRA implemented a credit for employers to offset the startup cost and the cost of educating employees about the 401(k) plan.

For costs paid or incurred in tax years beginning *after* December 31, 2001, for retirement plans that first become effective after that date, the employer (plan sponsor) may be able to claim a tax credit for part of the ordinary and necessary costs of starting a 401(k) plan (including a SEP, SIMPLE, or qualified plan). The credit equals 50% of the cost to set up and administer the plan and educate employees about the plan, up to a maximum of $500 per year for each of the first three years of the plan (total deduction is $1,500). For plans that become effective after 2002, the employer can choose to start claiming the credit in the tax year before the tax year in which the plan becomes effective.

To qualify for the credit the plan sponsor must have had 100 or fewer employees who received at least $5,000 in compensation from the employer for the preceding year. At least one participant must be a non-highly compensated employee (NHCE). The employees generally cannot be substantially the same employees for whom contributions were made or benefits accrued under a plan of any of the following employers in the three-tax-year period immediately before the first year to which the credit applies:

- The owner;
- A member of the controlled group that includes the owner; and
- A predecessor of the owner or a member of a controlled a controlled group that includes the owner.

The credit is part of the general business credit, which can be carried back or forward to other tax years if it cannot be used in the current year. However, the part of the general business credit attributable to the small employer pension plan startup cost credit cannot be carried back to a tax year beginning before January 1, 2002. To take the credit, the employer (plan sponsor) will file IRS Form 8881, Credit for Small Employer Pension Plan Startup Costs.

Chapter 2
Review Questions

1. In order for a 401(k) plan to be considered a "qualified" retirement plan, it must meet which Section of the Internal Revenue Code (IRC)?

( ) A. IRC § 401(a)
( ) B. IRC § 457
( ) C. IRC § 408
( ) D. IRC § 408A

2. Which of the following types of retirement plans can include a 401(k) plan and be considered a qualified retirement plan under IRC § 401(a)?

( ) A. A profit-sharing plan
( ) B. Stock bonus plan
( ) C. A money purchase pension plan in existence on June 27, 1974, that included a salary reduction arrangement on that date
( ) D. All of the above

3. Which of the following entities is not allowed to set up a 401(k) plan?

( ) A. Corporations
( ) B. Sole Proprietors
( ) C. State and local governments
( ) D. Tax-exempt entities

4. For an employer, what is the largest cost when setting up a 401(k) plan?

( ) A. Installation costs
( ) B. Employer contributions
( ) C. Administrative costs
( ) D. Compliance costs

5. Which of the following types of retirement plans will qualify for the Credit for Small Employer Pension Plan Startup Costs?

( ) A. SEP IRA
( ) B. 401(k) plan
( ) C. SIMPLE IRA
( ) D. All of the above

CHAPTER 3

401(k) PLAN CONTRIBUTIONS

Overview

As was discussed Chapter 1, a 401(k) plan is an employer sponsored defined contribution (DC) plan that is either a profit sharing plan or a stock bonus plan that contains what is known as a cash or deferred arrangement (CODA). All 401(k) plans by definition permit CODAs. For this reason, the terms CODA and 401(k) are used interchangeably, though technically the CODA is merely a feature of the 401(k) plan. In actuality, the term 401(k) governs only the employee's elective contributions (that is, the CODA). Other types of contributions are governed under different sections of the Internal Revenue Code (IRC). Yet, it is common for employers and employees to use 401(k) in reference to the whole plan.

This chapter will examine the various types of contributions allowed in a 401(k) plan, the minimum participation rules, as well as the maximum contribution limits. It will also examine the top-heavy rules by defining a key employee and a highly compensated employee (HCE), the aggregation rules, vesting schedules and the timing of making contributions to the plan.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Identify the four basic types of contributions to a 401(k) plan;
- Determine maximum contribution limits;
- Describe the minimum participation requirements;
- Relate the Top Heavy Contribution Rules and aggregation of plans;
- Distinguish the various vesting schedules; and
- Identify the time frame for making contributions.

Contributions

A 401(k) plan provides four basic types of contributions. They may include:

- Elective (salary) deferral contributions (pre-tax, after tax and catch up);
- Matching contributions;
- Discretionary non-elective contributions; or
- Catch-up contributions.

As a typical 401(k) feature, rollover contributions into a 401(k) plan are accepted. Other than rollover contributions, all of these contributions are made by the employer to the 401(k) plan.

Next, we will examine in greater detail each of these types of contributions, beginning with elective deferral contributions.

Elective Deferral Contributions

An elective deferral contribution, commonly called a salary deferral, is a contribution made by an employer pursuant to and after an employee's cash or deferred election is made [Treas. Reg. §§ 1.401(k)-1(g)(3), 1.401(k)-6]. Elective deferrals are amounts that employees elect to contribute to the 401(k) plan out of their wages. The maximum amount that any employee may elect to contribute to any 401(k) plan increases to $18,500 in 2018 from $18,000 in 2017 [IRC § 402(g)(1)]. This calendar limit is adjusted annually. Table 3.1 illustrates the historical elective deferral limits.

Table 3.1
Historical Elective Deferral Limits

Year	Limit
2006	$15,000
2007	$15,500
2008	$15,500
2009	$16,500
2010	$16,500
2011	$16,500
2012	$17,000
2013	$17,000
2014	$17,500
2015	$18,000
2016	$18,000
2017	$18,000
2018	$18,500

Source: Internal Revenue Code (IRC) Section 402(g)(1)

The 401(k) plan can be a profit-sharing, stock bonus, pre-ERISA money purchase pension, or a rural cooperative plan. The deferred wages (elective deferral) are not subject to federal income tax withholding at the time of deferral, and they are not reflected as taxable income on the employee's individual income tax return. Beginning in 2005, after passage of the Economic Growth Tax Relief Reconciliation Act (EGTRRA) of 2001, Section 402A, 401(k) plans are now permitted to allow their employees to make "*Designated Roth Accounts*" (DRACs) that are generally subject to taxation under the rules applicable to Roth IRAs. This option does not increase the amount ($18,500 for 2018) that may be contributed to the plan through elective deferrals. Rather, if the employer allows these DRAC contributions, the employee may choose to have part of all of his/her regular elective deferrals in the 401(k) plan contributed into a DRAC in the plan rather than into a regular account. The employer must maintain separate records for the DRAC and non-DRAC accounts [IRC § 402A (b)(2)] and the DRAC deferrals will be included in the employee's taxable income in the year of the deferral.

A 401(k) plan that provides for elective deferrals, must provide that for each participant the amount of elective deferrals under the plan and all other plans, contracts, or arrangements of an employer maintaining the plan may not exceed the amount of the limitation in effect, for 2018 $18,500 [IRC § 402(g)(1); IRC § 401(a)(30)]. In addition, elective deferral contributions, other than the age 50 catch-up contributions, are subject to discrimination testing under the ADP test (discussed in Chapter 4) unless it meets the rules and requirements of a Safe-Harbor plan discussed in Chapter 5. Elective contributions are 100 percent vested and are subject to the limitations on distributions.

Matching Contributions

A matching contribution is an employer contribution that is allocated on the basis of a participant's elective deferral contributions or, less typically, a participant's employee after tax contributions [IRC § 401(m)(4)(A); Treas. Reg. 1.401(m)-5]. The rate of matching contributions may be specified in the plan document or may be determined at the discretions of the employer. It may be made on an ongoing basis, as elective contributions are paid into the 401(k) plan, or at or after the end of the plan year. Matching contribution are subject to discrimination testing under the ACP test unless it meets the safe-harbor rules.

According to a recent study by BrightScope after reviewing DOL Form 5500 data in 2014 (latest data available), the percentage of all 401(k) plans with employer contributions (by plan assets) was 77 percent, which has not changed much over the past several years (see Table 3.2).

Table 3.2
Employer Contribution Activity in 401(k) Plans (2006-2014)

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Less than $1m	72	72	73	71	67	68	68	68	69
$1m to $10m	88	89	88	85	81	82	83	84	85
>$10m to $100m	94	94	95	91	89	91	92	92	93
>More than$100m	97	97	97	96	95	97	97	97	98
All	78	78	78	76	72	73	74	76	77

Source: BrightScope/ICI Defined Contribution Plan Profile: A Close Look At 401(k) Plans, 2014, December 2016
https://www.ici.org/pdf/ppr_16_dcplan_profile_401k.pdf

Larger plans were more likely to have employer matching contributions. In fact, more than nine in 10 plans with more than $10 million in plan assets had employer matching contributions in 2014.

For those 401(k) plans that do provide a match, there is a wide range of company match levels. A typical matching situation is: the employer matches 50% of employee contributions for the first 6% of salary that an employee contributes – so the company will not match more than 3% of the employees' salary (See Example 1 below). Some companies will provide a straight match, up to a certain limit – rather than matching 50% of employee contributions, they will match 100% of employee contributions up to a set percentage-of-employee-income (See Example 2 below). A few companies will provide a dollar-for-dollar match on all contributions by an employee, though it is rare. Under those circumstances, the company match would be limited only because the employee contribution is limited –the 2018 limit is $18,500 per year. Here are some example scenarios to illustrate how company matches work.

> ***Example 1****: Company Matches Percentage of Employee Contribution, Up to limit:*
> Tom Smith makes $50,000 and has elected to contribute 6% of his annual salary to his 401(k) plan. Tom's company will match 50% of his contributions, only up to 3% of his salary each year, Tom would contribute $3,000 (6% of his salary) to his 401(k) plan. Each year, Tom's company would contribute $1,500 (3% of his salary) to his 401(k) plan. The total yearly contribution made to Tom's 401(k) would be $4,500. Even if Tom elected to contribute 10% of his salary to his 401(k) plan, which would be $5,000, his company still would only contribute 3% because they stipulated that their match is capped at 3% of employee salary.

> ***Example 2:*** *Company Directly Matches Employee Contribution, Up To Limit:*
> Susie Jones makes $50,000 and has elected to contribute 5% of her annual salary to her 401(k) plan. Susie's company offers a 7% match each year, Susie would contribute $2,500 (5% of her salary) to her 401(k) plan each year, Susie's company would contribute $2,500 (5% of her salary) to her 401(k) plan. The total yearly contribution made to Susie's plan would be $5,000. Susie's company would be willing to match up to 7% of her salary (up to $3,500); since Susie only elected to contribute 5%; that is all her company will contribute.

A recent report, "*The 401(k) Benchmark 2016*," prepared by the 401(k) Help Center, reported that the average company contribution in 401(k) plans was 2.7% of pay. Numerous formulas are used to determine company contributions. The most common type of fixed match, reported by 40% of employers, is $.50 per $1.00 up to a specified percentage of pay (commonly 6%). Thirty-eight (38) percent of all plans match $1.00 per $1.00 up to a specified percentage of pay. Forty-three (43) percent of employees said the company match was the primary reason they participate in the plan.

Be aware, different employers have different ways of figuring the match. The problem is that depending on the match formula, employees can lose part of the match. As was mentioned above, most employers do it on a payroll basis, contributing a little bit with each paycheck, matching the amount the employee saves out of each paycheck.

Some 401(k) plans have what's called a "*true-up*" feature to help the employee get the maximum match. The employer looks at the employee's account to determine if the average percentage the employee contributed would result in the higher match; if that's the case the employer makes the "*true-up*" contribution.

As the advisor, you should always take time to review your client's 401(k) plan annually to make sure that they are maximizing all of the possible employer contributions to their 401(k) plan. Don't allow your clients to miss the "free-money."

Discretionary (Non-Elective) Contributions

A discretionary contribution, sometimes referred to as a profit-sharing or non-elective contribution (NEC), in a 401(k) plan is an employer contribution that is allocated on the basis of compensation or in some manner other than on the basis of elective contributions or employee after-tax contributions. Discretionary non-elective contributions do not need to be included in any of the special nondiscrimination rules under IRC § 401(a)(4). Discretionary non-elective contributions may sometimes be used to help satisfy the ADP and ACP tests. A participant's right to receive an allocation of a discretionary non-elective contribution cannot depend on whether h/she had made elective contributions [IRC § 401(k)(4)(A); Treas. Reg. § 1.401(k)-1(e)(6)(i)].

Catch-Up Contributions

Congress added the catch-up contribution option to retirement plans out of concern that baby boomers hadn't been saving enough for retirement. So, to encourage more savings by older workers, the *Economic Growth Tax Relief Reconciliation Act* (EGTRRA) of 2001 added "*catch-up"* contributions, which allow additional deferrals by employees (participants) who turn age 50 or older within the end of the plan year. Age-50 catch-up contributions are possible in 401k, 403(b) and 457 plans, and IRAs, but the rules differ among plans.

Participants in a 401(k) plan are allowed to contribute extra amounts over and above the before tax contribution limit (elective deferrals). The maximum dollar limitation under IRC § 414(v)(2)(B)(i) for catch-up contributions to a 401(k) plan remains at $6,000 for 2018 (see Table 3.3), except for a SIMPLE 401(k) the catch-up contribution limit is $3,000 (same as in 2017).

Table 3.3
Historical Catch-up Contribution Limits

Year	Limit
2006 - 2008	$5,000
2009 - 2014	$5,500
2015 - 2018	$6,000

Source: Internal Revenue Code (IRC) Section 414(v)

The catch-up contribution amount is in addition to IRC § 402(g) deferrals and the nondiscrimination tests do not cover catch-up contributions. Catch-up contributions are also not counted against the discrimination rules under the IRC § 415(c) limit. Employers do not have to offer catch-up contributions. But, according to the Plan Sponsor Council of America (www.psca.org), 98.6% of all 401(k) plans permit catch-up contributions and 42.7% of these plans offer a match on the catch-up contributions.

Overall Contribution Limitation

All 401(k) plans are profit sharing plans. Profit sharing plans have a deductibility limit for employer contributions of 25% of eligible compensation (20% if self-employed) but elective deferrals do not count towards the 25% limit [IRC § 404 (a)(3)].

As was discussed above, employer contributions include Matching, Discretionary (profit sharing), and Safe Harbor contributions. The annual allocation limit for each individual employee, which includes the non-catch-up salary deferral and all contributions and forfeitures allocated during the plan year, is the lesser of 100% of compensation or $55,000 in 2018, an increase of $1,000 from $54,000 in 2017 [IRC § 415].

> ***For Example:*** $18,500 401(k) salary deferral plus $36,500 discretionary contribution = $55,000; this meets the $55,000 limit in 2018. This employee (if age 50 or over) could also defer an additional $6,000—for a total of $61,000.

Note: As discussed above, the catch-up contribution of $6,000, if age 50 or above, is not counted towards the IRC § 415 limit. So the dollar limit for a salary reduction plan is, in effect $61,000 for 2018 ($55,000 plus $6,000 catch up amount).

Under IRC § 401(a)(17) and 404(I) the maximum annual compensation of each employee that can be taken into account under a plan for any year must not exceed $275,000 for 2018 (was $270,000 in 2017) and subject to cost-of-living adjustments in later years.

Minimum Participation Requirements

To participate in a 401(k) plan, an employer may choose to have no eligibility requirements, which means the employee becomes eligible on date of hire, or the employer may be allowed to impose two eligibility requirements. They are:

- Year of Service requirements [IRC §§ 410(a)(1)(B)(ii)]; and/or
- Age requirements [IRC § 410(a)(1)(A)(ii)].

Year of Service

The year of service requirement may require a certain number of months of employment, or may require up to one year of employment before becoming eligible to participate in the 401(k) plan. The biggest confusion regarding eligibility provisions surrounds the year of service calculation. A year of service is calculated generally as a twelve-month (12) period beginning on the first day of employment during which an employee completes at least 1,000 hours of service. If the employee does not complete 1,000 hours of service during the initial eligibility computation period, the next period begins on the anniversary date of employment or, if provided in the plan, on the first day of the plan year during which the anniversary date falls.

Age Requirement

The second eligibility that plans may impose is an age requirement. The maximum age requirement that a plan may impose for eligibility in the plan is age twenty-one (21) years.

Top-Heavy Contributions

The top-heavy plan rules were added to the Internal Revenue Code by the *Tax Equity and Fiscal Responsibility Act* (TEFRA) of 1982. To be qualified under IRC § 401(a), a 401(k) plan must contain provisions which meet the requirements of IRC § 416 and which will become effective if the plan becomes top-heavy [IRC § 401(a)(10(B)].

General Requirements

In general, a plan is top-heavy if 60 percent of the aggregate accrued benefits or account balances under the plan are for the benefit of certain "*key employees*." Generally, a key employee is:

- A 5 percent owner of the employer;
- A 1 percent owner of the employer with over $150,000 in compensation from the employer; or
- An officer of the employer with over $175,000 (and subject to cost-of-living adjustments in later years) in compensation from the employer [IRC § 416(i)(1)(A)(i)].

Plans covering few employees are more likely to be top-heavy than plans covering a large number of employees.

> ***For Example:*** If key employees make up a substantial percentage of the workforce, it is more likely the plan will become top-heavy. Plans of larger employers can also be top-heavy where the employer maintains separate plans for its divisions. If the smaller division employ a large number of highly-paid employees who are key employees, their plans may be top-heavy.

Even if a plan passes a nondiscrimination test of IRC § 401(a)(4), it must be examined for top-heaviness. Accrual or allocation rates under a plan can be nondiscriminatory, but the total amount of the allocations in the key employees' accounts (or their benefit accruals) could cause them to have too large a share of the plan assets and result in a top-heavy plan.

A top-heavy plan does not include a SIMPLE IRA under IRC § 408(p). Also, a SIMPLE IRA would not be included if it meets the plan requirements of IRC § 401(k)(11) and permits no contribution other than those required by IRC § 401(k)(11) [IRC § 401(k)(11)(D)(ii)]. And, a top-heavy plan does not include a plan for any year that it meets the "*Safe-Harbor*" requirements under IRC § 401(k)(12) for minimum contributions for participants and makes matching contributions that meet IRC § 401(m)(11) [IRC § 416(g)(4(H)].

Key Employee

The general rules which apply to a key employee are as follows:

- Any employee who at any time during the plan year containing the determination date (the determination date year) is an officer who meets a compensation threshold, a 5% owner of the employer, or a 1% owner of the employer who meets a compensation threshold [IRC § 416(i)];
- Compensation includes elective deferrals under a qualified cash or deferred arrangement (CODA) and other elective deferrals under IRC § 402(g)(3), as well as any amount which is contributed or deferred by the employer at the election of the employee and which is not includible in the gross income of the employee by reason of IRC §§ 125, 132(f)(4) or IRC § 457 [IRC § 416(i)(1)(D)]; and
- The compensation received from each employer is aggregated under IRC § 414(b), (c) and (m) to determine who is a key employee [Reg. 1.416–1, T–20].

Officer Defined

The general rules which apply to an officer are as follows:

- An officer of the employer having annual compensation in excess of $175,000 (adjusted under IRC § 416(i)(1)) is a key employee [IRC § 416(i)(1)(A) and Reg. 1.416–1, T–12];
- An officer is determined based on the source of the officer's authority, the term for which elected or appointed, and the nature and extent of the duties. If an employee has the title of an officer but not the authority, that employee is not an officer for purposes of determining who is a key employee. An employee who does not have the title of an officer but who has the authority of an officer is an officer for key employee purposes [Reg. 1.416–1, T–13];
- Officers (see Reg. 1.416–1, T–15) are in:
    - Corporations;
    - Sole proprietorships;
    - Partnerships;
    - Trusts;
    - Labor organizations; and

    - Associations.
- For purposes of determining the number of officers taken into account; employees described in IRC § 414(q)(5) are excluded [IRC § 416(i)(1)(A) and IRC § 414(q)(5)]; and
- There is no minimum number of officers that may be taken into account. The maximum number of employees who can be treated as officers for purposes of counting as key employees is 50, or, if lesser, the greater of 3, or 10% of the employees. If there are more than 50 officers who meet these requirements, select the 50 officers who had the largest annual compensation during the year of the determination date [IRC § 416(i)(1) and Reg. 1.416–1, T–14].

Five Percent Owner Defined

An employee who is a 5% owner of the employer at any time during the determination date year is a key employee (without regard to compensation). A 5% owner of a corporation is any person who owns more than 5% of the outstanding stock of a corporation or stock possessing more than 5% of the total combined voting power of all stock of the corporation. Use the constructive ownership rules of IRC § 318 to help determine the 5% owner. In determining who is a 5% owner, ownership is determined without aggregating any employers under IRC § 414(b), (c) or (m) [IRC § 416(i)(1)(B)(i)].

One Percent Owner Defined

An employee who is a 1% owner of the employer at any time during the determination year and whose compensation exceeds $150,000 for the determination date year is a "*key employee*" [IRC § 416(i)(1)(A)(iii)]. Use the constructive ownership rules of IRC § 318 to help determine the 1% owner. In determining who is a 1% owner, ownership is determined without aggregating any employers under IRC § 414(b), (c) or (m).

Top-Heavy Minimum Contributions

If a 401(k) plan is top-heavy, the employer must make a contribution to each non-key employee's account who is a plan participant equal to at least 3% of the participant's compensation.

Forfeitures allocated to a participant's account are included in determining whether a 3% minimum contribution has been made, but elective contributions are not. Matching contributions under IRC § 401(m)(4)(A) are taken into account for years after 12/31/01.

The 3% minimum contribution requirement is reduced if the largest percentage contribution made on behalf of a key employee for the plan year is less than 3%.

The minimum contribution cannot be reduced due to Social Security contributions. If the required aggregation group includes a defined contribution (DC) plan and a defined benefit (DB) plan aggregated to meet the requirements of IRC §§ 401(a)(4) or 410, then a 3% minimum contribution is generally required in the defined contribution plan even if the highest contribution rate for a key employee is less than 3% [IRC § 416(c)(2) and Reg. 1.416–1, M–7].

> ***Example 1:*** Plan A is a top-heavy plan. The largest percentage contribution made on behalf of a key employee during the 2018 plan year is to Employee M. Employee M's compensation is $280,000. The employer makes a contribution of $10,000 to Employee M. Because Employee M's compensation is limited to $275,000 for contribution purposes by IRC § 401(a)(17), the percentage contribution made on behalf of Employee M is 4% (10,000 ÷ 275,000 = 3.6%). Each non-key employee must receive a contribution equal to 3% of compensation.
>
> ***Example 2:*** The facts are the same as in the example above, except that the employer makes a contribution of $5,500 to Employee M in 2018. The percentage contribution made on behalf of Employee M is 2% (5,500 ÷ 275,000 = 2%). Each non-key employee must receive a contribution equal to 2% of compensation.

If the employer maintains only one defined contribution plan, each non-key employee covered by the plan must receive the defined contribution minimum. If the employer maintains more than one defined contribution plan and a non-key employee participates in more than one, then only one defined contribution plan has to provide a minimum contribution for the employee [Treas. Regs. 1.416–1, T–10, M–8 and M–12].

Aggregation of Plans

To determine whether a plan is top-heavy, it must be aggregated with certain other plans of the employer. This type of aggregation is known as the *"required aggregation group."* Under certain circumstances, an employer may use "*permissive aggregation*" to aggregate plans not part of a required aggregation group [IRC § 416(g)(2)].

Required Aggregation Group

The "*required aggregation group*" is defined in IRC § 416(g)(2)(A)(i). It consists of each plan of the employer in which a key employee participates during the determination date year (or participated in during any of the four preceding years), and any other plan of the employer which, during this period, is aggregated with a plan in which a key employee participates to meet the nondiscrimination requirements of IRC § 401(a)(4) or IRC § 410.

If the required aggregation group is top-heavy, each plan in the required aggregation group is top-heavy, even if it would not be top-heavy if tested independently, or if it covered no key employees. Similarly, if the required aggregation group is not top-heavy, no plan in the required aggregation group is top-heavy. All plans in a required aggregation group that are top-heavy must satisfy the vesting requirements of IRC § 416(b) and the minimum benefits requirements of I.R.C. § 416(c). [Treas. Reg. 1.416–1, T–10].

Only one defined contribution plan need satisfy the minimum contribution requirements for any non-key employee who participates in more than one defined contribution plan in the required aggregation group [Treas. Reg. 1.416–1, M–8 and T–10].

Permissive Aggregation Group

An employer may also aggregate plans that are not part of a required aggregation group with plans in a required aggregation group, to create a permissive aggregation group, as long as the permissive aggregation group satisfies IRC § 401(a)(4) and IRC § 410 [IRC§ 416(g)(2)(A)(ii)].

If a permissive aggregation group is not top-heavy, none of the plans are top-heavy. If a permissive aggregation group is top-heavy, then the top-heavy requirements apply only to those plans in the required aggregation group [IRC § 416(g)(2) and Treas. Regs. 1.416–1, T-1(b) and (c), T-6, T-7, and T-9–11].

> ***For Example:*** An employer maintains Plan A which covers key employees as well as other employees and independently satisfies the requirements of IRC § 401(a)(4) and IRC § 410. Assume that Plan A is top-heavy when tested on its own. The employer also maintains Plan B. Plan B has no key employees. Plan B is not top-heavy. The employer may permissively aggregate these plans in testing for top-heaviness provided the permissive aggregation group satisfies IRC § 401(a)(4) and IRC § 410.

Vesting

Vesting refers to the extent to which a participant's interest in a 401(k) plan is non-forfeitable. Any portion of that interest that is not vested is subject to possible forfeiture.

Under IRC § 411, it provides the minimum vesting requirements that each employee vest or own, at a minimum, a stated percentage of their interest in the plan each year. A plan's vesting schedule will be set out in the plan document. Amounts that are not vested may be "forfeited" by the employees when they separate from service with the employer. The plan must describe how these forfeitures will be used: either to increase benefits or to fund future benefits for other plan participants.

Contributions to Be 100% Vested

The following kinds of contributions must always be 100% vested:

- Elective contributions [Treas. Reg. §§ 1.401(k)-1(c), 1-401(k)-6];
- Qualified matching contributions (QMACs) [Treas. Reg. §.1.401(k)-6];
- Qualified non-elective contributions (QNECs) [Treas. Reg. § 1.411(a)-1(a)(2)];
- Deemed IRA contributions [IRC § 408(q)];
- Rollover contributions; and
- Non-elective and matching contributions in a SIMPLE 401(k) or Safe Harbor 401(k) Plan.

Also, all of a participant's interest in a 401(k) plan must be 100 percent vested upon the participant's attainment of normal retirement age (NRA), upon the termination or partial termination of the plan, or upon the complete discontinuance of contributions to the plan [Treas.

Reg. §§ 1.411(a)-1(a)(1), 1.411(d)-2(a)(1)]. Although this is not legally required, nearly all 401(k) plans will provide for 100 percent vesting upon a participant's death or disability.

Contributions Not Subject to 100% Vesting

In a 401(k) plan that does not qualify as a SIMPLE plan or a Safe Harbor 401(k) plan, non-elective contributions and matching contributions are not required to be 100 percent vested at all times.

Vesting Schedules

Prior to the enactment of the Pension Protection Act (PPA) of 2006, a 401(k) plan, satisfied the minimum vesting requirements with regard to employer non-elective contributions if the vesting schedule was at least as fast as a five-year "*cliff*" vesting schedule or a three-to-seven year "*graded*" vesting schedule (see Table 3.4). The passage of the Pension Protection Act (PPA) of 2006, reenacted faster vesting rules for 401(k) plans. Effective for plan years beginning in 2007 and thereafter, a 401(k) plan must provide for a participant to become vested in *employer contributions* made in plan years after December 31, 2006, over a schedule that does not exceed one of the following two alternatives:

- *Three-year cliff vesting.* After the completion of three years of service, the participant is fully vested in his or her account. Should the employee terminate service with the employer prior to the completion of three years of service, the employee would not be entitled to any portion of the plan account attributable to employer contributions other than IRC § 401(k) contributions that are 100% vested (see Table 3.4);
- *Two- to six-year graded vesting.* After the completion of two years of service, the participant becomes 20% vested in his or her employer contributions. For each additional year of service after three years, an increase in vesting must occur at a rate of at least 20% per year. The participant is fully vested at the end of six years of service (see Table 3.5).

Table 3.4
Vesting Table for Non-Elective and Matching Contributions
Prior to PPA of 2006

Non-Elective Contributions		Matching Contributions	
Years of Service	Vested %	Years of Service	Vested %
Fewer than 3	0	Fewer than 2	0
3	20	2	20
4	40	3	40
5	60	4	60
6	80	5	80
7 or more	100	6 or more	100
Fewer than 5	0	Fewer than 3	0
5 or more	100	3 or more	100

Table 3.5
Three-Year Cliff Vesting

Years of Service	Vested %
0 - 2	0%
3	100%

Table 3.6
2/20 Graded 6 Year Vesting

Years of Service	Vested %
2	20%
3	40%
4	60%
5	80%
6	100%

Alternative vesting schedules can be used as long as those schedules are as favorable to employees as the two schedules described above:

- *Employer matching contributions.* As under prior law, if the employer matches employee (or employee elective) contributions, the vesting schedules for employer matching contributions may not exceed a two-to six- year graded vesting schedule, or three-year cliff vesting. The PPA did not modify the vesting rules for employer matching contributions, nor did it modify the top-heavy vesting rules; and
- *Dual vesting schedules*. Because the faster vesting schedules enacted by PPA apply to employer contributions (other than employer matching contributions that were already subject to faster vesting requirements) made in plan years after December 31, 2006, a plan may choose to vest employer contributions made for plan years prior to 2007 ("old money") according to the prior law slower vesting schedule used for employer contributions; e.g., five-year cliff vesting or three-to seven-year-graded vesting. The simultaneous use of a prior law vesting schedule (or old vesting schedule) for old money and a new vesting schedule for contributions made after a certain date (plan years after December 31, 2006) is known as "dual vesting." Although dual vesting might achieve a cost savings for an employer that maintains a large plan, the cost associated with additional recordkeeping and administration would probably make this impractical for a small plan.

The IRS refers to dual vesting as "*bifurcated vesting*" (see IRS Notice 2007-7). Among other things, a qualified plan must separately account for contributions made before and after December 31, 2006, and give a participant with at least three years of service the right to elect to have the pre-amendment vesting schedule apply.

Note: The top-heavy vesting rules apply to all employer contributions held in a participant's defined contribution plan account (or all of a defined benefit plan participant's accrued benefits), including those made in plan years prior to 2007. Therefore, a top-heavy defined contribution plan (or defined benefit plan) is not permitted to maintain dual vesting schedules.

Nondiscrimination Tests

One major requirement of any type of 401(k) plan is that it cannot discriminate in favor of certain employees, known as *Highly Compensated Employees* (HCEs). To prevent this from happening, the IRS has developed different tests that a 401(k) must meet depending on the types of contributions, based on the source of contribution and tax treatment.

Coverage Requirements

In addition, the 401(k) plan must be set up to meet the minimum coverage requirements required under IRC § 410, which requires that the employees covered by the plan must meet one of the following three tests designed to ensure that the plan covers at least 70 percent of the non-highly compensates (NHCEs). They are:

- Coverage of 70 percent of non-highly compensated employees;
- The ratio percentage test; and
- The average benefit test.

Definition of "Highly Compensated Employee"

Under IRC § 414(q)(1), in order for the 401(k) plan to be considered "qualified," employee elective contributions and benefits cannot discriminate in favor of HCEs who are defined as any employee who owns:

- 5% or more of the company; or
- Received compensation from the company during the previous year in excess of the compensation threshold for that year. (The "look-back" year for 2018 is 2017. The compensation threshold for 2017 was $120,000. The compensation threshold in effect for 2018 remains at $120,000).

An employer (plan sponsor) can elect to count as HCEs only employees who rank in the top 20% of compensation in the firm, but must include anyone who owns 5% or more of the company.

Time Frame for Depositing 401(k) Contributions

The Department of Labor has enforceable regulations governing when the employer (plan sponsor) has to deposit employer contributions to a 401(k) plan [DOL Reg. § 2510.3-102]. Below we will examine the rules for participant elective contributions and other employer contributions (matching and discretionary non-elective contributions).

Elective Contributions

Under DOL Reg. § 2510.103, the regulations required that participant's elective contributions to a 401(k) be deposited to the plan on the earliest date that the employer can be reasonably segregated from the employer's general assets. Originally, the DOL regulations imposed a 90-day outer limit, but this was shortened because some employers were found to be abusing the system. In its 1996 amendments the DOL issued Reg. § 2510.3-102(b)(1); the regulations now allow an ultimate outer limit deposit deadline in no event later than the fifteenth (15) business day of the month following the month in which the participant elective contributions are deducted from their pay. However, this does not mean an employer can routinely wait until the 15th business day to deposit the funds. The 15th business day is not a safe harbor. Rather, the general rule is that the deferrals be deposited as soon as is reasonably possible after payday. If the employer can segregate and deposit the contributions prior to this deadline, they must do so.

Most companies get it transferred within just a few days. Once at the investment company or plan custodian, it can then take a day or so to get invested and reflected in the participant's account.

The DOL has made another change for 401(k) (and other retirement plans) with fewer than 100 participants. In such plans, contributions must now be deposited with the 401(k) no later than the seventh (7) business day following the day on which such amount was deducted from the employee's paycheck. According to DOL analysis cited in the preamble:

> *"...accelerated remittances could result in $34.5 million in additional income to be credited annually to participant accounts under the plans if no employers choose to delay remittances in response to the safe harbor and $15 million annually even if all eligible employers were to delay remittances to the full duration of the safe harbor."*

To obtain these figures, the DOL used an annual return of 8.3 percent which they note is "an estimate of the long-term rate of return on defined contribution plan assets implicit in the flow of funds account of the Federal Reserve [Board]."

An employer can request an extension of 10 business days beyond the 15 allowed, but most don't because it involves time-consuming administrative procedures. To obtain the extension, the employer must comply with the following requirements set out in the regulation [DOL Reg. § 2510.3-102(d)]:

- Making the contribution to the plan (but not segregating it);
- Notifying the employees and the DOL; and
- Providing a performance bond or letter of credit that must stay in effect for three months after the month in which the extension expires.

For many employers this would be too time consuming and embarrassing to consider.

Other Employer Contributions

Under IRC § 404(a)(6), it provides a different deadline for employer contributions, whether matching or discretionary non-elective, may be made until the due date of the employer's federal income tax return, including extensions.

Contributing to Multiple Plans

Participants with access to both a 401(k) plan, used by most private employers, and a 403(b) plan, used by many nonprofits—perhaps the account holders have two jobs—can contribute to both the 401(k) and the 403(b) plan, but both plans share a combined annual limit ($18,500 in 2018). Each dollar a participant puts in a 403(b) plan reduces the amount they can contribute to the 401(k) plan.

However, the annual limit for a section 457 plan sponsored by a state or local government employer is treated as separate from the 401(k)/403(b) limit. Many large government employers offer their employees both 401(k) and 457 plans, which enables employees to contribute to both plans, and thus have an opportunity to supercharge their retirement savings.

But stay tuned: the Senate GOP's tax reform bill proposed to put in place a single aggregate limit on contributions for an employee in a governmental section 457(b) plan and elective deferrals for the same employee under a 401(k) or 403(b) plan.

Chapter 3
Review Questions

1. Generally, which of the following contributions can be made to a 401(k) plan?

( ) A. Elective contributions
( ) B. Matching contributions
( ) C. Non-elective contributions
( ) D. All of the above

2. Which of the following statements about elective contributions is FALSE?

( ) A. Elective contributions are treated as employer contributions
( ) B. Elective contributions are subject to discrimination testing under the ADP test
( ) C. Elective contributions are treated as employee contributions not employer contributions
( ) D. Age 50 catch-up contributions are not subject to discrimination testing under the ADP test

3. Which of the following kinds of contributions do NOT have to be 100% vested immediately?

( ) A. Employer non-elective contributions
( ) B. Qualified matching contributions (QMACs)
( ) C. Elective contributions
( ) D. Rollover contributions

4. Under the top heavy rules an officer of the employer having annual compensation in excess of what amount would be considered a key employee?

( ) A. $120,000
( ) B. $270,000
( ) C. $150,000
( ) D. $175,000

5. A top-heavy plan requires the employer to make a contribution to each non-key employee's account who is a plan participant equal to what percent of the participant's compensation?

( ) A. 5%
( ) B. 3%
( ) C. 6%
( ) D. 7%

This page left blank intentionally

CHAPTER 4

NONDISCRIMINATION TESTING

Overview

In order for a 401(k) plan to retain its tax qualified status under IRC § 401(a), the Employee Retirement Income Security Act (ERISA) requires several tests each year to prove the plan does not discriminate in favor of employees with higher incomes, known as highly compensated employees (HCEs).

Even though nondiscrimination testing is likely performed by a plan's record-keeper or third-party administrator (TPA), advisors need to understand the basics of the tests, including the types of contributions that are tested, the methods used and the consequences of failing.

This chapter will identify the four nondiscrimination requirements under the Internal Revenue Code (IRC). Then it will examine the various coverage requirement tests under IRC § 410(b), the ADP and ACP tests. The end of the chapter will examine the steps that need to be taken if a 401(k) plan fails the nondiscrimination and coverage tests.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Clarify the purpose of the nondiscrimination tests;
- Demonstrate the applicability of the four nondiscriminatory requirements;
- Apply the three basic coverage tests required under IRC § 410(b);
- Identify the purposes of the ADP and ACP tests;
- Apply the ADP and ACP test requirements; and
- Relate the steps to be taken if a plan fails the nondiscrimination and coverage tests.

Background

Like other qualified retirement plans, a 401(k) plan will retain its qualified status only if the plan contributions or benefits do not discriminate in favor of highly compensated employees (HCEs). As was discussed in Chapter 3, the Internal Revenue Service (IRS) defines "highly compensated employee" as an individual who:

- Owned more than 5% of the interest in the business at any time during the year or the preceding year, regardless of how much compensation that person earned or received; or
- For the preceding year, received compensation from the business of more than $120,000 (if the preceding year is 2017), and, if the employer so chooses, was in the top 20% of employees when ranked by compensation.

To meet this requirement the IRS has created certain coverage and nondiscrimination rules that limit the extent to which plan sponsors may maintain a 401(k) plan that exclusively or primarily benefits only highly compensated (HCE) or key employees. The nondiscrimination rules can be broken down into four parts:

- The plan must meet certain minimum standards concerning coverage of employees [IRC § 410(b)];
- The plan must not discriminate in favor of highly compensated employees (HCEs) with respect to the amount of contributions or benefits, and with respect to the availability of benefits, and features of the plan [IRC § 401(a)(4)];
- Elective contributions, matching contributions, and other contributions must meet special nondiscrimination tests: ADP/ACP [IRC § 401(k)(3)(A)(ii) and IRC § 401(m)(2)]; and
- A plan that is top-heavy must meet additional rules concerning minimum contributions or benefits [IRC § 416].

Next, we will examine in greater detail the rules to ensure there is broad coverage of employees, under the IRC § 410(b) coverage test.

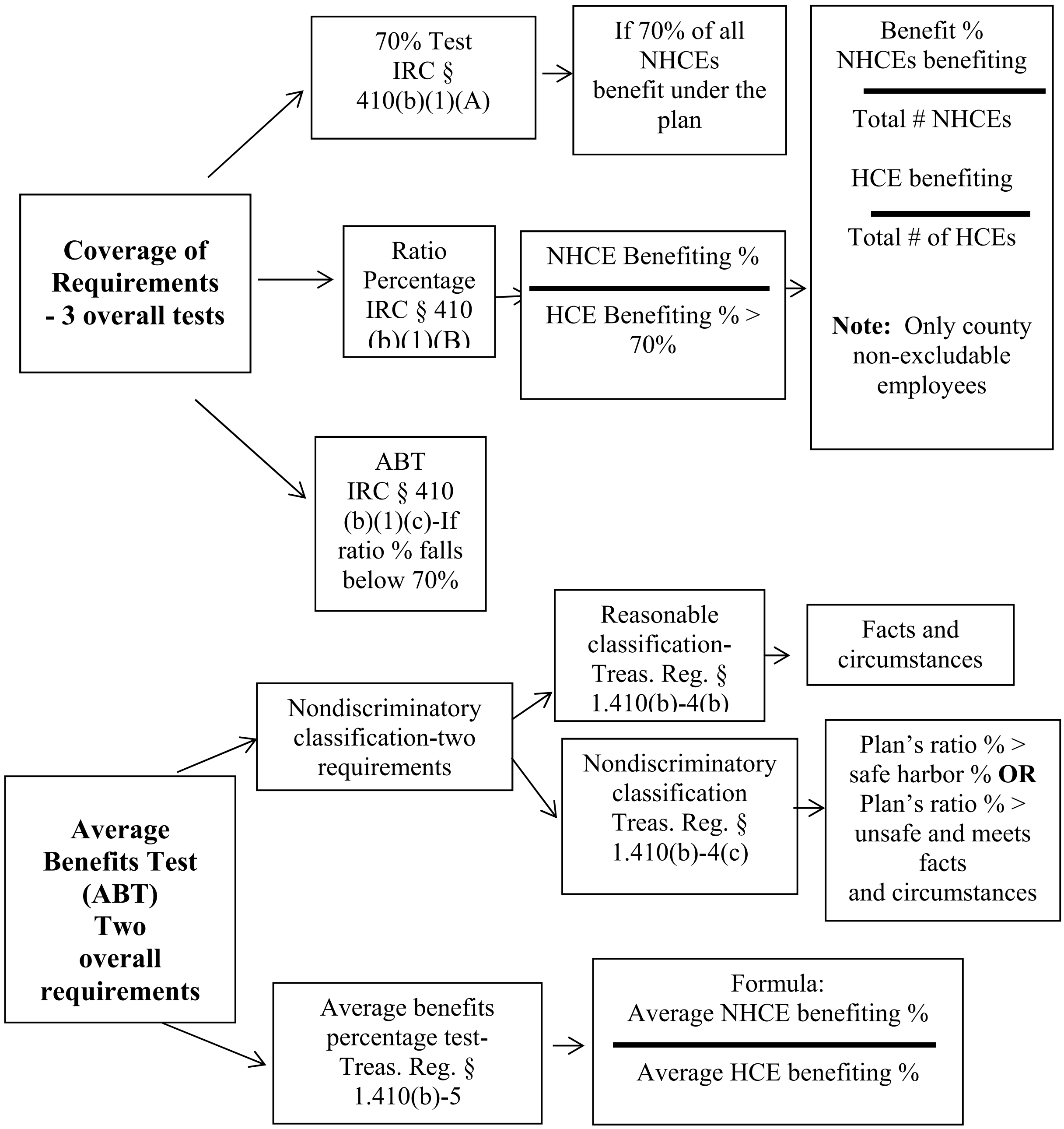
Minimum Coverage Rules IRC § 410(b)

Under IRC § 410(b) every employer (plan sponsor) must perform certain coverage tests to demonstrate that their plan benefits a nondiscriminatory cross-section of employees. To meet this requirement the IRS has created three basic tests. They are:

- *The Percentage (70%) Test*. Under IRC § 410(b)(1)(A), the plan must benefit at least 70 percent of the employer's non-highly compensated employees (NHCEs) (*the percentage test*);
- *The Ratio Percentage Test.* Under IRC § 410(b) (1)(B), the plan must benefit a percentage of NHCEs that is at least 70 percent of the highly compensated employees (HCEs) benefiting from the plan (the *ratio-percentage test*); or
- *The Average Benefit Test.* Under IRC § 410(b)(1)(C), the average benefit test compares the average benefit of non-highly compensated employees (NHCEs) with the average benefit of highly compensated employees (HCEs).

The employer (plans sponsor) should first try to satisfy either the percentage test (70%) test or the ratio percentage test (70%). If the ratio percentage test is not met the average benefit test must be satisfied (see Figure 4.1). A plan only has to pass one of the coverage tests each year. The coverage test being used can change from year-to-year. This is not a document issue but rather an administrative testing issue. A plan may call for the correction of the ratio percentage test and preclude the use of the average benefits test.

Figure 4.1
IRC § 410(b) Flowchart of Coverage



The above coverage tests demonstrate that a 401(k) plan provides benefits to a significant percentage of an employer's NHCE. The coverage tests were developed to measure the ratio of NHCEs to HCEs benefiting under the plan. An individual is considered to be benefiting under the 401(k) plan if he or she is eligible to make elective deferrals. The coverage requirements may be tested on a daily, quarterly or annual basis; 401(k) elective deferrals and matching contribution percentage testing must be done on an annual basis.

The Ratio Percentage Test

The ratio percentage test is a test that requires that the percentage of NHCEs benefiting under the plan be at least 70 percent of the percentage of HCEs benefiting under the plan [Treas. Reg. § 1.410(b)-2(b)(2)]. Thus, the relative number of NHCEs and HCEs benefiting are compared under the plan, and the plan is not required to benefit an absolute percentage of NHCEs of the employer.

> ***For Example:*** If a plan benefits 35 percent of an employer's NHCEs and 65 percent of the employer's HCEs, then the plan's ratio percentage is 54 percent (35% of NHCEs /65% of HCE), which is less than the required 70 percent.

Alternatively, the test can be performed by calculating the coverage of the HCE group, by determining what 70 percent of that coverage is, and comparing the percentage to the NHCE coverage. Here, the HCE coverage is 65 percent; 70 percent of that is 45.5 percent. Thus, the NHCE coverage must be at least 45.5 percent to pass the test. Since the NHCE coverage is only 35 percent, the plan fails the test.

The Average Benefit Test

As was discussed above, typically, the ratio (70%) percentage test is done first as it is administratively much easier to perform. If the plan fails the ratio percentage test, the employer can either take steps to pass the ratio percentage test by providing a benefit to enough individuals in order to pass the ratio test or the employer may perform the "*average benefits test*" to see if the coverage requirement can be passed using that test.

The Average Benefit Test (ABT) consists of two separate tests:

- The Nondiscriminatory Classification Test; and
- The Average Benefits Percentage Test.

Both parts of the ABT must be passed in order to satisfy coverage testing.

The Nondiscriminatory Classification Test

The first-part-nondiscriminatory classification test has two tests. They are:

- The Reasonable Classification; and
- The Nondiscriminatory Classification [Treas. Reg. § 1.410(b)-2(b)(3)].

The *reasonable classification* test is a facts and circumstances analysis, whether the classification satisfies "*reasonable business criteria*". Under Treas. Reg. Section 1.410(b)-4(b), the classification must be reasonable and established under objective business criteria that identify the category of employees who benefit under the plan.

Under Treas. Reg. § 1.410(b)-4(a*), the nondiscrimination test* is a test that requires the 401(k) plan to benefit a class of employees established by the employer that is both *reasonable and nondiscriminatory*.

Under Treas. Reg. § 1.410(b)-4(b), *a reasonable classification* is one established under objective business criteria that identify the group of employees who are eligible to participate in the 401(k) plan. Reasonable classifications include the following:

- Job categories;
- Nature of compensation (hourly or salaried); and
- Geographical location.

A list of named employees eligible to participate in the plan would not be considered a reasonable classification.

Under Treas. Reg. § 1.410(b)-4(c)(2), a classification is automatically considered nondiscriminatory if the 401(k) plan's ratio percentage (discussed above) is greater than or equal to the safe harbor percentage. If the plan's ratio percentage is less than the safe harbor percentage, a classification can still be considered nondiscriminatory if:

- The plan's ratio percentage is greater than or equal to the plan's unsafe harbor percentage; and
- The classification, based on all relevant facts and circumstances, is determined by the IRS to be nondiscriminatory.

Under Treas. Reg. § 1.410(b)-4(c)(4)(i), the safe harbor percentage is 50 percent, reduced by three quarters of a percentage point (.75 percent) for each whole percentage point by which the NHCEs concentration percentage exceeds 60 percent. The NHCE concentration percentage is simply the percentage of employees who are NHCEs, excluding any excludable employees.

Under Treas. Reg. § 1.410(b)-4(c)(4)(ii), the unsafe harbor percentage is 40 percent reduced by three quarters of a percentage point (.75) for each whole percentage point by which the NHCE concentration percentage is greater than 60 percent. In no event, however, can the unsafe harbor percentage be less than 20 percent.

An employer's NHCE concentration percentage is the percentage of all employees of the employer who are NHCEs. This percentage is determined by taking into account only non-excludable employees [Treas. Reg. § 1.410(b)-4(c)(4)(iii)]. Table 4.2 shows the safe and unsafe harbor percentages for any given NHCE concentration percentage.

The facts-and-circumstances test is satisfied if a plan's ratio is greater or equal to the unsafe harbor percentage and the classification satisfies the factual determination test [Treas. Reg. § 1.410 (b)-4(c)(3)]. The unsafe harbor percentage is calculated in the same way as the safe harbor percentage, using 40 percent in place of 50 percent. The minimum unsafe harbor percentage is 20 percent. If the ratio percentage does not equal or exceed the unsafe harbor percentage, the plan is discriminatory and it is unnecessary to consider if the factual determination test is met.

Treas. Reg. § 1.410(b)-4(c)(3)(ii) cites several examples of facts and circumstances that will be taken into account in determining whether a classification is nondiscriminatory:

- The underlying business reason for the classification. The greater the business reason for the classification, the more likely the classification is nondiscriminatory. Reducing the employer's cost of providing retirement benefits is not considered a relevant business reason [Treas. Reg. § 1.410(b)-4(c) (3) (ii)(A);
- The percentage of the employer's employees benefiting under the plan. The higher the percentage, the more likely the classification is nondiscriminatory [Treas. Reg. § 1.410(b)-4(c) (3) (ii)(B)];
- Whether the number of employees benefiting under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce. In general, the more representative the percentages of employees benefiting under the plan in each salary range, the more likely the classification is nondiscriminatory [Treas. Reg. § 1.410(b)-4(c) (3) (ii)(C)];
- The difference between the plan's ratio percentage and the safe harbor percentage. The smaller the difference, the more likely the classification is nondiscriminatory [Treas. Reg. § 1.410(b)-4(c) (3) (ii)(D); and
- The extent to which the plan's average benefit percentage exceeds 70 percent [Treas. Reg. § 1.410(b)-4(c) (3) (ii)(E)].

The following examples illustrate the computation of the safe harbor rule and the ratio percentage test.

> ***Example 1:*** The Able Company has 130 non-excludable employees. Of those employees, 120 are NHCEs and 10 are HCEs. Able Company maintains a 401(k) plan that benefits 60 NHCE and 9 HCEs. Thus, the plan's ratio percentage is 55.56 percent [60/120) / (9/10) = 0.5556], which is below the percentage (70 percent) necessary to satisfy the ratio percentage test.
>
> Able Company's NHCE concentration percentage is 92.3 percent (120/130); thus, Employer's A's safe harbor percentage is 26 percent, and its unsafe harbor percentage is 20 percent (see Table 4.2). Because the plan's ratio percentage is greater than the safe harbor percentage, the plan's ratio percentage is greater than the safe harbor percentage, the plan's classification is considered nondiscriminatory.
>
> ***Example 2:*** The Swift Company has 10,000 non-excludable employees. Of those employees, 9,600 are NHCEs and 400 are HCEs. Swift Company maintains a 401(k) plan that benefits 500 NHCEs and 100 HCEs. Thus, the plan's ratio percentage is 20.83

percent [500/9,600) / (100/400) = 0.2083], which is below the percentage necessary (70 percent) to satisfy the ratio percentage test.

Swift Company's NHCE concentration percentage is 96 percent (9,600 / 10,000); thus, the plan's safe harbor percentage is 23 percent, and its unsafe harbor percentage is 20 percent. Because the plan's ratio percentage (20.83 percent) is above the unsafe harbor percentage (20 percent) and below the safe harbor percentage (23 percent), the IRS may determine that the classification is nondiscriminatory after considering all the facts and circumstances.

Table 4.2
Safe and Unsafe Harbor Percentages

NHCE Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
0-60%	50.00%	40.00%
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75
64	47.00	37.00
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75
68	44.00	34.00
69	43.25	33.25
70	42.50	32.50
71	41.75	31.75
72	41.00	31.00
73	40.25	30.25
74	39.50	29.50
75	38.75	28.75
76	38.00	28.00
77	37.25	27.25
78	36.50	26.50
79	35.75	25.75
80	35.00	25.00
81	34.25	24.25
82	33.50	23.50
83	32.75	22.75
84	32.00	22.00
85	31.25	21.25
86	30.50	20.50
87	29.75	20.00
88	29.00	20.00
89	28.25	20.00
90	27.50	20.00
91	26.75	20.00
92	26.00	20.00
93	25.25	20.00
94	24.50	20.00

95	23.75	20.00
96	23.00	20.00
97	22.25	20.00
98	21.50	20.00
99	20.75	20.00

Average Benefits Percentage Test

The second part of the ABT is the average benefits percentage test (ABPT). This test requires an average of the "*employee benefit percentages*" of both the highly compensated employees (HCEs) and the non-highly compensated employees (NHCEs). The plan's average benefit percentage has to be equal to or greater than 70%. The average benefit percentage is calculated:

$$\frac{\text{Average benefit \% of NHCEs}}{\text{Average benefit \% of HCEs}}$$

The average benefit percentage of the NHCEs, determined individually for each NHCE, is the average of all of the NHCEs actual benefit percentages, as a percentage of their compensation. The plans considered for this test is all of the employer's plans (including controlled groups), in the "testing group" for that testing period. The same calculation is used for the NCE average benefit percentage.

Note: For purposes of this test, all non-excludable NHCEs and HCEs are taken into account even if they are not benefiting under any plan that is taken into account [Treas. Reg. §1.410(b)-(5)(c)].

In summary, the ABPT test is done as follows:

- Step 1. The employer determines an annual contribution or accrual rate for each employee covered under the plan. Alternatively, an accrued-to-date method may be used;
- Step 2. The contribution or accrual rate determined in Step 1 is divided by the employee's compensation to determine a percentage;
- Step 3. If the plan may use and utilizes permitted disparity, the percentage determined in Step 2 may be increased by an amount representing the employer-provided portion of Social Security. This provides a higher rate for those earning lower amounts. The resulting percentage is added to the percentage for plans that cannot use permitted disparity (for example, CODAs and ESOPs), and the result is the benefit percentage for each employee; and
- Step 4. The individual benefit percentages are then averaged for both HCEs and NHCEs to determine whether the average benefit percentage for NHCEs is at least 70 percent of the ABP for HCEs.

Average Benefit Test (ABT) Example

If a plan sponsor has: 4 non-excludable HCEs, all benefiting and 9 non-excludable NHCEs of which 6 were benefiting:

- *Calculate the HCE Benefit Percentage***.** Each HCE Benefit Percentage (Based on benefit/compensation); and
- *Calculate the NHCE Benefit Percentage***.** Each NHCE Benefit Percentage (Based on benefit/compensation).
-

Table 4.3
Average Benefit Test Example

Calculate the HCE Benefit Percentage Each HCE Benefit Percentage (Based on benefit/compensation)		Calculate the NHCE Benefit Percentage Each NHCE Benefit Percentage (Based on benefit/compensation)	
HCE 1	7.05%	NHCE 1	9.32%
HCE 2	6.01%	NHCE 2	8.75%
HCE 3	5.31%	NHCE 3	6.32%
HCE 4	4.54%	NHCE 4	5.32%
Total	22.91%	NHCE 5	5.18%
Divided by Number of Non-excludable HCEs	22.91% / 4 = 5.72%	NHCE 6	4.87%
HCE benefiting percentage	5.72%	NHCE 7	0%
		NHCE 8	0%
		NHCE 9	0%
		Total	39.76%
		Divided by Number of non-excludable NHCEs	39.76%/9 = 4.41%
		NHCE Benefiting Percentage	4.41%
		*NOTE: NHCEs 1-6 are covered by the plan, NHCEs 7 - 9 are not covered but must be included in the test as zeros.	

4.41%/5.72% = 77.1%. This plan sponsor passes both parts of the ABT test.

If the allocation fails the average benefits percentage test on a contribution allocation basis, the allocation may be cross-tested to see if the allocation passes on a benefit accrual basis.

Employees Who Must Be Considered in Coverage Testing

For purposes of the coverage requirements, all eligible (some exclusions permitted-see below) employees of the employer must be considered, including leased employees and those employed by Controlled Groups and Affiliated Service Groups (multiple companies – common ownership and/or shared revenue).

Excludable Employees

The concept of non-excludable and excludable employees is important for determining who is counted for coverage and nondiscrimination. If an employee is considered excludable, that employee is not counted for coverage and nondiscrimination purposes [Treas. Reg. § 1.410(b) 6]. Thus, these employees are "invisible" and are not counted in either the numerator or denominator of the NHCE or HCE benefiting percentages. Excludable employees are as follows:

- Employees that have not met the statutory age (21) or service requirements (1 year of service based on 1,000 hours in a 12 month period).

Note: *Plans that permit earlier entry are permitted to test affected employees separately. Specifically, the plan would test the "otherwise excludable group" that is those under age 21 and those with less than 1 year of service as a separate testing group:*

- Terminated participants who have completed less than 500 hours of service during the year tested;
- Employees who are members of a collective bargaining unit (union) if retirement benefits have been the subject of good faith bargaining;
- Nonresident aliens with no U.S. source of income; and
- Employees of an employer which is part of the controlled group but which is considered a separate line of business (generally separate business with 50 or more employees).

Note*: Employees that are eligible and cannot be excluded as described above are considered "non-excludable" and therefore must be included in testing.*

Nondiscriminatory Contribution Rules

Once the plan has determined that there is a sufficient number of NHCEs covered, the next test is to determine that the benefits, rights and features of the plan are not discriminatory. This is tested by the following tests:

- Actual Deferral Percentage Test; and
- The Actual Contribution Percentage Tests.

Next, we will examine these two tests in greater detail, beginning with the ADP.

Actual Deferral Percentage (ADP) Test

The ADP test is considered the central test applied to 401(k) plans when determining if the 401(k) plan is discriminatory. It is designed to limit the extent to which elective contributions made on behalf of HCEs exceed the contributions made on behalf of NHCEs. If the ADP test is satisfied, the plan is treated as satisfying IRC § 401(a) (4) requirements with respect to elective contributions only.

The purpose of the ADP test is to determine whether HCEs are taking a significantly greater advantage of the plan than the NHCEs (the rank-and-file employees). The ADP test limits the unbridled use of 401(k) arrangements by HCE by limiting their deferrals based on the deferrals of other employees (participants). If the 401(k) plan fails the ADP test, corrective actions will have to be taken. Such corrective actions are discussed below.

The ADP test must be calculated each plan year to determine whether the 401(k) plan meets the strict nondiscrimination limitations. Several steps must be understood and followed to apply this test accurately. Employers (plan sponsors) should hire a qualified professional plan administrator to apply these tests.

Basic Mechanisms of the ADP Test

The first step to determine if the 401(k) plan meets the ADP test requirements, the plan administrator will compare the ADPs of HCEs and NHCEs. This requires the calculation of the actual deferral ratio (ADR) The ADR is merely the ratio of the employee's elective contribution to his or her compensation [IRC § 401(k)(3)(B)].

For example, consider ABC Company. ABC Company has four employees, Bob, Ed, Mary and Kevin. ABC Company sponsors a profit sharing plan that includes a 401(k) plan. Both Bob and Ed are HCEs. Mary and Kevin are NHCEs. Table 4.4 shows their compensation, elective deferrals and ADRs for the current plan year.

Table 4.4
ABC Company ADP Test

Employee	Compensation	Elective Deferrals	Actual Deferral Ratio (ADR)
Bob	$200,000	$12,000	6%
Ed	$115,000	$11,500	10%
Mary	$40,000	$ 1,200	3%
Kevin	$30,000	$ 900	3%

The next step in the ADP test process is to compute the ADP for both the HCEs and NHCEs employees. The ADP for highly compensated employees is determined by taking the average of the ADRs for all HCEs who are eligible under the plan. The same procedure is performed for all NHCEs eligible under the plan.

In the case of ABC Company, the ADP for the NHCEs is 3 percent (6 percent/2), and the ADP for the HCEs is 8 percent (16 percent/2). As will be discussed later, this plan would fail the ADP test because the ADP for the HCEs exceeds the ADP of the NHCEs by more than the allowable margin.

Once the plan administrator has performed the calculations described above to determine if the ADP for both HCEs and NHCEs is more than the allowable margin, they then perform the actual ADP test to determine whether the ADP for the HCEs exceeds the ADP for the NHCEs. Generally a plan will pass the ADP test if at least one of the following tests is met:

- *Basic/General Test: 1.25 Requirement.* To meet this requirement, the ADP for the highly compensated employees cannot be more than 125% of the ADP for the non-highly compensated employees [I.R.C. § 401(k)(3)(A)(ii)(I)]; and
- *Alternate Test: Two percentage/200% requirement (2 +2 Test).* To meet this requirement, the ADP for the highly compensated employees cannot be more than two percentage points greater than the ADP for the non-highly compensated employees *and* the ADP for the highly compensated employees cannot be more than two times the ADP of the non-highly compensated employees [IRC § 401(k)(3)(A)(ii)(II)].

In the ABC Company example, the plan fails the ADP test in this particular plan year because the following two facts:

- *The Basic Test: 1.25 times test:* The limit is 3.75% (3% x 1.25). The ADP for HCEs of 8.0% exceeds the limit. Test: *FAILED*; and
- *Alternate Test: 2 + 2 test:* The 8% ADP for the HCEs is greater than 5.0% (the NHCEs ADP of 3.0% plus 2). The 8.0% ADP for the HCEs is greater than an 6.0% (the NHCEs ADP of 3.0% multiplied by 2 percent). Test: *FAILED*.

The following simple rule of thumb is useful in understanding the ADP test alternatives:

- If the average ADP of NHCEs is less than 2%, then the test used to determine the maximum average ADP of HCEs is the Alternative Test—2 x the average NHCEs ADP;
- If the average ADP of NHCEs is between 2% and 8%, then the test used to determine the maximum average ADP of HCEs is the Alternative Test—plus 2% of the average NHCEs ADP; and
- If the average ADP of NHCEs is more than 8%, then the test used to determine the maximum average ADP of HCEs is the Basic Test—1.25 times average NHCEs ADP.

Applying this simple rule of thumb to the ABC Company reveals that the highest contribution the HCEs would be permitted would be 5 percent. Because the NHCEs are contributing at a rate of 3 percent, the application of the above rule would allow the HCEs to contribute at a rate two-percentage points higher.

Table 4.5 displays a guide to the application of the 1.25 times test and the 2+2 test, given an ADP for NHCEs.

Table 4.5
Maximum ADP for HCEs, Given an ADP for NHCEs

ADP for Non-highly Compensated Employees (NHCEs)	Maximum ADP for Highly Compensated Employees (HCEs)	Rule Used
1.0%	2.00%	Times 2
2.0%	4.00%	Plus 2
3.0%	5.00%	Plus 2
4.0%	6.00%	Plus 2
5.0%	7.00%	Plus 2
6.0%	8.00%	Plus 2
7.0%	9.00%	Plus 2
8.0%	10.00%	Times 1.25
9.0%	11.25%	Times 1.25
10.0%	12.50%	Times 1.25

Choosing Plan Year Method for ADP Calculation for NHCEs

Under Treas. Reg. § 401(k)-2 (a)(2)(ii), the employer (plan sponsor) has a choice of determining the ADP for eligible NHCEs using either the prior-year testing method or the current-year testing method. The plan document must specify its choice of the current-year or prior-year testing method [Treas. Reg. § 401(k)-1 (e)(7)].

The prior-year testing method will use the ADP for NHCEs from the 401(k) plan year immediately before the plan year being tested. It uses the eligible employees who were NHCEs in that year, regardless of whether they were eligible employees or NHCEs in the plan year being tested. The current-year method uses the ADP for the eligible NHCEs in the plan year being tested. Both methods use the current year ADP for HCEs [Treas. Reg. § 401(k)–2(a)(2)(ii)].

Under Treas. Reg. § 401(k)–2(c)(2), unless the 401(k) plan is a successor to another plan, in its first year, a plan that elects the prior-year testing method is allowed to use either its ADP in that first plan year or 3 percent as its ADP.

A 401(k) plan is allowed to change from the prior-year testing method to the current-year testing method for any year [Treas. Reg. § 401(k)–2(c)(1)(i)]. Plans deciding to change to the prior-year testing method are required to meet certain requirements set out in the regulations. Under Treas. Reg. § 401(k)–2(c)(1)(ii), one of the general requirements is that the plan must have used the current-year testing method for each of the five plan years preceding the year of change or, if less, the number of years the plan has been in existence.

Under Treas. Reg. § 401(k)–2(c)(4), a 401(k) plan that chooses to use the prior-year testing method and has changed in the group or groups of eligible employees during a plan year may be required to use special rules to calculate the ADP for NHCEs. For the special rules to apply, the change must be due to:

- The establishment or amendment of a plan;
- A plan merger, consolidation, or spinoff;
- A change in the way plans are combined under the permissive aggregation rules;
- A reclassification of employees that has the same effect as a plan amendment; or
- A combination of these [Treas. Reg. § 401(k)–2(c)(4)(iii)(A)].

In addition, the change must affect more than ten (10) percent of the NHCEs. If it does not, the plan can provide that it will use the ADP for the eligible NHCEs for the prior year [Treas. Reg. § 401(k)–2(c)(4)(ii)].

Note: The advantage of using the prior-year testing method is that the ADP for the NHCEs for the prior year is known early in the current year. The employer and plan administrator can then calculate the ADP limit for HCEs for the current year. They can then monitor the ADP for HCEs and reduce the likelihood that the plan will fail the ADP test. Because HCEs may leave the employer, new ones may become participants, change their contributions, their compensation may change or other occurrences can change their Actual Deferral Ratio (ADR), it is unlikely that a plan can determine if it satisfied the ADP test until the end of the plan year.

Determining Compensation

IRC § 401(k)(9), defines "*compensation*" in a 401(k) plan under IRC § 414(s). This section of the Code generally looks to the definition of compensation in IRC § 415(c)(3), which provides several safe harbor rules for the definition of compensation. These safe harbor rules include the definition of wages under IRC § 3401(a) for income tax withholding purposes [Treas. Reg. § 1.415-2(d)(3)] and amounts included on the employee's Form W-2 for the year [Treas. Reg. § 1.415-2(d)(4)]. Compensation also includes an employee's elective deferrals to the 401(k) plan as well as IRC § 125 (cafeteria) plan deferrals, qualified transportation fringes, and deferrals to a I.R.C. § 457 plan [IRC § 415(c)(3)(D)].

An employee's compensation used to compute the ADR cannot exceed the compensation limit of $275,000 in 2018 [IRC § 401(a)(17)].

Note: Treas. Reg. § 1.414(s)-1(d)(2)(ii) allows the employer to use a broad definition of compensation that will reduce the ADRs and which produces a lower ADP. For example, a plan that excludes irregular or additional compensation such as overtime pay and shift differentials will have lower total compensation for an employee who receives that type of compensation than if the plan included such compensation.

Making QMACs and QNECs to Comply with ADP

A 401(k) plan can include employer contributions that qualify as qualified matching contributions (QMAC) and qualified non-elective contributions (QNEC) in addition to elective deferrals in calculating an employee's ADR.

QMACs and QNECs are available corrections when a 401(k) plan fails the required ADP testing. If the plan is deemed to have failed the ADP tests, a correction must be made by either returning excess deposits to the HCEs or making either a QMAC or QNEC (sometimes both) to all eligible NHCEs, in order to increase their average percentage deferrals or match in comparison to the HCEs.

QMACs are immediately vested matching contributions made by the employer (plan sponsor), calculated based on a percentage of the employee's elective deferral. The total amount the NHCE receives from the QMAC cannot exceed:

- 5% of their compensation, two times the plan representative *matching*; or
- The total amount of the NHCE's elective deferrals.

QNECs are also immediately vested contributions made by the employer (plan sponsor) to an employee's (participant's) account. QNECs are calculated based on a percentage of the participant's compensation, which is limited to 5%. An exception, however, is if the plan has implemented a representative contribution rate, which is the lowest percentage of compensation the NHCE can receive from a QNEC. In this case, the maximum percentage of compensation the NHCE can receive cannot exceed two times the representative contribution rate.

An employer must contribute a QMAC or QNEC by the end of the 12-month period after the plan year or applicable year. If the plan uses the prior-year testing method, this means that the contribution for NHCEs must be made by the end of the plan year being tested.

> ***For Example:*** If a plan uses QMACs or QNECs to help pass the ADP test for the 2018 plan year, prior-year testing method requires the QMACs and QNECs must be allocated to the plan for the accounts of the NHCEs for the 2017 plan year by the end of 2018. In contrast the allocation must be made by the end of 2019 for HCEs [Treas. Reg. § 1.401(k)-2(a)(6)(i)].

If the plan treats QMACs or QNECs as elective contributions to satisfy the ADP test, they cannot be used in determining if a plan meets the ACP test or the ADP test for the same or any other plan or for any other year [Treas. Reg. § 1.401(k)-2(a)(6)(vi)].

Special Rules

There are several special rules for determining if a plan violates the ADP test. They are:

- An employee's elective deferrals are considered employer contributions [IRC § 401 (k)(3(D)(i)];
- An employer may elect to include matching contributions and qualified non-elective (QNECs) in computing the ADP test if the requirements set out in the regulations are met [IRC § 401(k)(3) (D)(ii); Treas. Reg. 1.401(k)-2(a)(6)];
- In a plan's first year, the ADP for NHCEs is 3 percent unless the employer elects to use the ADP for the NHCEs determined for the plan year [IRC § 401 (k) (3(e)];

- If all eligible employees in a plan year are HCEs, the plan is deemed to satisfy the ADP test for that plan year [Treas. Reg. 1.401(k)-2(a)(1)(ii)];
- Elective deferrals made for a partner or sole proprietor are treated as if they are allocated to the partner's account on the last day of the proprietor's or partnership's tax year [Treas. Reg. 1.401(k)-2(a)(4)(ii)];
- Elective deferrals of HCEs include any excess contributions, even if the excess deferrals are distributed [Treas. Reg. 1.401(k)-2(a) (4)(ii)]; and
- A participant's catch-up contributions are subtracted from the participant's elective deferrals for the plan year in determining the participants ADR [Treas. Reg. 1.401(k)-1(d) (2) (i)].

Chapter 5 will discuss alternative methods to meet/avoid the ADP Test.

Actual Contribution Percentage (ACP) Test

In addition to the ADP test discussed above, a special nondiscrimination test required under IRC § 401(m), the *Actual Contribution Percentage* (ACP) test, applies to employer matching contributions and to employee after-tax (non-Roth) contributions. Fortunately, the ACP test is similar to the ADP for employee elective deferral contributions, except that it uses employer matching contributions and employee non-deductible (after-tax) contributions as its testing base.

The ACP testing is based on each participant's actual contribution ratio (ACR): current year after-tax contributions and matching contributions divided by compensation. All participants who could have made salary deferrals are included in the ACP test IF they are eligible to receive a match. However, if the individual's ability to receive a match is conditioned on additional service (e.g., a 1,000 hours of service requirement in the current plan year) or employment at the end of the plan year, and the individual does not meet these conditions, the individual is excluded from the ACP testing. However, when such a condition applies to receipt of the match, the group of participants who are eligible to receive matching contributions (e.g., those not excluded because they were employed on the last day of the plan year) must satisfy the IRC §410(b) minimum coverage requirements. Basically, a participant so excluded is treated as not benefiting [Treas. Reg. §1.401(m)-1(a)(2)].

A plan may not exclude participants from the ACP test who are not eligible to receive a match simply because they choose not to make a deferral. Such an individual will have a contribution ratio in the ACP test of "0" [Treas. Reg. §1.401(m)-1(f)(4)(i).].

After-tax employee contributions are also tested under the ACP test, even if the plan isn't a 401(k) plan. After-tax contributions cannot generally exceed 10% of the employee's taxable compensation. [Rev. Rul. 80-350, 1980-2 C.B. 133]. And remember that after-tax employee contributions are part of the employee's annual addition limitation under IRC § 415(c) [IRC § 401(m)(1) and (m)(4)].

Basic Mechanisms of the ACP Test

The first step consists of classifying all eligible employees as HCEs or NHCEs. The next step is determining the "actual percentage ratio" for each participant: that is the sum of the employer's matching contributions and other ACP contributions divided by the participant's annual compensation. A nondiscriminatory definition of compensation must be used for the test. In ACP testing, a critical decision must be made whether an employee is considered an NHCE based upon the current year or the prior one.

The average ACP percentage for HCEs and NHCEs is then calculated. The average percentage of the HCEs must not exceed the average percentage of the NHCEs by specified margins to satisfy the ACP test.

Like the ADP tests, discussed above, the ACP for the group of HCEs must:

- Not be greater than 125% of the ACP of the group of NHCEs cannot be more than 125 percent of the ACP of the eligible NHCEs (Basic/General test); or
- Not be higher than the ACP of the NHCEs by more than two percentage points and not be more than 2 times the ACP of the group of NHCEs (The Alternate test) [Treas. Reg. § 1.401(m)-2(a)(1)].

Table 4.6 displays these limits to show the maximum ACP for HCEs, given an ACP for NHCEs.

Table 4.6
Maximum ACP for HCEs, Given an ACP for NHCEs

ACP of Mach and Voluntary Contributions for NHCEs	Maximum ACP Permitted for the HCEs	Rule Used
1.00%	2.00%	Times 2
2.00%	4.00%	Plus 2
3.00%	5.00%	Plus 2
4.00%	6.00%	Plus 2
5.00%	7.00%	Plus 2
6.00%	8.00%	Plus 2
7.00%	9.00%	Plus 2
8.0%	10.00%	Times 1.25
9.0%	11.25%	Times 1.25
10.0%	12.50%	Times 1.25
12.0%	15%	Times 1.25

Example 1: If the ACP of the NHCEs is 1.23 percent, the ACP of the HCEs can be no greater than 1.23 times 2, or 2.46 percent;

> *Example 2:* If the ACP of the NHCEs is 7.87 percent, the ACP of the HCEs can be no greater than 7.87 plus 2, or 9.87 percent; and
> *Example 3:* If the ACP of the NHCEs is 10.98 percent, the ACP of the HCEs can be no greater than 10.98 times 1.25, or 13.73 percent.

As a general rule, employer matching contributions and employee non-deductible (after-tax) contributions are combined for ACP testing purposes. However, if qualified non-elective (after-tax) contributions (QNECs) are treated as elective contributions for purposes of satisfying the ADP test, these contributions do not have to satisfy the ACP test; furthermore, they cannot be used to help a 401(k) plan satisfy the ACP test.

A 401(k) plan can also run into trouble with the IRS if it makes excessive aggregate contributions on behalf of HCEs as a group. An excess contribution is the excess of employee contributions (this includes mandatory employee contributions and voluntary contributions) and matching contributions made to a 401(k) plan for the benefit of HCEs during a particular plan year over the maximum amount of such contributions allowed under the ACP test for that plan year. If the ACP test for a plan year is not satisfied, the plan will no longer be qualified. However, the regulations provide the following five mechanisms for correcting an ACP test that does not meet the requirements of the law:

- The employer makes QNECs that are treated as matching contributions for purpose of the ACP test and that, when combined with employee and matching contributions, cause the ACP test to be satisfied;
- Elective contributions are treated as matching contributions for purposes of the ACP test and, when combined with employee and matching contributions, cause the ACP test to be satisfied;
- Excess aggregate contributions and allocable income are distributed;
- If the plan so provides, excess aggregate contributions, to the extent attributable to non-vested matching contributions, and allocate income are forfeited; and
- The portion of the 401(k) plan attributable to employee and matching contributions is restructured.

A plan may use one or more of these correction methods [Treas. Reg. §§ 1.401(m)-2(b)(1), 1.401(m)-2(a)(6), 1.401(m)-2(a)(1)(iii)].

Failing the Nondiscrimination or Coverage Requirements

A 401(k) plan that fails the general nondiscrimination test of IRC § 401(a)(4) or the coverage requirement tests under IRC § 410(b) will be disqualified and lose the benefits provided to qualified retirement plans. In addition, the plan's assets become subject to tax and the plan is governed by the rules applicable to nonqualified plans – IRC § 83, IRC § 401(b)(1), and IRC § 409A. Employees must recognize income when they become substantially vested in the benefits. Employees cannot deduct contributions to the plan. Rather their deduction is delayed until benefits are paid to participants. This obviously creates a mismatch between when the employee includes the benefits in income and when the employer can deduct them.

Under IRC § 401(b)(4(B)), there is a special rule that will allow the 401(k) plan (as well as other defined contribution plans) to continue to apply to NHCEs if the only reason the plan is disqualified is its failure to meet IRC § 410(b) coverage test.

ADP Test Failure

If the ADP test for a 401(k) plan year is not satisfied, the portion of the 401(k) plan attributable to elective contributions—and, most likely, the plan in its entirety—will no longer be qualified. Fortunately, under Treas. Reg. § 1.401(k)-2(b) (1)(ii), plan administrators have several mechanisms for making corrections and can use one or a combination of them to bring the plan into compliance with the test:

- The portion of the 401(k) plan attributable to elective contributions is restructured to prevent excess contributions [Treas. Reg. § 1.401(k)-2(b) (1)(ii)];
- The employer can make fully vested qualified non-elective contributions (QNECs) or qualified matching contributions (QMACs) that are treated as elective contributions for purposes of the ADP test. When combined with elective contributions, these may satisfy the ADP test [Treas. Reg. § 1.401(k)-2(b) (1)(i)(A)];
- Excess deferrals and allocable income are distributed [Treas. Reg. § 1.401(k)-2(b) (1)(i)(B)]; and
- Excess deferrals or contributions are recharacterized. Excess contributions may be recharacterized as employee after-tax contributions, if those are allowed by the plan [Treas. Reg. § 1.401(k)-2(b) (1)(i)(C)].

If a combination of methods is used, the use of QNECs and QMACs are considered before distributions or recharacterizations.

Under Treas. Reg. § 1.401(k)-2(b)(1)(iii), a plan cannot leave excess contributions unallocated, allocate them to a suspense account, or correct them using the retroactive correction rules under Treas. Reg. § 1.401(a)(4)-11(g).

A plan can allow an HCE to elect whether to have excess contributions distributed or recharacterized. If a HCE made both pre-tax contributions and Roth contributions, the plan can allow them to elect whether the excess contributions are attributed to the pre-tax contributions or Roth contributions [Treas. Reg. § 1.401(k)-2(b) (1)(ii)].

Correcting Excess Contributions

The most commonly used method for correcting excess contributions is the distribution of excess contributions. Under this method, the excess contribution is distributed to the employee along with earnings (if any) on the excess contributions, and the total is treated as taxable income.

To determine the excess contributions, the amount of the excess contribution is the excess of the total employer contributions for HCEs for the plan year over the maximum amount of HCE contributions permitted if the plan meets the ADP test.

For example, ABC employer has three HCEs. Their elective deferrals for the current year are:

Employee	Compensation including Deferrals	Elective Deferrals	Actual Deferral Ratio (ADR)
A	$120,000	$9,000	7.5%
B	$110,000	$8,250	7.5%
C	$80,000	$10,000	12.5%

The actual deferral percentage (ADP) for the NHCEs is 4.0 percent. This means the maximum actual deferral percentage (ADP) for the HCEs is 6.0 percent. The HCEs ADP, before any corrective action, is 9.17 percent.

The excess contributions for an individual HCE are the amount that the HCE contributions must be reduced to equal the highest permitted actual deferral ratio (ADR) under the plan. The procedure set out in the regulation is to start with the HCE who has the highest actual deferral ratio (ADR) and reducing his/her ADR to equal the ADR of the HCE with the next highest ADR. If the ADP test can be met with a smaller reduction, the smaller reduction is used. The process continues until the ADRs have been reduced enough for the HCEs ADP to meet either the 1.25 test or the 2+2 test. While this procedure is used to determine the excess contributions, it is not used to determine the required reduction in each HCEs contribution.

Using the information from ABC Company in the above example, employee C's ADR would be reduced to 7.5 percent, reducing his/her contribution to $6,000. This reduces the ADP to 7.5 percent, still above the 6 percent allowable. The ADPs for all three employees must then be reduced to 6 percent each, reducing their contributions to $7,200, $6,600, and $4,800 respectively. The maximum allowable contribution for the HCEs is $18,600. The excess contributions are $8,650 ($27,250 total contributions minus $18,600).

The same result should be produced by multiplying the HCEs compensation by the maximum ADP for the HCEs. Using the example above, this would involve multiplying the maximum ADP of 6 percent by $310,000, the total compensation for the HCEs. This also produces a maximum contribution for the HCEs of $18,600 and excess contribution of $8,650.

This excess is allocated to the HCEs based on the amount of contributions by or for each employee. This means that the contributions of the HCE with the largest contributions are reduced first until reaching the amount of contributions of the HCE with the next most contributions. The order of reduction is based on the amount of contributions and ignores the ADR. A smaller amount can be allocated if sufficient to allocate all of the excess contributions. Once the reduced contributions of the HCEs with the largest contributions equal the contributions of all HCEs the next highest contribution, the reduction applies to the contribution of all HCEs at that contribution level. If a HCE makes elective contributions to more than one plan of the employer, the allocation is limited to the amount that HCE actually contributed to the plan during the year. The process continues until all of the excess contributions have been allocated among HCEs [Treas. Reg. § 1.401(k)-2(b) (2)].

Using the same facts as above, to allocate the $8,650 of excess contributions ABC Company first reduces Employee C's compensation by $1,000, to $9,000. It then reduces both Employee A's and Employee C's contribution by $750 each, to $8,250. Finally, it must reduce the contribution of all three employees by $2,050 each, to $6,200.

Employee	Compensation including Deferrals	Elective Deferrals	Actual Deferral Ratio (ADR)
1	$120,000	$6,200	5.17%
2	$110,000	$6,200	5.64%
3	$80,000	$6,200	7.75%

The HCEs ADP is not retested after the excess contributions are distributed, even though the revised ADP is 6.17 percent still exceeds the maximum allowable ADP of 6 percent.

In addition to the excess contributions, the plan must also determine and distribute the income allocable to the excess contributions. For this purpose, only the income on the excess contributions allocable to the plan year must be distributed. The plan does not have to distribute the income attributable to the excess contributions earned between the end of the plan year and the date of distribution. Under Treas. Reg. § 1.401(k)-2(b) (2)(iv), the plan may use any reasonable method to compute the income allocable to the excess contributions, if the method:

- Does not violate the nondiscrimination rules of IRC § 401(a)(4);
- Is applied consistently for all participants and all corrective distributions under the plan for the plan year; and
- Is used by the plan for allocating to participants' accounts.

The income allocable to excess contributions must be determined no more than seven (7) days before the distribution.

The regulation provides an alternative method. The plan would first determine the income for the plan year allocable to elective contributions and amounts treated as elective contributions. It would then multiply that income by a fraction, using the employee's excess contributions for the plan year as the numerator and the beginning of the year plan balance of elective contributions and amounts treated as elective contributions plus any additional contributions for the plan year as the denominator.

> ***For Example:*** A plan determines that the income allocable to the excess contributions is $5,000. At the beginning of the year, an HCE's account balance is $100,000 and the

employee made \$8,000 of elective contributions, including \$1,000 found to be an excess contribution. Under the alternative method, the allocable income is:

\$5,000 x (\$1,000/(\$100,000 + \$8,0000)) = \$46.30

Distributing Excess Contributions

To avoid the plan from being disqualified, the plan must distribute the excess contributions allocated to each HCE and the related income within 12 months after the end of the plan year. Under IRC § 401(k)(8), the plan may make the corrective distribution without regard to any other provision in the law. The employer must designate the distribution as a corrective distribution. If an HCE receives a distribution of his/her entire account before the corrective distribution is made, a portion of the distribution is deemed a corrective distribution to the extent one would have been made to that employee [Treas. Reg. § 1.401(k)-2(b) (2)(v)].

If the plan completely terminates in the year an excess contribution occurs, the corrective distribution must be made as soon as administratively feasible after the date of the plan termination. Under Treas. Reg. § 1.401(k)-2(b) (2)(iv), it must occur no later than 12 months after the date of the plan termination.

The corrective distribution does not require any consent from the employee or the employee's spouse [Treas. Reg. § 1.401(k)-2(b) (2)(vii)(A)]. They are treated as employer contributions for purposes of IRC § 404 and I.R.C. § 415. If the plan makes partial distribution to an HCE, it is treated as a pro rata distribution of the excess contributions and allocable income [Treas. Reg. § 1.401(k)-2(b) (2)(vi)(D)].

Tax Treatment of Corrective Distribution

Any corrective distribution distributed to an HCE will be considered taxable income to the HCE for the year distributed. Under Treas. Reg. § 1.401(k)-2(b) (2)(vi)(A), the additional 10 percent penalty tax of IRC § 72(t) does not apply. Designated Roth contributions distributed as part of a corrective distribution are not included in income but the allocable income is [Treas. Reg. § 1.401(k)-2(b) (2)(vi)(C)].

Recharacterizing Excess Contributions

A plan may allow HCEs to elect to have the excess contributions treated as having been distributed to them and then contributed to the plan. If the plan does not allow employee contributions, the excess contributions cannot be recharacterized. A recharacterization causes the excess contributions to be treated as employee contributions for purposes of I.R.C. § 72, the nondiscrimination rules under IRC § 401(a)(4) and IRC § 401(m) and Treas. Reg. § 1.401(k)-2 and the distribution limitation of Treas. Reg. § 1.401(k)-1(d). The recharacterization must be reported as employee contributions [Treas. Reg. § 1.401(k)-2(b) (3)(ii)]. For all other purposes, they are treated as employer contributions.

The recharacterization is deemed to have occurred on the date that the last HCE with excess contributions to be recharacterized receives the required notice that the recharacterization was treated as employee contributions. The recharacterization must be made within 2 ½ months after the end of the plan year. The total of the recharacterization excess contributions and the HCEs employee contributions cannot exceed the maximum amount of employee contributions permitted for the plan year in which the excess contributions were made. For this purpose, the maximum amount is computed before the actual contribution percentage limit is applied [Treas. Reg. § 1.401(k)-2(b) (3)(iii)(C)].

Applicability of the 10% Excise Tax on Excess Contributions

The plan must meet the deadline of the end of the following plan year to distribute excess contributions to avoid disqualification. To avoid the IRC § 4979 10 percent excise tax on excess contributions imposed on the employer, the excess contribution must be distributed within 2 ½ months after the end of the plan year. In addition, QNECs and QMACs do not need to be made within the 2 ½ month period if they are timely made. Under IRC § 4979(f), this period is extended six (6) months if the plan includes an eligible automatic contribution arrangement (EACA). The six-month period applies only if all HCEs and NHCEs are covered by the plan for the entire year (or the portion for which they are eligible to participate [Treas. Reg. § 54.4979-1(c)].

ACP Test Failure

When a 401(k) plan fails the ACP test, the plan is said to have "*excess aggregate contributions*." The excess aggregate contributions are the total matching contributions and (after-tax employee contributions) that must be distributed, or forfeited, to the HCEs to satisfy the ACP testing. The employer (plan sponsor) has several options with respect to correcting any "excess aggregate contributions" in the plan. They include:

- The employer (plan sponsor) can make qualified matching contributions (QMACs) to the accounts of some or all of the NHCEs in an amount sufficient to raise the average contribution percentage (ACP) for the group of NHCEs to pass the ACP test [Treas. Reg. § 1.401(m)-2(b) (1)];
- To the extent matching contributions are vested, they are distributed (along with earnings) to the HCEs before the end of the next plan year or forfeit the "excess aggregate contributions" by the end of the following plan year [Treas. Reg. § 1.401(m)-2(b) (1)];
- To the extent matching contributions are not vested, they can be forfeited; or
- A combination of these methods.

In addition, it may limit employee contributions or matching contributions to prevent excess aggregate contributions from being made. If a plan chooses a combination of these methods, it must first consider the additional made before making any distributions or forfeitures [Treas. Reg. § 1.401(m)-2(b) (1)(ii)]. Under IRC § 401(m)(6)(B), "excess aggregate contributions" are the excess of the total matching contributions and employee contributions (and any QNECs or elective contribution included in computing the ACP) actually made for HCEs for the plan year less the maximum contributions permitted under the ACP tests.

Corrections cannot be made by forfeiting vested matching contributions, distributing non-vested matching contributions, recharacterizing matching contributions, or not making required matching contributions. In addition, the excess aggregate contributions cannot remain unallocated or be allocated to a suspense account for future allocation. Under Treas. Reg. § 1.401(m)-2(b) (1)(iii), the retroactive rules of Treas. Reg. § 1.401(a)(4)-11(g) are not available.

If a plan provides for the forfeiture of matching contributions, they are treated as employer contributions, even if distributed from the plan. Under Treas. Reg. § 1.401(m)-2(b)(3)(ii), any forfeitures reallocated to other participant accounts are included in determining if the annual contribution limits are met.

As with corrective distributions for the ADP test, a plan's distribution of excess aggregate contributions may be made without regard to any other provision of the law [IRC § 401(m)(6)(A)] or any notice or consent that would otherwise be provided [Treas. Reg. § 1.401(m)-2(b) (3)(i)]. The tax treatment for corrective distributions made to correct a failed ACP test is the same as the tax treatment for corrective distributions for a failed ADP test, except these distributions may not be recharacterized as catch-up contributions, and an HCE will only receive a refund to the extent he/she is vested in the matching source. The vested portion is distributed to the HCE, and the unvested portion if forfeited.

Note: If a corrective distribution of designated Roth contributions is made, those distributions are not taxable but the income allocable to them is [Treas. Reg. § 1.401(m)-2(b) (2)(vi)]. Corrective distributions are not considered in determining if a plan meets the required minimum distribution (RMD) requirements [Treas. Reg. § 1.401(m)-2(b) (3) (iii)].

Chapter 5 will discuss alternative methods to meet/avoid the ACP Test.

Nondiscrimination Tests for P/S Plan

IRC § 401(m) contains special nondiscrimination requirements relating to the amount of employee contributions and employer matching contributions under a plan. A plan will fail to satisfy the general nondiscrimination requirements under IRC § 401(a)(4) unless it satisfies the special nondiscrimination requirements of IRC § 401(m). Matching contributions and after-tax employee contributions to a profit sharing (P/S) portion of a 401(k) plan must meet the same nondiscrimination tests of IRC § 401(a)(4) and the coverage tests of IRC § 410 (b) as the 401(k) portion. Instead of the ADP test, they must satisfy an actual contribution percentage (ACP) contributions and employee contributions to compensation for the NHCEs and HCEs for the year [Treas. Reg. § 1.401(m)-2]. Any employee who is eligible to make an employee contribution or to receive a matching contribution is considered an eligible employee for purposes of the ACP test [IRC § 401(m)(5)(A)].

Matching Contributions

The IRC defines a matching contribution as follows:

- Any employer contribution made to a defined contribution plan for an employee based on a contribution made by the employee (other than elective deferral) [IRC § 401(m)(4)(A)(i)];
- Any employer contribution made to a defined contribution plan for an employee based on the employee's elective deferral [IRC § 401(m)(4)(A)(ii)]; and
- Any forfeiture allocated on the basis of employee contributions, matching contributions, or elective deferrals [Treas. Reg. § 401(m)-1(a)(2)(C)].

Under Treas. Reg. § 401(m)-2(a)(4)(iii), to be included in the actual contribution ratio for an eligible employee, each of the following requirements must be met:

- The matching contribution must be allocated to the employee's account as of a date within the year being considered;
- The matching contribution is made or allocated based on the employee's elective deferrals or contributions for the year; and
- The matching contribution is actually paid to the trust by the end of the 12-month period immediately following the year that includes the allocation date.

The regulation also specifies certain employee contributions and matching contributions that are not taken into account under the ACP test. Under Treas. Reg. § 401(m)-2(a)(5) these include matching contributions that do not meet the requirements previously discussed. Instead, those contributions must satisfy the general nondiscrimination test of IRC § 401(a)(4). Other contributions not included in the ACP test are disproportionate matching contributions, qualifying matching contributions used to satisfy the ADP test, and matching contributions considered under safe harbor provisions.

Employee Contributions

Under Treas. Reg. § 1.401(m)-1(a)(3), employee contributions are contributions treated as after-tax employee contributions and allocated to an individual account for each eligible employee. An employer treats contributions as after-tax employee contributions by subjecting them to withholding. The definition of employee contributions excludes certain amounts to be paid to a plan on a participant's behalf, including Designated Roth contributions, loan repayments, rollover contributions, and employee contributions transferred from another plan [Treas. Reg. § 1.401(m)-1(a)(3)(ii)]. Matching contributions made for self-employed persons are not considered elective employee contributions [IRC § 402 (g) (8)]. Employee contributions also include contributions applied to the purchase of whole life insurance protection or survivor benefit protection and excess contributions and related income recharacterized as employee contributions to satisfy the ADP test [Treas. Reg. § 1.401(m)-1(a)(3)].

Chapter 4
Review Questions

1. True or False. The ratio percentage test is satisfied if the plan's "*ratio percentage*" is greater than or equal to 50%.

( ) A. True
( ) B. False

2. Which of the following would NOT be considered an excludable employee?

( ) A. Employee who has not met the statutory age or service requirement
( ) B. Employees who are members of a collective bargaining unit (union)
( ) C. Terminated participants who have completed more than 500 hours of service during the year tested.
( ) D. Nonresident aliens with no U.S. source of income.

3. An employee's compensation used to compute the Actual Deferral Ratio (ADR) cannot exceed the compensation limit of IRC § 401(a)(17), as adjusted for inflation. For 2018, what is that limit?

( ) A. $275,000
( ) B. $55,000
( ) C. $18,500
( ) D. There is no compensation limit

4. Which of the following is NOT one of the three basic tests the IRS has created to demonstrate that a plan benefits a nondiscriminatory cross-section of employees?

( ) A. The Percentage Test
( ) B. The Actual Contribution Percentage Test
( ) C. The Ratio Percentage Test
( ) D. The Average Benefits Test

5. To avoid a 401(k) plan from being disqualified, the plan must distribute the excess contributions allocated to each HCE and the related income within how many months after the end of the plan year?

( ) A. 2 ½ months
( ) B. 6 months
( ) C. 9 months
( ) D. 12 months

CHAPTER 5

SAFE HARBOR 401(k) PLANS

Overview

The Safe-Harbor 401(k) is increasingly becoming a popular choice among plan sponsors. A Safe Harbor 401(k) plan is not actually a separate plan from the traditional 401(k), rather it is an optional provision that can be added to the 401(k) plan document. Electing to be a Safe Harbor 401(k) plan is simple, and a traditional 401(k) plan can easily be amended to allow for Safe Harbor contributions.

However, in order to achieve this simplicity, employers must work through additional layers of complexity. There are many nuances to ADP/ACP safe harbor requirements that present traps for the unwary, which can render them unsafe, but the same complexity that creates these traps also creates planning opportunities.

This chapter will examine the rules and requirements of the "*traditional*" Safe Harbor plan under IRC § 401(k)(12) and the Safe Harbor plan with QNACs under IRC § 401(k(13). In addition, we will examine the rules and requirements for two additional types of 401(k) plans that may qualify as a Safe Harbor plan: the SIMPLE 401k plan and the Individual (Solo) 401(k) plan.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Recognize the benefits of a Safe Harbor 401(k) plan;
- Identify the entities eligible to set up a Safe Harbor 401(k) plan;
- Describe the "traditional" Safe Harbor 401(k)12 plan rules and requirements;
- Identify the rules and benefits of the Safe Harbor 401(k)(13) with qualified automatic contribution arrangements;
- Relate to features of and benefits of a SIMPLE 401(k) plan; and
- Present the rules and benefits of an Individual (Solo) 401(k) plan.

Background

Plan sponsors (employers) are interested in Safe Harbor plan designs because they free the 401(k) plan from ADP/ACP testing. Generally, it is not the testing itself that concerns the plan sponsors (employers), as the testing is often done by the plan's record-keeper, but rather the impact on HCEs that results from failing the test; such as reduced limits on deferrals and matching contributions, refunds of elective deferrals, and distributions or forfeitures of matching contributions, as was discussed in Chapter 4. These refunds, forfeitures and distributions can come as an unwelcome surprise.

Safe Harbor 401(k) plan designs have become increasingly prevalent, and plan sponsors (employers) increasingly rely on these designs to provide certainty that HCEs will be able to maximize their use of the 401(k) plan. The "core" of the Safe Harbor designs is a quid pro quo between the plan sponsor (employer) and the government. The plan sponsor (employer) agrees to make contributions at (or above) a threshold amount (under a relatively fast vesting schedule) and, in exchange, the government grants the employer a "free pass" on ADP and ACP testing. However, there are a large number of ancillary rules that are also a part of obtaining Safe Harbor status, and plan sponsors (employers) focus heavily on the major components of the Safe Harbor tests; such as minimum contribution levels, vesting and restrictions on in-service withdrawal. However, IRS is focused on the full range of ancillary rules, in effect "guarding" Safe Harbor status. As a result, plan sponsors (employers) that do not pay attention to this full set of requirements are exposed to the risk that their "*Safe Harbor*" design may not be so safe after all. In fact, IRS has put investigations of Safe Harbor plans high on its work plan.

Let's first explain the business entities who are allowed to set up a Safe Harbor plan.

Eligible Business Entities

The same business entities that can sponsor a traditional 401(k) plan can sponsor a Safe Harbor 401(k) plan. The Safe Harbor 401(k) plan is one of the most popular plan designs, especially for small employers. Any non-governmental employer is eligible to establish a Safe Harbor 401(k) plan. There are no requirements pertaining to the number of employees in the organization; thus, large and small employers are eligible.

Safe Harbor Plan Designs

There are two distinct basic ADP/ACP safe-harbor plan designs (see Table 5.1). They are:

- 401(k)(12) Safe Harbor plan. Referred to as *traditional* Safe Harbor plan. These Safe Harbor plans offer minimum matching contributions or non-elective contributions (NECs); and
- 401(k)(13) Safe Harbor plan. Plans offering qualified automatic contribution arrangement (QACAs) with a minimum matching contribution or non-elective contribution (NECs).

In addition, there are additional types of 401(k) Safe Harbor plans that can avoid the nondiscrimination ADP/ACP testing rules. They are:

- SIMPLE 401(k) plans;
- Individual (Solo) 401(k) plans; and

- Combination Plans under IRC § 414(x) Safe Harbor. Combined defined benefit plans and 401(k) plans (also known as "DB/K plans").

401(k)(12) Safe Harbor Plan

The *Small Business Job Protection Act of (SBJPA) of 1996* introduced the first ADP/ACP Safe Harbor design effective in 1999. Under IRC § 401(k)(12), the traditional 401(k) Safe Harbor plan requires the plan sponsor (employer) to make specified contributions for NHCEs, meet withdrawal and vesting restrictions, and notify eligible employees of the rights and obligations under the plan. If it does, it will limit the ADP test (as was discussed in Chapter 4). If it meets those requirements and complies with limits on matching contributions, it will also satisfy the ACP test for matching contributions [IRC § 401(m) (11)(A)]. There is no provision for satisfying the ACP test for employee after-tax contributions using this safe harbor. The safe harbor contributions must be fully 100% vested and subject to the same distribution restrictions as elective deferrals [IRC § 401(k)(12) (E)(i)].

Safe-Harbor Contribution Requirement: ADP Test

There are two alternative contribution requirements under a 401(k)(12) Safe Harbor plan:

- A matching contribution requirement; or
- A non-elective contribution (NEC) requirement [IRC § 401(k)(12) (B)].

There are no restrictions in the statute or the regulations on the employer's switching back and forth between the matching and NEC methods of satisfying the safe harbor contribution requirements, so long as:

- The plan permits switching from year to year;
- The employer determines which test it will satisfy before the beginning of the year; and
- The notice requirement is met before the beginning of the year.

The matching contribution or NEC, whichever is used, must be made on behalf of all eligible employees under the plan; meaning, for example, that the plan cannot restrict these contributions to employees employed on the last day of the plan year or to employees who have at least 1,000 hours of service in the plan year. In addition, both the safe harbor matching contributions and safe-harbor NECs must be 100% vested and have specific withdrawal restrictions. Hardship distributions and in-service withdrawals prior to age 59 ½ are not allowed from safe harbor contributions. The safe-harbor matching contribution must match elective deferrals and catch-up contributions.

Safe harbor matching contributions and NECs can be used to satisfy the safe harbor requirements for only one plan and the safe harbor contribution requirements must be satisfied without regard to IRC § 401(l).

Safe Harbor Matching Contribution

The safe harbor matching contribution requirement is satisfied if, under the plan, qualified matching contributions are made on behalf of each eligible non-highly compensated employee (NHCE) in an amount determined under a "*basic matching formula*" or an "*enhanced matching formula*," and certain other conditions are met [IRC § 401(k) (12)(B)];

- *BASIC Match Formula:* The basic matching formula provides for matching contributions to be made on behalf of each non-highly compensated employee (NHCE) equal to:
  - 100 percent of the employee's elective contributions up to 3 percent of the employee's compensation;
  - 50 percent of the employee's elective contributions that exceed 3 percent of the employee's compensation but do not exceed 5 percent of the employee's compensation [Treas. Reg. § 1.401(k)-3(b)(2)]; and
  - Thus, the maximum matching contribution required for an employee to meet the safe harbor is equal to four percent (4%) of compensation.
- *The ENHANCED Matching Formula:* The enhanced matching formula provides matching contributions for each eligible non-highly compensated employee (NHCE) under a formula that:
  - Provides an aggregate amount of qualified matching contributions at least equal to the aggregate amount that would have been provided under the basic matching formula at any elective contribution rate [Treas. Reg. § 1. 401(k)-3(c)(13)];
  - The rate of matching contributions may not increase as an employee's rate of elective contributions increases; and
  - One example of an enhanced matching formula that would meet the requirements is a match equal to 100 percent of elective contributions up to 4 percent of compensation.
- If the plan involved allows for employee after-tax contributions, additional rules apply in order to satisfy the safe harbor matching formula [Treas. Reg. § 1.401(k)-3(c)(5)(i)].

The additional requirements regarding vesting, eligibility, and withdrawal restrictions are applicable. A last day and/or hour requirement is not allowed for the safe harbor matching contribution.

Let's review a couple of examples.

> ***Example 1**:* A 401(k) plan provides a fixed matching contribution equal to 100% of elective deferrals up to a maximum of 4% of compensation; this formula satisfies the safe harbor matching contribution because all participants who are deferring will get a contribution at least equal to the contribution which would be made under the safe harbor basic matching contribution described above.
>
> ***Example 2:*** A fixed matching contribution equal to 150% of elective deferral up to a maximum of 3% of compensation, and then a 100% match for elective deferrals exceeding 6% of compensation is not a safe harbor matching contribution because of the prohibition for an escalating formula.

The type of safe harbor matching contribution selected (basic or enhanced) must be described in the plan document and in the annual notice to eligible participants. Unlike the NEC, there is no flex matching contribution option.

Safe Harbor Non-elective Contribution

In lieu of satisfying the matching contribution safe harbor, an employer may satisfy the safe harbor by making a non-elective contribution (NEC) equal to:

- At least three percent (3%) of the employee's safe harbor compensation (commonly known as the “3% NEC”), without regard to whether the employee makes elective contributions [IRC § 401(k)(12)(C); Treas. Reg. §1.401(k)-3(b)].

This contribution can be greater than 3%. Generally, the 3% NEC must be provided to all employees eligible to make elective deferrals to the plan regardless of whether the employee makes elective deferrals to the plan. The NEC may be either a guaranteed contribution or a flexible (“tentative”) contribution. The employer will make this selection in the plan document. The guaranteed contribution requires that a NEC be made each plan year, unless the employer amends the plan and removes the provision before the start of the new plan year.

If the contribution is “tentative,” the employer can wait until 30 days before the end of the plan year to decide whether or not to make a safe harbor NEC. Employees must receive notice within a reasonable period before the beginning of the plan year of the possibility of a safe harbor contribution being made (discussed below). A supplemental (“condition”) notice may be required at least 30 days before the end of the plan year that the employer has decided to make or not make the “*tentative*” safe harbor NEC.

Definition of “Compensation” for Safe-Harbor Matching and Enhanced Contributions

One of the first practical considerations an employer encounters in making the safe harbor contributions is the definition of compensation used. Safe harbor employer contributions must be based on a definition of compensation within the meaning of Treas. Reg. § 1.401(k)-6, which refers, in turn, to the definition of compensation under IRC § 414(s), but without the ability to exclude all compensation in excess of a specified dollar amount [Treas. Reg. § 1.401(k)-3(b)(2)].

In order to use the safe harbor, a plan must use a specific definition of compensation. If a plan uses a definition of compensation outside of this specified “safe harbor” definition of compensation, then the plan loses its safe harbor status.

Safe-Harbor Contribution Requirement: ACP Test

In order to satisfy the safe harbor ACP test with respect to matching contributions, a plan must satisfy the ADP test safe harbor and limit matching contributions in accordance with IRC § 401(m)(11) and Treas. Reg. § 1-401(m)-3(d). The ACP test is satisfied if any of the safe harbor

ADP contributions described above are made, including the safe harbor NEC. If the plan wants to take advantage of the ACP safe harbor, there are additional requirements for all of the employer matching contributions made to the plan. These additional requirements are automatically met if the plan uses only the safe harbor basic matching formula described in "*Safe Harbor BASIC matching contribution*" above. The "*additional*" matching contribution does not have to be 100% vested or have withdrawal restrictions, but it must be tracked as a separate contribution source.

It is, however, possible for an employer to provide additional matching contributions, i.e., a more generous matching contribution formula, and to continue to be treated as satisfying the ACP test if, under the plan:

- Matching contributions are not made with respect to elective contributions or employee contributions that in aggregate exceed 6 percent of employee's compensation [Treas. Reg. § 1.401(k)-3-d(3)(i)];
- The rate of matching contribution does not increase as the rate of employee contributions or elective contributions increases [Treas. Reg. § 1.401(k)-3-d(2)]; and
- For employee contribution or elective deferral, the matching contribution with respect to a highly compensated employee (HCE) may not be greater than the matching contribution with respect to a non-highly compensated employee (NHCE) [Treas. Reg. § 1.401(k)-3-d(4)].

A plan does not fail to satisfy this last requirement merely because it provides that matching contributions will be made separately with respect to each payroll period, or with respect to all payroll periods ending with or within each month or quarter of a plan year, so long as the matching contributions for any quarter are contributed to the plan by the last day of the following quarter. In applying the fourth limitation, matching contributions for a highly compensated employee (HCE) under all plans of the employer will be taken into account. However, non-simultaneous participation in more than one plan during a year, or the period used to determine compensation under each plan is limited to periods of actual participation in the plan, will not result in failure to satisfy the safe harbor matching contribution requirements [Treas. Reg. § 1.401(k)-3-d(5)].

Effect of Additional Matching, NEC, or After-Tax Employee Contributions

The basic purpose of a Safe Harbor 401(k)(12) plan is to enable the plan sponsor (employer) and its plan administrator to avoid the nondiscrimination testing associated with the employees' salary deferral contributions and the employer's matching contributions. As discussed above, a 401(k)(12) Safe Harbor plan must satisfy the safe harbor contribution requirements for purposes of the ADP and ACP tests. What is the effect on the contribution safe harbor for the ADP and ACP tests if the employer makes matching or NECs in excess of the safe harbor amounts or if the employer allows employees to make after-tax contributions?

General Rule. Additional contributions above and beyond the safe harbor contributions are treated in the same manner as contributions to a non-safe harbor plan. In practical terms, that means the additional contributions allocated to employees must be tested for coverage under IRC

§ 410(b) and for nondiscrimination under IRC § 401(a)(4). It also means that the additional contributions are not subject to the vesting and withdrawal requirements that apply to safe harbor contributions.

Additional NECs

As mentioned above, employer contributions in excess of the NEC safe harbor contribution limits are subject to the general nondiscrimination requirements of IRC § 401(a)(4). In meeting these requirements, the safe harbor NEC made to the plan may be taken into account. NECs used to satisfy the design-based safe harbor can be used to satisfy other qualified retirement plan nondiscrimination rules as well [Treas. Reg. § 1.401(k)-3(h)(2)]. However, these contributions cannot be taken into account in determining whether a plan meets the permitted disparity rules of IRC § 401(l) [IRC § 401(k)(12)(E)(ii); Treas. Reg. §1.401(k)-3(h)(2)].

After-Tax Employee Contributions

The designed-based safe harbors provide relief from ACP testing only for matching contributions, and not after-tax employee contributions. After-tax employee contributions continue to be subject to ACP testing [IRS Notice 98-52]. Moreover, employer matching and NECs used to satisfy the safe harbor requirements cannot be considered in applying that ACP test, except to the extent they exceed the amounts required to satisfy the safe harbor requirements. It is for this reason that a plan intended as a 401(k)(12) Safe Harbor plan will not likely include a provision for after-tax employee contributions.

Effect of Additional Contributions on the IRC § 416 Top-Heavy Requirement

The top-heavy rules do not apply to a 401(k)(12) Safe Harbor plan that only provides for safe harbor contributions [IRC § 416(g)(4)(H)]. The mere inclusion in a plan of a provision that provides for additional contributions at the employer's discretion will also not cause the plan to be subject to the top-heavy rules [Rev. Rule. 2004-13]. However, any additional contribution that is actually made will cause the plan to be subject to the top-heavy rules. If a 401(k)(12) Safe Harbor plan falls outside of the top-heavy exemption, safe harbor NECs may be counted under IRC § 416 toward the minimum contribution requirement for top-heavy plans [IRS Notice 98-52].

Withdrawal, Vesting, and Other Restrictions

A 401(k)(12) Safe Harbor plan must provide that all safe harbor employer contributions, including safe harbor matching contributions, are fully vested and non-forfeitable [IRC § 401(k)(12)(E)(i)]. In addition to vesting limitations, safe-harbor plans may not condition contributions on certain requirements. A plan may not require that an employee be employed on the last day of the plan year in order to receive a safe harbor matching or NEC and may not condition the match or NEC upon completion of a certain number of hours of service, e.g., 1,000 hours of service in the plan year [Treas. Reg. § 1.401(k)-3(c)(7, Ex. 7]). In addition, a safe-harbor plan must impose the same withdrawal restrictions that apply to elective deferrals under a 401(k) plan to employer safe harbor contributions [IRC § 401(k)(12)(E)(i)].

A 401(k)(12) Safe Harbor plan does not require that the CODA include an automatic contribution arrangement. That is, in contrast to the QACA safe harbor found in IRC § 401(k)(13) (discussed below), a 401(k)(12) Safe Harbor plan may require affirmative elections to defer. However, nothing found in a 401(k)(12) Safe Harbor plan precludes a plan from including an automatic contribution arrangement.

Notice Requirement

The second requirement necessary to satisfy the ADP test safe harbor is the notice requirement, which is satisfied if each eligible employee for the plan year is given written notice of the employee's rights and obligations under the plan and the notice satisfies the content requirement and the timing requirement [Treas. Reg. § 1.401(k)-3(d)]. The notice must be in writing or in such other form as may be approved by the Commissioner.

The content requirement requires that the notice must be sufficiently accurate and comprehensive to inform the employee of the employee's rights and obligations under the plan and written in a manner calculated to be understood by the average employee eligible to participate in the plan.

The notice must accurately describe:

- The safe harbor matching contribution or safe harbor NEC formula used under the plan (including a description of the levels of safe harbor matching contributions, if any, available under the plan);
- Any other contributions under the plan or matching contributions to another plan on account of elective contributions or employee contributions under the plan (including the potential for discretionary matching contributions) and the conditions under which such contributions are made;
- The plan to which safe harbor contributions will be made (if different than the plan containing the 401(k) plan);
- The type and amount of compensation that may be deferred under the plan;
- How to make cash or deferred elections, including any administrative requirements that apply to such elections;
- The periods available under the plan for making cash or deferred elections;
- Withdrawal and vesting provisions applicable to contributions under the plan; and
- Information that makes it easy to obtain additional information about the plan (including an additional copy of the summary plan description-SPD) such as telephone numbers, addresses and, if applicable, electronic addresses, of individuals or offices from whom employees can obtain such plan information [Treas. Reg. § 1.401(k)-3(d)(3)(11)].

The timing requirement requires that the plan sponsor must provide notice within a reasonable period before each year. This requirement is deemed to be satisfied if the notice is given to each eligible employee at least 30 days and not more than 90 days before the beginning of each plan year. In the case of a newly-hired employees, the notice must be provided within the ninety (90) day-period ending with the day the employee becomes eligible [Treas. Reg. § 1.401(k)-3(d)(3)(ii)]. However, the general rule is that the notice must be provided within a reasonable period before the beginning of the plan year (or, in the year the employee becomes eligible, within a reasonable period before the employee becomes eligible), determined based on all the facts and circumstances.

A special notice must be provided if the employer decides to suspend its contributions mid-year. The required notice may be provided in writing or in electronic form, provided that the general IRS requirements for paperless delivery of notices in Treas. Reg. § 1.401(a)-21 is satisfied .given (and the employee able to make a deferral election) before the employee's first payday.

Plan Year Requirements

As a general rule, a plan will not satisfy the 401(k)(12) Safe Harbor plan design unless plan provisions that satisfy the applicable rules are adopted before the first day of the plan year and remain in effect for the entire twelve (12)-month plan year [Treas. Reg. § 1.401(k)-3(e)(1)]. The regulations go on to provide that, except as provided with respect to a permissible reduction or suspension of safe harbor contributions in accordance with Treas. Regs. § 1.401(k)-3(g), a plan which includes provisions that satisfy the rules of a 401(k)(12) Safe Harbor plan will not satisfy the requirements of Treas. Reg. § 1.401(k)-1(b) [the coverage and nondiscrimination requirements applicable to the CODA] if it is amended to change such provisions for that plan year [Treas. Reg. § 1.401(k)-3(e)(2)]:

- *Initial Plan Year*. The regulations provide that a newly-established plan (other than a successor plan) may have a plan year that is less than twelve (12) months long, but at least three (3) months long. A newly-established employer may establish its plan as soon as administratively feasible after the employer comes into existence. A CODA may be added to an existing profit sharing, stock bonus, or pre-ERISA money purchase pension plan for the first time during that year provided that:
    - o the plan is not a successor plan; and
    - o the CODA is made effective no later than three (3) months prior to the end of the plan year [Treas. Reg. § 1.401(k)-3(e)(2)].
- *Change of Plan Year*. A plan that has a short plan year as a result of changing its plan year does not violate the general rule that a plan must have a twelve (12)-month plan year, provided that:
    - o the plan satisfied the plan year requirements for the immediately preceding plan year; and
    - o the plan satisfies the plan year requirements for the immediately following plan year [Treas. Reg. § 1.401(k)-3(e)(3)];
- *Final Plan Year*. A plan that terminates during a plan year, with the result that the final plan year is less than twelve (12) months in length does not fail to satisfy the general rule if the plan.

Permitted Suspension or Reduction of Safe-Harbor Contributions

If a plan utilizes matching contributions to satisfy the safe harbor contribution requirement, the plan may be amended during the plan year to reduce or suspend those safe harbor matching contributions on participants' future elective contributions provided certain conditions are met:

- In the case of plan years beginning on or after January 1, 2015, the employer either:
  - is operating at an economic loss as described in IRC § 412(c)(2)(A) for the plan year; or
  - includes in the annual notice to participants a statement that the plan may be amended during the plan year to reduce or suspend safe harbor NECs and that the reduction or suspension will not apply until at least thirty (30) days after all eligible employees are provided notice of the reduction or suspension.
- All eligible employees are provided a supplemental notice that explains:
  - the consequences of the amendment that reduces or suspends future safe harbor contributions; and
  - the procedures for changing cash or deferred elections and (if applicable) employee after-tax contribution elections; and (C) the effective date of the amendment.
- The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of the date the amendment is adopted or thirty (30) days after eligible employees are provided the supplemental notice;
- Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;
- The plan is amended to provide that the ADP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in Treas. Reg. § 1.401(k)-2(a)(2)(ii); and
- The plan satisfies all the requirements of Treas. Reg. § 1.401(k)-3 [the safe harbor regulations] with respect to amounts deferred through the effective date of the amendment [Treas. Reg. § 1.401(k)-3(g)(1)(i)].

If a plan utilizes NECs to satisfy the safe harbor contribution requirement, then for amendments adopted after May 18, 2009, the plan may be amended during the plan year to reduce or suspend those safe harbor NECs provided certain conditions are met:

- The employer either:
  - is operating at an economic loss, as described in IRC § 412(c)(2)(A) for the plan year; or
  - includes in the annual notice to participants a statement that the plan may be amended during the plan year to reduce or suspend safe harbor NECs and that the reduction or suspension will not apply until at least thirty (30) days after all eligible employees are provided notice of the reduction or suspension.
- All eligible employees are provided a supplemental notice that explains:

    - the consequences of the amendment that reduces or suspends future safe harbor contributions;
    - the procedures for changing cash or deferred elections and (if applicable) employee after-tax contribution elections; and
    - the effective date of the amendment.
- The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of the date the amendment is adopted or thirty (30) days after eligible employees are provided the supplemental notice;
- Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;
- The plan is amended to provide that the ADP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in Treas. Reg. § 1.401(k)-2(a)(2)(ii); and
- The plan satisfies all the requirements of Treas. Reg. § 1.401(k)-3 [the safe harbor regulations] with respect to amounts deferred through the effective date of the amendment [Treas. Reg. § 1.401(k)-3(g)(1)(ii)].

Automatic Contribution Arrangement (ACA) in a 401(k)(12) Safe Harbor Plan

There are certain automatic contribution arrangements (ACAs) that have permeated 401(k) plan design in recent years and include:

- Automatic Contribution Arrangements (ACA);
- Eligible Automatic Contribution Arrangements (EACA); and
- Qualified Automatic Contribution Arrangements (QACA).

It is significant to note that a QACA, found in a 401(k)(13) Safe Harbor plan, can be utilized as an alternative safe-harbor arrangement to a 401(k)(12) Safe Harbor plan. The 401(k)(12) Safe Harbor plan does not require that the CODA include an ACA. That is, in contrast to the QACA 401(k)(13) Safe Harbor plan, a 401(k)(12) Safe Harbor plan may require affirmative elections to defer. However, nothing found in a 401(k)(12) Safe Harbor plan precludes a plan from including an ACA.

Next we will examine the second safe harbor plan design: the 401(k)(13) Safe Harbor plan.

401(k)(13) Safe Harbor Plan

The Pension Protection Act (PPA) of 2006 (Public Law 109-280), Section 902, added IRC §§§ 401(k)(13), 401(m)(12) and 414(w), which relieves employers who automatically enroll employees into 401(k) plans with a *qualified automatic contribution arrangement* (QACA) from certain "*non-discrimination*" rules that would otherwise apply.

In 2009, the IRS promulgated final regulations addressing automatic enrollment, "*Automatic Contribution Arrangements*, 74 Fed. Reg. 8,200 February 24, 2009 (to be codified at 26 C.F.R. pts. 1 and 54). A QACA allows an employer to automatically enroll employees in the plan and establish a minimum contribution level (discussed below). The objective of automatic enrollment is to encourage employees to increase their retirement savings by eliminating the need for them to make an affirmative election to participate in the plan with a default percentage contributed. Instead, they must opt out of participating or for a lower contribution. As the GAO reported in 2009, existing studies have shown that automatically enrolling employees in 401(k) plans can substantially increase participation rates (GAO-10-31).

A plan that includes a QACA must include safe-harbor non-elective contributions or matching contributions and meet certain other requirements. If it does, it will satisfy both the ADP and ACP tests. A QACA can also include an eligible automatic contribution arrangement (EACA) discussed below.

QACA Contributions

To encourage more employers to adopt automatic enrollment, the new law establishes 401(k) "S*afe-Harbor*" plans to include employer contributions, computed in a manner similar to those of a traditional Safe Harbor plan. Under IRC § 401(k)(13)(D)(i), the employer must make either minimum non-elective contributions (NECs) to all employees covered in the plan or make matching contributions.

QACA Minimum Non-elective Contributions

If a participant fails to make an election to defer compensation into the plan, the QACA must provide that no less than 3 percent of the participant's compensation must be deferred into the plan during the plan year in which the employee becomes a plan participant and the following plan year. After that plan year, the QACA must provide that the deferral percentage will increase by at least one percentage point each plan year thereafter until the participant's rate of deferral equals 6 percent of compensation [Treas. Reg. § 1.401(k)-3(j)(2)]. Employees will be fully vested in any employer contribution after two years of service.

The percentage automatically withheld must apply uniformly to all employees covered by the plan and must not exceed 10 percent of salary.

QACA Matching Contribution

The employer can provide QACA matching contributions for NHCEs must be 100 percent of the first 1 percent of compensation plus 50 percent of the next 50 percent of compensation. This produces a 3.5 percent match for an employee who contributes at least 6 percent of compensation. This is slightly less than the 4 percent match discussed above for a traditional safe harbor plan.

The type of safe harbor contribution selected must be described in the annual notice to eligible participants.

Notice Requirements

As with a traditional Safe Harbor plan, each year a written notice of the employee's rights and obligations under the plan must be provided to the participants to whom the QACA applies. The plan may provide the notice electronically if it complies with the rules in Treas. Reg. § 1.401(a)-21. The notice must be sufficiently accurate and comprehensive to inform employees of their rights and obligations under the plan and be written in a way that is calculated to be understood by the average eligible employee.

In addition to the information required for a traditional Safe Harbor plan, the notice for a QACA must explain the following:

- Investment provisions describing the plan methods of investing the trust or custodial funds, including funding options, the availability of loans and self-directed investments;
- Administrative provisions such as how responsibilities are allocated among fiduciaries, the resignation or replacement of fiduciaries, claims procedures, recordkeeping requirements; and
- CODAs.

The notice timing requirement will be satisfied if the notice is provided at least 30 days (and not more than 90 days) before the beginning of each plan year, or in the case of a new employee not more than 90 days before the employee is eligible to participate. The plan must provide the notice early enough that the employee has reasonable time to make the elections on whether to have a different amount or percentage contributed or no contribution made and how any contributions made are to be invested. Under Treas. Reg. § 1.401(k)-3(k)(4)(iii), the default election cannot become effective sooner than the earlier of the pay date for the second payroll period beginning after the date the notice is provided and the first pay date that is at least 30 days after the notice is provided.

> ***For Example:*** An employer pays its employees on the first and fifteenth of every month. On July 1, the first day of the pay period ending on July 15^{th}, it provides the required notification concerning the QACA and how to change the default elections. The default election cannot become effective until August 15.

Safe Harbor Contributions Not Eligible for Hardship Distribution

Safe-harbor contributions are not eligible for hardship withdrawal. This is because safe harbor contributions must satisfy the distribution restrictions of IRC § 401(k), but hardship distributions under that Code section and the corresponding regulations are limited to contributions pursuant to a cash or deferred election to a 401(k) plan or pursuant to a salary reduction agreement to a 403(b) plan. Safe harbor contributions are not elective contributions to a 401(k) or 403(b) plan and so are not eligible for hardship withdrawal [IRC § 401(k)(12)(E) (i); IRC § 401(k)(13(D)(iii)(II)].

No Exception From Safe Harbor Matching Contributions for Catch-Up Contributions

If a plan uses safe harbor matching contributions to satisfy the ADP safe harbor requirements and the plan permits age-50 catch-up contributions, the safe harbor matching contributions must be applied to the age-50 catch-up contributions to the extent the safe harbor matching contributions would otherwise apply to elective deferrals under the plan. The preamble to the 401(k) regulations issued in 2004 made clear that there is no exception with respect to those catch-up contributions.

> ***For Example*****:** A participant could contribute the maximum dollar amount ($18,500 for 2018) before receiving the plan's maximum match as limited by the compensation limit ($275,000 for 2018). If the plan matched elective deferrals dollar for dollar up to 8% of compensation, the compensation limit would cap matching contributions at $22,000 (8% of $275,000) and $3,300 of catch-up contributions would need to be matched.

A safe harbor plan document must specify which safe harbor is used and which safe harbor contributions are used to satisfy the safe harbor requirements, as well as any optional provisions applicable to the selected safe harbor. The plan document cannot provide that ADP or ACP testing will be used if the requirements for the ADP or ACP safe harbor are not satisfied [Treas. Reg. § 1.401(k)-1(e)(7) and Treas. Reg. § 1.401(m)-1(c)(2)].

Traditional vs. QACA Safe Harbor

With both safe-harbors, the 401(k) plan is relieved of complying with the ADP and ACP tests. The major difference between the two safe-harbors is that the QACA safe-harbor imposes minimum contribution percentages (see Table 5.1). A traditional Safe Harbor plan can have an automatic contribution arrangement that does not meet the QACA minimum percentages and is not subject to the uniformity requirement. However, the employer contributions under a traditional Safe Harbor plan must immediately be fully vested while a QACA Safe Harbor plan can use a vesting schedule. The QACA Safe Harbor also requires a slightly lower employer match requirement. If an employee contributes 5 percent, the traditional Safe Harbor plan results in a 4 percent employer match while a QACA Safe Harbor produces a 3.5 percent match.

Qualified Default Investment Alternatives

If an employee becomes a participant through a QACA or EACA, elective deferrals and contributions may be made before the individual has chosen how the funds should be invested. If the plan fiduciary invests the funds in a Qualified Default Investment Alternative (QDIA), the participant is considered to have exercised control over the investment of the account assets and the fiduciary is not liable for their performance.

Eligible Automatic Contribution Arrangements (EACA)

An Eligible Automatic Contribution Arrangement (ECAC) can be part of a safe-harbor 401(k) plan or a QACA. It can be applied to all employees or only to employees who become eligible to participate in the plan after the ECACs effective date.

Table 5.1
Traditional Safe Harbor vs. QACA Safe-Harbor Comparison

Basic Design Requirements	Traditional 401(k)(12) Safe Harbor	QACA 401(k)(13) Safe Harbor
Safe Harbor Matching Contributions	Match each plan year 10% of first 3% of safe harbor compensation deferred by each eligible NHCE, plus 5% of next 2% of safe harbor compensation deferred by the NHCE.	Match each plan year 100% of first 1% of safe harbor compensation deferred by each eligible NHCE, plus 50% of next 5% of safe harbor compensation deferred by the NHCE.
Or	**Or**	**Or**
Safe Harbor NEC	Provide each plan year a non-matching NEC contribution of at least 3% of safe harbor compensation to each eligible NHCE	Provide each plan year a non-matching NEC of at least 3% of safe-harbor compensation to each eligible NHCE.
Vesting of Safe Harbor Employer Contribution	Immediate 100% vesting	100% vesting after two years of service
Limitations on Matching Contributions	Matching contributions cannot be made with respect to elective deferrals (including Roth contributions) or employee non-Roth after-tax contributions that exceed 6% of an employee's safe harbor compensation. **And** Discretionary matching contributions cannot exceed 4% of an safe harbor compensation safe harbor compensation	Matching contributions cannot be made with respect to elective deferrals (including Roth contributions) or employee non-Roth after-tax contributions that exceed 6% of an employee's safe harbor compensation. **And** Discretionary matching contributions cannot exceed 4% of an safe-harbor compensation safe harbor compensation

Timeline for Making Safe Harbor 401(k) Plan Contributions

Employer contributions to a retirement plan can be made anywhere from the first day of the plan year through the due date of the company's income tax return for that year. With respect to safe harbor contributions timing options are as outlined below:

- Matching contributions may be funded under one of the following options:
  - *Each payroll period*. Under this option, only that pay period's compensation and contribution are taken into consideration for determining the match to be allocated at that time;
  - *Monthly*. All pay periods in a month are taken into consideration for determining the match to be allocated that month;
  - *Quarterly*. All pay periods in a quarter are taken into consideration for determining the match to be allocated that quarter; and
  - *Plan Year*. All pay periods during the year are taken into account for determining the match to be allocated that year.
- Non-elective contributions (NECs) may be funded during the year, but must always be reviewed at the end of the year to confirm that each participant receives 3% of pay.

SIMPLE 401(k) Plans

Under IRC §§ 401(k)(11)(A) and 401(m)(10) a plan sponsor (employer) can establish a SIMPLE 401(k) that can be treated as meeting the ADP tests of IRC § 401(k)(3)(A)(ii) and the ACP test of IRC § 401(m)(2). By limiting employer contributions to only the matching contributions or the non-elective contributions, the SIMPLE 401(k) plan also satisfies the top- heavy rules, however, the plan sponsor is required to make employer contributions that are fully 100% immediately vested.

SIMPLE 401(k) plans closely follow the requirements for SIMPLE IRA plans described in IRC § 408(p), but SIMPLE IRA plans are far more popular with employers because the IRA plans are less burdensome to set up and maintain; for example, Form 5500s are not required for SIMPLE IRA plans.

SIMPLE 401(k) Eligible Employers

Any employer that has 100 or fewer employees with at least $5,000 of compensation in the preceding calendar year is eligible to set up a SIMPLE 401(k) plan. Eligible employers include:

- Self-employed individuals;
- Corporations;
- Partnerships;
- Tax-exempt entities (Except Government employers); and
- Indian Tribal governments.

An eligible employer who establishes a SIMPLE 401(k) plan cannot maintain any other plan for employees who are eligible to participate in the SIMPLE 401(k) plan and cannot receive any contributions or benefit accruals under any other plans of the employer. By contrast, provided certain requirements are met, an employer who establishes a traditional 401(k) plan may choose to establish a SEP IRA, profit-sharing or other defined contribution plan, maintain both plans concurrently and allow eligible employees to participate in both plans.

Employee Elective Contributions

The 2018 dollar limitation on elective contributions is $12,500 (adjusted for inflation annually in increments of $500). There is also a provision for catch-up contributions for participants who have reached age 50 by year-end of $3,000 in 2018 [IRC § 414(v)(2)].

Note: As compared to a traditional 401(k) plan the SIMPLE 401(k) plan limit is significantly less than the dollar limit that applies to a regular or safe harbor 401(k) plan or a 401(k) plan containing a qualified automatic contribution arrangement (QACA).

Employer Contributions and Deductions

The employer is required to make a contribution to the employee's SIMPLE 401(k) account an amount equal to either:

- Dollar for dollar matching contributions equal to the lesser of the eligible employee's elective contributions for the year or 3% of the eligible employee's SIMPLE compensation for the entire calendar year; or
- Non-elective contributions equal to 2% of the eligible employee's SIMPLE compensation for the entire calendar year, but the plan can limit the non-elective contribution to those eligible employees who received at least $5,000 of SIMPLE compensation from the employer for the entire calendar year.

SIMPLE 401(k) plans are subject to the same "*annual additions*" limits of IRC § 415(c). Additions to a participant's account cannot exceed the lesser of $55,000 or 100% of compensation (maximum for 2018). Also, the compensation limit applies to both plans, which means the employer cannot consider compensation in excess of $275,000 for 2018 for plan purposes.

Therefore, an employee's total contribution to a SIMPLE 401(k) plan for 2018 can be as much as $23,750 (see Table 5.2), while contributions to a traditional 401(k) plan can be as much as $55,000 plus catch-up contribution of $6,000 for a total contribution of $61,000 in 2018.

Table 5.2
SIMPLE 401(k) 2018 Contributions

Contributions	Amounts in 2018
Elective deferrals	$12,500
Matching employer contributions	8,250
Catch-up contributions	3,000
Total	$23,750

Note: Employees are 100% immediate vested in all contributions. Loans are permitted. In-service withdrawals are permitted on account of hardships.

Deadline to Establish SIMPLE 401(k)

A SIMPLE 401(k) must be established between January 1 and October 1. An exception applies to businesses that come into existence after October 1. For these businesses, the plan can be established as soon as administratively feasible.

Annual Notice Requirements

There are special election and notice requirements for SIMPLE 401(k) plans:

- For an employee's initial year of participation, he or she must be permitted to make a cash or deferred election under the plan during a 60-day period that includes either the day the employee becomes eligible or the day before; and
- For each subsequent year, the employee must be permitted to make or modify his or her cash or deferred election during the 60-day period immediately preceding such calendar year.

An eligible employee must be permitted to terminate his or her cash or deferred election at any time.

The employer must notify each eligible employee within a reasonable time prior to each 60-day election period that he or she can make or modify a cash or deferred election and whether the employer will be making matching or non-elective contributions for the year.

Individual (Solo) 401(k) Plan

The Individual 401(k) is a self-employed retirement plan that is sometimes referred to as an "Individual (k)", "Solo 401k", "Single (k)" and "Self Employed 401k". The Individual 401(k) came about with the enactment of the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA). This tax law became effective beginning January 1, 2002 and provides significant advantages to small business owners whose only employee is the owner and the owner's spouse.

What makes the Individual 401(k) unique is that compared to other self-employed retirement plans greater contributions may be made at identical income levels, therefore maximizing retirement contributions and valuable tax deductions (discussed below).

Employer Eligibility

The Individual 401(k) is for owner-only businesses or owner and spouse businesses. The business can be:

- Incorporated (or unincorporated);
- Sole proprietors;
- Partnerships;
- S corporations;
- C corporations; and
- Limited Liability Corporations.

A business that employs part-time W-2 employees may be able to exclude them from plan participation. Independent contractors (IRS Form 1099 employees) employed by the business are excluded from the plan and would not disqualify the employer from setting up an Individual 401k. Generally, under federal law, the following types of employees are permitted to be excluded:

- Employees under age 21;
- Employees with less than one year of service;
- W-2 employees who work less than 1000 hours per year;
- Certain union employees; and
- Certain nonresident alien employees.

Plan Benefits

The Individual 401(k) plan has several benefits for small business owners and the self–employed;

- Higher Contribution Limits;
- Tax Deductible Contributions;
- Tax Deferred Growth;
- Contribution Flexibility;
- Access to Tax Free Loans;
- Cost Effective Administration; and
- Retirement Plan Consolidation.

Compared to a Traditional 401(k), the Individual 401(k) plan is easy, flexible and inexpensive to maintain because administration is minimal, and complex nondiscrimination tests are not required. Fees vary depending on the level of administrative services provided by the Individual

401(k) administrator. If an Individual 401(k) is greater than $250,000, IRS Form 5500 needs to be filed and the administrator may charge a fee for its completion or the individual can could elect to complete the form himself/herself.

Another important feature of the Individual 401(k) plan is the opportunity for small business owner's to consolidate retirement assets into one account. This includes Traditional IRAs, SEP IRA Plans, 401(k) Plans, Money Purchase Plans, SIMPLE IRAs, Profit Sharing Plans, Defined Benefit Plans, 403(b) Plans and IRA Rollovers.

Consolidating retirement accounts is particularly important if the individual small business owner would like to use the loan provision (discussed below). Other advantages of rolling over and consolidating his/her retirement plans into his/her Individual 401(k) are improved financial organization and ease of monitoring the retirement portfolio.

Contributions

Individual 401(k) retirement plans may provide significant tax savings because in general, the small business owner may deduct 100% of contributions made into an Individual 401(k) from their taxable income. Incorporated businesses can generally deduct the salary deferral contribution from W-2 earnings and the profit sharing contribution as a business expense. Unincorporated businesses such as sole proprietors can generally deduct contributions made to an Individual 401(k) from personal income (discussed below).

Individual 401(k) contribution limits are $55,000 in 2018 ($61,000 if age 50 or older). The annual Individual 401(k) contribution consists of two parts:

- A salary deferral contribution; and
- A profit sharing contribution.

The total allowable contribution adds these two parts together to get to the maximum Individual 401(k) contribution limit.

Note: Individual 401(k) salary deferral contributions can be made as Roth 401(k) (after tax) or traditional 401(k) (pre-tax).

Calculation for an S or C corporation or an LLC taxed as a corporation:

- *Salary Deferral Contribution*: In 2018, 100% of W-2 earnings up to the maximum of $18,500 or $24,500 if age 50 or older ($6,000 catch up contribution) can be contributed to an Individual 401(k); and
- *Profit Sharing Contribution:* A profit sharing contribution up to 25% of W-2 earnings can be contributed into an Individual 401(k).

Individual 401(k) contribution calculation for a sole proprietorship, partnership or an LLC taxed as a sole proprietorship:

- *Salary Deferral Contribution:* Although the term salary deferral is used, these businesses do not provide a W-2 salary to the business owner. For businesses of this type, the salary deferral contribution is based on net adjusted business profit. Net adjusted business profit is calculated by taking gross self-employment income and then subtracting business expenses and then subtracting 1/2 of the self-employment tax. In 2018, 100% of net adjusted business profits income up to the maximum of $18,500 or $24,500 if age 50 or older can be contributed in salary deferrals into an Individual 401(k); and
- *Profit Sharing Contribution*: A profit sharing contribution can be made up to 20% of net adjusted businesses profits. Net adjusted business profit is calculated by taking gross self-employment income and then subtracting business expenses and then subtracting 1/2 of the self-employment tax.

Each year the funding of an Individual 401(k) retirement plan is completely discretionary. The individual can increase or decrease your salary deferral and/or profit sharing contributions depending on the profitability of your business.

Loans

Similar to a traditional 401(k), an Individual 401(k) loan is permitted at any time using the accumulated balance of the 401(k) as collateral for the loan. Individual loans are permitted up to ½ of the total balance of the 401(k) up to a maximum of $50,000. A loan from an Individual 401(k) is received tax free and penalty free. There are no penalties or taxes due provided loan payments are paid on time.

Generally, Individual 401(k) loans have a 5 year maximum repayment term. Individual 401(k) loans used for the purchase of a primary residence may extend the loan repayment term up to 10-15 years. Loans must be repaid according to the terms of the loan amortization schedule which is provided when a loan is initiated. Failure to repay the loan according to these terms may result in a loan default causing taxes as well as IRS penalties.

Loan payments are made monthly or quarterly. Loan payments of principal and interest are repaid back into the individual's own Individual 401(k). Because of this an Individual 401(k) loan may be a favorable option compared to other loans where interest is paid to the bank or lending institution.

The proceeds from an Individual 401(k) loan can be used for any purpose and there are no income or credit qualifications to receive the loan. The ease of an Individual 401(k) loan is attractive because start-up businesses and self-employed business owners often run into difficulties with qualifying for a self-employed loan through banks and lending institutions.

Note: Loans are not permitted with traditional IRAs or Roth IRAs, SEP IRAs, or Keogh (Money Purchase/Profit Sharing Plans).

IRS requires that the employer notify each employee of the availability of the feature at the time he or she becomes a participant and each year thereafter, and that the employee has a reasonable period of time to elect out of the automatic enrollment feature.

Chapter 5
Review Questions

1. Which of the following statements about Safe Harbor 401(k) plans is FALSE?

( ) A. Provides for employer contributions that are fully vested when made.
( ) B. Eliminates the nondiscrimination and top heavy tests ordinarily applied under a traditional 401(k) plan.
( ) C. There are requirements pertaining to the number of employees in the organization
( ) D. Ideal for businesses with highly compensated employees (HCEs) whose contributions would be limited in a traditional 401(k) plan.

2. Under the 401(k)(12) Safe Harbor plan basic match formula, what is the maximum matching contribution required for an employee to meet the safe harbor requirement?

( ) A. 10% of compensation
( ) B. 6% of compensation
( ) C. 3.5% of compensation
( ) D. 4% of compensation

3. Which of the following enacted by Congress added IRC § 401(k)(13) Safe Harbor plans?

( ) A. The Pension Protection Act (PPA) of 2006
( ) B. The Small Business Job Protection Act (SBJA) of 1996
( ) C. The Deficit Reduction Act (DRA) of 2005
( ) D. The Economic Growth Tax Relief Reconciliation Act (EGTRRA) of 2001

4. Under a 401(k)(13) Safe Harbor plan, when the employee contributes 6 percent, the traditional Safe Harbor plan results in a 4 percent employer match, while a QACA Safe Harbor will produce what percent match?

( ) A. 1%
( ) B. 3.5%
( ) C. 4%
( ) D. 6%

5. True or False. Form 5500 must be filed for an Individual 401(k) if the total assets are above $250,000.

( ) A. True
( ) B. False

This page left blank intentionally

CHAPTER 6

COMBINATION PLANS

Overview

Many large firms are converting their DB plans into hybrid DB plans as a way to cap their pension liabilities. We also see a number of small- and midsize firms are starting to rely on these plans, which when used in combination with a 401(k) plan, can help participants cut their current tax bill and sock away quite a bit of money for retirement. These types of "*combination plans*" were authorized after Congress passed the Pension Protection Act of 2006, specifically Section 903, which created IRC Section 414(x) in the Internal Revenue Code.

This chapter will examine the benefits of "*Eligible Combined Plans*." It will begin with a history and background of the legislative changes that enacted IRC § 414(x). Then discuss its legal structure, minimum benefits, vesting, and eligibility requirements.

Learning Objectives

Upon completion of this chapter, you will learn to:

- Describe the background of the DB(k) Plan;
- Identify who can benefit from setting up a DB(k);
- Recognize the structure of the DB(k)Defined Benefit Plan and Defined Contribution Plan;
- Identify the eligibility requirements under IRC § 414(x), its minimum benefits, vesting and eligibility requirements;
- Determine the minimum benefits and vesting requirements; and
- Outline the considerations for adopting an eligible combination plan.

Background

Section 903 of the Pension Protection Act of 2006 allows an employer, beginning in 2010, to adopt an "*Eligible Combined Plan*," consisting of a DB plan and a DC plan, more than likely a 401(k) profit sharing plan held in a single trust, using one plan document, one summary plan description, one Form 5500, and one audit (if required). The idea behind the Combination Plan was simple. By combining a DB plan and a DC plan, a small employer (at least 2 but less than 500 employees) could potentially reduce the cost and administration requirements of maintaining two separate plans. In addition, the Combination Plan would enable the small employer to offer the guaranteed income of a pension and the opportunity for the workers to save in a DC plan (401(k) plan).

Eligible Combined Plan

Under IRC § 414(x)(2)(A) of the Code, an "*eligible combined plan*" is a plan:

- That is maintained by an employer that is a small employer (defined below) at the time the plan is established;
- That consists of a DB plan and an applicable DC plan;
- The assets of which are held in a single trust forming part of the plan and are clearly identified and allocated to the DB plan and the applicable DC plan to the extent necessary for the separate application of the Code; and
- That meets the benefit, contribution, vesting, and non-discrimination requirements under IRC § 414(x).

Eligible Small Employers

Under IRC § 414(x)(2)(A) an eligible "*small employer*" is generally an employer (taking into account the rules of IRC § 414(b), (c), (m), and (o) that employed an average of at least 2 but not more than 500 employees on each business day during the preceding calendar year and who employs at least 2 employees on the first day of the plan year.

In the case of an employer that was not in existence throughout the preceding calendar year, the determination of whether the employer is a small employer is based on the average number of employees it is reasonably expected the employer will employ on business days in the current calendar year.

IRC § 414(x) (7) defines an "*applicable defined contribution plan*" as a DC plan that includes a qualified cash or deferred arrangement.

Eligibility Requirements for Combined Plans

IRC § 414(x)(1) provides that, the requirements of the Code are applied to a DB plan or applicable DC plan that is part of an eligible combined plan in the same manner as if each such plan were not a part of the eligible combined plan. Further, in the case of the termination of both the DB plan and the applicable DC plan forming an eligible combined plan, the DB plan and the applicable DC plan must be terminated separately by the plan administrator. Under IRC § 414(x)(6)(A), the rules of IRC § 414(k), which determine the requirements applicable to DB pension plans with separate participant accounts, do not apply to eligible combined plans.

Minimum Benefits and Vesting under DB Plan

Under IRC § 414(x)(2)(B), the DB plan that forms part of the eligible combined plan must provide each participant with a minimum employer-provided accrued benefit. The minimum benefit must be an annual retirement benefit that is not less than the applicable percentage of the participant's final average pay. For this purpose, the applicable percentage is the lesser of:

- 1 percent multiplied by the participant's years of service with the employer; or
- 20 percent.

Final average pay is determined using the period of consecutive years (not exceeding five) during which the participant had the greatest aggregate compensation from the employer.

As an alternative to the minimum benefits mentioned above, the DB component of the eligible combined plan may be a Cash Balance Plan, under which the accrued benefit is calculated as the balance of a hypothetical account or an accumulated percentage of the participant's average compensation, and which meets the applicable interest credit requirements of IRC § 411(b)(5)(B)(i) (as added by the PPA of 2006). The plan would be treated as meeting the benefit requirements if each participant received a pay credit for the year which is not less than a specified percentage of compensation, based on the participant's age (see Table 6.1). For participants who are age 30 or less at the beginning of the year, the percentage is 2. The applicable percentage increases to 4 for participants older than 30, but younger than 40; 6 for participants older than 40, but younger than 50; and 8 for participants who are age 50 or older.

Table 6.1
Minimum Benefit Rules

Participant's Age as of Beginning of Plan Year	Percentage
30 or less	2
Over 30 but less than 40	4
40 or over but less than 50	6
50 or over	8

For purposes of the minimum benefit rules, years of service are determined under the rules of IRC § 411(a)(4), (5), and (6), except that the plan may not disregard any year of service merely because a participant makes, or fails to make, any elective contributions under the qualified cash or deferred arrangement that is included in the applicable DC plan that forms part of the eligible combined plan.

Under IRC § 414(x)(2)(D)(i), a participant must be fully vested in his or her employer-provided accrued benefit under the DB plan after completion of three (3) years of service.

Minimum Contributions and Vesting under DC Plans

Under IRC § 414(x)(2)(C), the applicable DC plan that forms part of the eligible combined plan must meet certain contribution requirements. In particular, the qualified cash or deferred arrangement included in such plan must constitute an automatic contribution arrangement, pursuant to which each eligible employee is treated as having elected to make an elective contribution of 4 percent of compensation. However, an eligible employee may elect not to make such contributions or elect contributions at a different enrollment rate.

In addition, the employer must be required to make matching contributions on behalf of each employee eligible to participate in the qualified cash or deferred arrangement. To satisfy the basic matching contribution requirement in IRC § 414(x)(2)(C)(i)(II), matching contributions must be made in an amount equal to 50 percent of the elective contributions of the employee to the extent such elective contributions do not exceed 4 percent of compensation. Alternatively, the plan may provide for a different rate of matching contribution, provided that the rate of matching contribution does not increase as the participant's rate of elective contribution increases, and the aggregate amount of matching contributions at each rate of elective contribution is no less than the aggregate amount of matching contributions that would be provided under the basic matching contribution requirement. In no case may the rate of matching contribution for any elective contribution of a highly compensated employee at any rate of elective contribution be higher than the rate of matching contribution for a NHCE.

The applicable DC plan can also provide for non-elective employer contributions (NECs), but non-elective contributions are not taken into account in determining whether the matching contribution requirements are met.

Under IRC § 414(x)(2)(D)(ii)(l), all participants must be fully vested in any matching contributions provided under the applicable DC plan, including any matching contributions exceeding required matching contributions. In addition, under IRC § 414(x)(2)(D)(ii)(ll), a participant must be fully vested in any non-elective contributions under the applicable DC plan after completion of three (3) years of service.

Under IRC § 414(x)(2)(E), all contributions and benefits under the DB plan and applicable DC plan forming part of the eligible combined plan, and all rights and features under each such plan, must be provided uniformly to all participants.

Under IRC § 414(x)(2)(F), the minimum benefit and contribution requirements applicable to the DB plan and applicable DC plan must be met without application of the permitted disparity rules under IRC § 401(l). In addition, the DB plan and applicable DC plan must meet the non-discrimination requirements under IRC § 401(a)(4) and the minimum coverage requirements under IRC § 410(b) without application of the permitted disparity rules and without being combined with any other plan.

Non-discrimination and Top-Heavy Requirements

Under IRC § 414(x)(3), a qualified cash or deferred arrangement that is included in the applicable DC plan that forms part of an eligible combined plan and that meets the minimum contribution requirements described above is treated as meeting the actual deferral percentage (ADP) test under IRC § 401(k) on a safe harbor basis. In addition, in applying the safe harbor contribution percentage test for matching contributions under IRC § 401(m)(11), the minimum contribution requirements described above and the notice requirements described below are substituted for the otherwise applicable minimum contribution and notice requirements.

Under IRC § 414(x)(4), a DB plan and applicable DC plan forming part of an eligible combined plan for any plan year are treated as meeting the top-heavy requirements under IRC § 416.

Automatic Contribution and Notice Requirements

Under IRC § 414(x)(5), the qualified cash or deferred arrangement that is included in an eligible combined plan is treated as an automatic contribution arrangement (ACA) if it meets certain notice and election requirements and provides that each employee eligible to participate in the arrangement is treated as having elected to make elective contributions in an amount equal to four (4) percent of the employee's compensation unless the employee specifically elects not to have such contributions made or to have such contributions made at a different rate. Each employee eligible to participate in the qualified cash or deferred arrangement must receive a notice explaining the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf or to have the contributions made at a different rate. Each eligible employee must also have a reasonable period of time after receipt of the notice and before the first elective contribution is made to make an election. In addition, within a reasonable period before any year, each eligible employee must be given notice of the employee's rights and obligations under the arrangement. The notice must be sufficiently accurate and comprehensive to apprise the employee of the employee’s rights and obligations and must be written in a manner calculated to be understood by the average eligible employee.

Considerations for Adopting a Combination Plan

Under IRC § 414(x), benefits may be required to vest over a shorter period than they would otherwise be required to under the terms of the plan. Likewise, the contributions required may or may not be greater than the current contribution requirements depending on many factors, including the plan’s current top-heavy status, DB plan formulas, actual employee turnover, etc. While there are many things to consider when adopting any type of retirement plan, the major considerations include:

- *Required Funding.* Given the volatility of the stock market and the inflexible funding requirements mandated by the PPA of 2006, by utilizing IRC § 414(x), an employer (plan sponsor) gives up the flexibility of discretionary matching contributions found in the 401(k) world and the DB plan contribution must be funded no matter what the magnitude;

- *Cash Flow.* Consistent and positive cash flow is a must for this type of plan;
- *Company Size.* Small, owner-dominated companies that have both types of retirement plans are the most likely candidates; and
- *Impact of Current Testing.* The more the plans are already affected by the top-heavy and non-discrimination rules, the more preferable this sort of arrangement becomes.

For many small business owners who want to control costs of their retirement plan, while further increasing their own allocations, the eligible combination plan may be their choice. Table 6.2 illustrates the unparalleled flexibility of the Cash Balance and 401(k) Combination Plan arrangement.

Table 6.2
Cash Balance Plan and 401(k) Combination Plan□

Census Data			Safe Harbor and 401(k) Profit Sharing Plan□				Cash Balance Plan □□		Combined Total
Position	**Age**	**Annual Pay**	**Salary Deferral**	**3% SHNEC**	**Cross-Tested PS**	**Total % of Pay**	**Cost Allocation**	**% of Pay**	
Owner A	55	$275,000	$24,500	$0	$8,250	3%	$148,500	54%	$173,000
Owner B	50	$275,000	$24,500	$0	$8,250	3%	$148,500	54%	$173,000
EE 1	50	$75,000	$0	$2,250	$3,750	8%	$1,500	2%	$7,500
EE2	55	$50,000	$0	$1,500	$2,500	8%	$1,000	2%	$5,000
EE 3	35	$40,000	$0	$1,200	$2,000	8%	$800	2%	$4,000
EE 4	30	$35,000	$0	$1,050	$1,750	8%	$700	2%	$3,500
EE 5	25	$30,000	$0	$900	$1,500	8%	$600	2%	$3,000
		Owners	$49,000	$ 0	$16,500		$297,000		$346,000
		EEs	$0	$6,900	$ 9,500		$ 4,600		$ 23,000
		Totals	$49,000	$6,900	$26,000		$301,600		$369,000
							Percent to Owners		94%

□Assumes a benefit based on 10% of average monthly compensation multiplied by a maximum of ten years of participation, and a Target Normal Cost calculated using mandated segment rates. □ 3% Safe Harbor Non-Elective employer contribution is allocated to all eligible participants plus a 5% regular employer Profit Sharing allocation to non-owner participants. Complying with Safe Harbor provisions allows the owners to make maximum salary deferrals without failing required non-discrimination testing. □ Profit Sharing, Safe Harbor, Salary Deferral and Cash Balance allocations are converted to monthly benefits at age 65 (Normal Retirement Age) and aggregated to pass non-discrimination testing. Analysis by author.

In this design, the 401(k) Plan portion uses a 3% Safe Harbor Non-Elective Contribution (SHNEC) for all non-owners to allow the owners to make maximum salary deferrals plus catch-up contributions, without fear of failing the ADP Test for non-discrimination of deferrals. The 3% SHNEC also helps to satisfy complex dual plan Top Heavy Minimum and Gateway Test requirements.

The non-owners receive the bulk of their benefits in the 401(k) Plan, while the owners receive the bulk of their benefits in the Cash Balance Plan (54% of pay). The profit sharing allocations are converted to benefit accruals at age 65 and are cross-tested in aggregation with the Cash Balance Plan benefits to demonstrate that combined employer contributions are non-discriminatory. Although assumed to be zero, additional voluntary salary deferrals by non-owners will not impact the testing of this arrangement.

The combination design reduces the non-owner plan cost by $8,100, while increasing total allocations to the owners by $127,500. The percent of total plan contributions that attributes to the owners is an astounding 94%. I don't believe there is any other type of qualified retirement plan that could rival the benefits and provide the flexibility of the Cash Balance and 401(k) Combination Plan design.

Table 6.3 identifies some high-level considerations and comments on whether an eligible combination plan under IRC §414(x) plan merits consideration:

Table 6.3
IRC § 414(x) Requirements

Employer Type	Current Defined Benefit Plan	Consistent and Positive Company Cash Flow	Refunds in 401(k) Plan	Already Top Heavy	IRC § 414(x) Worthy of Consideration
Small, 25 Employees	Yes	Yes	Yes	Yes	Yes – this type of arrangement may be less expensive than a safe harbor defined contribution plan (for the DC plan).
Medium, 250 Employees	Yes	Yes	Yes	Yes	Maybe – this is an efficiency issue, providing the minimum benefits may be much more expensive than making the refunds.
Large, 500 Employees	Yes	Yes	Yes	Yes	No – if the employee base is growing then this option may not be available for long: 500 employees is the limit.
Any (with 500 or fewer employees)	No	Yes	Yes	Yes	Maybe – careful consideration is necessary: adding a DB plan is not a benefit that allows flexibility in funding.
Any (with 500 or fewer employees)	Yes/No	No	Yes	Yes	Maybe – again, careful consideration is necessary; adding a DB plan is not a benefit that allows flexibility in funding; if the goal is to reduce the current level of benefits provided in the DB plan, this kind of plan might be useful

IRS Revenue Ruling 2012- 4: DC to DB Rollovers

Employers who sponsor both a 401(k) or other DC plan and a DB plan (combination plans) may be able to offer participants a lifetime income benefit that is already largely in place. Such employers can permit terminating employees who are covered under both plans, to roll all or a portion of their DC benefits over to the pension plan to receive a greater life annuity benefit from the pension plan. This approach may be beneficial for retirees and other terminating employees, while still helping to minimize the employer's administrative burdens.

Although some employers have offered such rollovers, many others were reluctant to follow suit in the absence of formal guidance on how such rollovers actually work in practice. Now that the Treasury Department and Internal Revenue Service (IRS) have issued guidance with IRS Rev. Ruling 2012-4, clarifying how this annuity conversion can be accomplished under the rules for qualified plans (discussed below), there is a renewed interest in DC to DB rollovers.

Let's review some of the advantages and disadvantages of these rollovers, from the employer's and the employees' perspective.

For the employer's, there are several advantages of offering a DC to DB rollover:

- *Distinguishing the Employer's DC Plan from the Competition.* Until this feature becomes commonplace, this option can be communicated as a positive feature of the employer's program, setting it apart from other DC plans in the marketplace. It also is a feature that employers without a DB plan, frozen or otherwise, cannot replicate;
- *Using the DC Plan to Aid Retention.* Offering this option only for employees who retire after certain age/service criteria is achieved may encourage mid-career employees to stay until the attainment of the rollover criteria;
- *Opportunity to Generate Investment Gains.* For purposes of the conversion to lifetime income, the lifetime income stream created from the rollover will be valued using actuarial assumptions based on interest rates on corporate bonds. However, unless the plan's assets are invested only in fixed-income investments, the DB plan's long time horizon may allow it to invest in other investments and thus possibly earn a greater return than the fixed-income rate used in the conversion; and
- *Marginal Improvement in Funded Status.* To the extent that a plan is less than 100 percent funded, rollovers will increase its funded status. This occurs because the additional liabilities attributable to the rollover are essentially 100 percent funded at the time of rollover and, therefore, drive the total plan's funded status a bit closer to 100 percent.

Employees may want to make a DC to DB plan rollover for the following reasons:

- *Obtain Longevity Protection at Below Insurance Market Costs.* Provides longevity protection without expense and profit loads found in commercial annuities, the conversion rates used by the plan will typically be less than prevailing rates in the individual annuity marketplace. This is the primary advantage of such rollovers for employees; and.
- *Avoid the Section 415 Maximum Benefit Limit.* That limit does not apply to the rollover provided the annuity is calculated using IRC §417 (e) assumptions.

The primary disadvantages of rolling money from a DC to a DB plan are:

- *Increased Financial Exposure to the Employer.* Employees may not want to have too much of their net worth in their employer's DB plan, especially if there are concerns about the financial solvency of the employer and if the DB plan is underfunded;
- *Use of Unisex Annuity Rates***.** The DB plan would need to use unisex rates for these conversions and, unless a 100 percent female table is used, the unisex table will provide a subsidy to the female participant and penalize the male participant. From the male participant's point of view, this financial disadvantage may outweigh the financial advantage of not having to pay for insurance company expense and profit loads; and
- *Lack of a Cash-Value Feature***.** This can pose a problem for employees who face unforeseen large expenses. Of course, this can be mitigated to some extent by rolling over only a portion of the DC account balance.

Employers who are thinking about offering a DC to DB rollover option should be aware that there are still some ambiguities about the design, as noted below:

- *Pension Benefit Guaranty Corporation (PBGC) Protection***.** The PBGC has not yet provided guidance on how its benefit guarantees will apply to additional lifetime payment amounts derived from a rollover contribution. In addition, in some cases, the rollover amount could cause the total benefit payable from the DB plan to exceed the maximum PBGC guarantee. Without PBGC protection, there is a possibility that participants could lose all or a portion of the rollover benefit should the plan terminate with insufficient assets;
- *How to Handle After-Tax Contributions***.** Transfers of after-tax money will likely require special tax treatment; additional IRS guidance is needed; and
- *Potential Administrative Issues.* It is unclear whether the non-discrimination rules allow the employer to require a minimum transfer amount to avoid the administrative costs of small annuities. For example, to avoid *de minimis* payments, the usual cash-out rule should apply, allowing employers to only have to pay annuity amounts that have a present value (combined with the regular DB benefit) of $5,000 or more.

Chapter 6
Review Questions

1. Which Act by Congress permits employers with 500 or fewer employees the authority to establish a combination plan under IRC Section 414(x)?

( ) A. Employee Retirement Income Security Act of 1974
( ) B. Deficit Reduction Act of 2005
( ) C. Pension Protection Act of 2006
( ) D. Economic Growth Tax Relief Reconciliation Act of 2001

2. Which of the following statements about an eligible combination plan under IRC § 414(x) is FALSE?

( ) A. The plan must meet specified benefit, contribution, vesting and non-discrimination requirements.
( ) B. Must file only a Single Form 5500
( ) C. Must file only one plan document
( ) D. Must file two separate plan documents

3. In an eligible combination plan, a participant must be fully vested in his or her employer-provided accrued benefit under the DB plan after completion of how many years of service?

( ) A. 3 years
( ) B. 5 years
( ) C. 6 years
( ) D. 7 years

4. Under IRC § 414(x)(2)(B), the DB plan must provide each participant with a minimum benefit that is lesser of 1 percent multiplied by the participant's years of service with the employer; or what percent

( ) A. 10%
( ) B. 20%
( ) C. 50%
( ) D. 60%

5. True or False. Under IRC § 414(x)(4), the DB plan and DC plan are treated as meeting the top-heavy requirements under IRC § 416.

( ) A. True
( ) B. False

CHAPTER 7

ROTH 401(k) DESIGNATED ROTH ACCOUNTS

Overview

Offering Roth accounts, technically referred to as Designated Roth Accounts (DRAC), within a 401(k) plan has become increasingly common and, is expected to soon become the norm—not the exception. The DRAC was first introduced with the signing of *The Economic Growth Tax Relief and Reconciliation* Act (EGTRRA) of 2001 and became permanent in the tax code with the passing of the Pension Protection Act of 2006. According to Vanguard's report, "*How America Saves, 2017*," at year end 2016, the DRAC feature was adopted by 65% of Vanguard plans. However, the DRAC option is woefully underutilized by participants. Vanguard reported that only 13% of participants that have the option currently make DRAC contributions. But, they do anticipate steady growth in DRAC adoption rates, given the feature's tax diversification benefits.

This chapter will examine the features and benefits of the DRAC, describe how participants can fund the account with annual contributions and conversions, and detail the tax diversification benefits why a participant should consider a DRAC. The chapter will also review the technical issues pertaining to DRAC rollovers and distributions requirements.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Relate the background of the Designated Roth Account (DRAC);
- Know the differences between a traditional 401(k) and a DRAC 401(k);
- Describe the rules for DRAC In-plan Conversions; and
- Apply the rules for DRAC Rollovers and distributions

Background

Beginning in 2006, a provision in the *Economic Growth Tax Relief and Reconciliation Act of 2001* (EGTRRA), Section 617(f), allowed employers who had a 401(k) plan to set up a DRAC. If an employer amended their 401(k) plan documents to permit DRAC contributions, participants would be able to elect to allocate part or all of their elective deferrals ($18,500 in 2018) into a DRAC within their 401(k) plans. A DRAC combines many of the benefits of the Roth IRA and the traditional 401(k) (See Table 7.1).

Table 7.1
DRAC vs. Traditional 401(k) Plan (2018)

	DRAC	Traditional 401(k)
Contributions Are	Post -Tax	Pre-Tax
Can be Started By	Employer only	Employer only
Matching Funds Are	Pre-Taxed in a Traditional 401K	Pre-Taxed in a Traditional 401K
Maximum Annual Individual Contribution (2016)	$18,500	$18,500
Catch-up Contribution	$6,000	$6,000
Can Roll-Over to	Roth IRA or new employer's 401K	Traditional IRA, a new employer's Traditional 401K, or a Roth IRA (pay taxes)
Pay Taxes At	Time of Contribution	Withdrawal in Retirement
Can Begin Withdrawing Earnings Without Penalty	At age 59 ½	At age 59 ½
Taxes in Account	No taxes on dividends, capital gains, or interest	No taxes on dividends, capital gains, or interest

Under EGTRRA of 2001, DRAC plans were available for tax years beginning in tax year 2006. But like all other provisions contained in the Act, the DRAC contributions were to sunset and not be permissible after December 31, 2010. All of that changed with the enactment of the Pension Protection Act (PPA) of 2006 which gave permanence to the DRAC.

DRAC Qualification Requirements

To meet the qualifications requirements, a 401(k) plan must do the following:

- Establish separate DRAC accounts for the contributions of each employee and any earnings properly allocable to the DRAC; and
- Maintain separate recordkeeping for each DRAC [IRC § 402A (b)(2)].

DRAC Contributions

By contributing to a DRAC, participants are electing to trade the tax deductions available in the current year in exchange for tax-free benefits in retirement. Specifically, individuals contribute to a DRAC on an after-tax basis, and upon retirement, these contributions and the earnings on them can be withdrawn tax-free, if certain requirements are met [IRC § 402A(b)(1)].

The maximum deferral amount permitted by law may be allocated between the traditional and DRAC inside a 401(k) [IRC § 402(a)(c)(2)]. As mentioned above, the maximum contribution limitation for 2018 is $18,500 (subject to limitations by the actual deferral percentage (ADP) and actual contribution percentage (ACP) discussed in Chapter 4), and indexed for inflation thereafter, plus catch-up contributions of $6,000 for workers age 50 or above. Therefore, the total amount a business owner or employee over age 50 could contribute to his or her regular and Roth accounts inside of a 401(k) plan is $24,500 in 2018.

Note: Employer matching contributions cannot be allocated to the Roth accounts in a 401(k) plan.

Whether DRAC contributions are better than before-tax contributions depends on two factors:

- The tax rate today; and
- The tax rate in retirement.

If tax rates are higher in retirement, the DRAC contribution is more beneficial. Conversely, if tax rates are lower in retirement, before tax contributions will yield more take-home income. Consider the following simplified example illustrated in Table 7.2, comparing how retirement income differs when $5,000 is contributed to a DRAC, a before-tax account and an after-tax account for 30 years at a 7% rate of return.

Table 7.2
Comparison of Retirement Income

	DRAC	Before-Tax	After-Tax
Contribution	$5,000	$5,000	$5,000
Balance After 30 Years	$38,061	$38,061	$38,061
Tax Amount (25% Tax Rate)	$ 0	$9,515	$8,265*
Ending Balance	**$38,061**	**$28,546**	**$29,796**

*For purposes of simplicity, this example assumes the 25% tax is paid on the investment earnings which equal the ending balance ($38,061) minus the initial contribution of $5,000. In reality, the tax situation could be much more complicated.

In contrast to a Roth IRA, there is no income ceiling above which an employee is not allowed to make DRAC contributions [IRC § 402A]. There is no age limit above which the employee cannot contribute to a DRAC. An employee can contribute to a DRAC even if he or she is also a participant in other retirement plans offered by the same or another employer.

The DRAC offers several benefits to participants. Among them are:

- No income phase-outs on contributions to the plan;
- Continue ability to make DRAC contributions (if other conditions are met);
- Creation of a hedge against future tax increases; and
- Exemption from the required minimum distribution rules.

DRAC In-Plan Conversions

On September 27, 2010, President Obama signed into law the *Small Business Job Protection Act (SBJPA) of 2010*. The Act, under Sections 2111 and 2112, now permitted 401(k), 403(b) and governmental 457(b) employers (plan sponsors) to amend their plans to permit vested account balances that can be distributed as an eligible rollover distribution to be converted to DRAC amounts within the plan (DRAC In-Plan Conversions). The converted amounts will be treated as distributions and taxable in the year of conversion. The in-plan DRAC conversion provision was included in the Act because it was expected to raise more than $5.5 billion over a 10 year period from participants who perform in-plan rollovers to DRAC programs. The implementation of this feature is discretionary.

Note*:* A special rule permitted amounts converted in 2010 to be recognized as income over a two-year period starting in 2011, unless the participant elects to have the income recognized in 2010.

Prior to the enactment of SBJPA, a participant could take a distribution of retirement plan assets (to the extent permitted under law and by the plan) and convert the assets outside the plan by rolling over the distribution to a Roth IRA. The prior law put plan sponsors in somewhat of a dilemma because if they wanted to allow participants to maximize the amount of money they could roll over to a Roth IRA, the plan had to expand its in-service distribution features. However, if the plan expanded its in-service distribution features, then those features would need to be offered to a non-discriminatory cross-section of participants—and some of the participants might use a distribution for a purpose other than Roth conversions. This concern about "*leakage*" from the retirement system caused many plan sponsors to refrain from expanding their in-service distribution options.

SBJPA fixed the "*leakage*" problem. Specifically, the Act stated that a plan can restrict its expanded in-service distribution options solely to DRAC conversions. In other words, a plan can be amended to permit expanded in-service distributions *solely* for the purpose of making in-plan DRAC conversions. Now, if the plan permits, a participant or beneficiary eligible to take an in-service distribution may elect to convert plan assets into DRAC amounts and keep the assets in the plan. As a result, plan sponsors that were considering amending in-service distribution rules to permit participants to roll over accounts to Roth IRAs in order to take advantage of 2010 tax rules can now amend their plans to liberalize in-service distribution rules solely for purposes of converting plan assets into DRAC assets inside the plan.

Requirements for In-Plan DRAC Conversions

A plan may (but is not required to) permit in-plan DRAC conversions only if the plan is a 401(k) or 403(b) plan that has a DRAC elective deferral arrangement. So, for example, a plan that is only a profit sharing plan would not be eligible to offer in-plan DRAC conversions.

If a plan permits DRAC conversions, a participant can only convert amounts that are otherwise distributable under the terms of the plan (as amended) and qualify as eligible rollover distributions. Under the Internal Revenue Code (IRC), the maximum extent to which in-service distributions are permissible depends on the type of contribution:

- Participant 401(k) deferrals are generally distributable only upon the participant's severance from employment, death, disability or attainment of age 59½;
- Employer matching and profit sharing contributions generally can be distributed while a participant is actively employed if the employer contributions have accumulated for a fixed number of years, upon the attainment of a stated age or upon any other stated event. Internal Revenue Service (IRS) rulings have clarified that the "*fixed number of years*" generally must be at least two (2) years, but that a plan can permit a full distribution of all employer contributions after a participant has been in the plan for a period of at least five (5) years. These "*two-year/five-year*" rules are commonly accepted as the most liberal rules a plan can permit for in-service distribution of employer matching and profit sharing contributions; and
- After-tax and rollover contributions are generally freely distributable at any time.

Plan sponsors may amend their plans to permit in-plan Roth conversions for some or all of these types of contributions.

Benefits to Participants

The ability to convert plan assets into DRAC assets may be popular with plan participants because they can choose to convert plan assets into DRAC assets and later take a tax-free distribution, provided the participant meets the requirements for a "*qualified distribution*" (discussed below). Participants who are unsure about future tax rates or their future tax bracket can diversify by converting some retirement plan assets into DRAC assets and maintaining other assets as traditional pre-tax assets.

Converted amounts are not subject to the 10 percent early distribution tax under IRC § 72 (t) (generally applicable to distributions to participants under age 59½ that are not rolled over to an IRA).

New Law Expands "In-Plan" DRAC Conversions

On January 2, 2013, President Obama signed into law the *American Taxpayer Relief Act of 2012* (ATRA) (the "*fiscal cliff*" bill). The new law, Section 902 of the Act, permits 401(k) plans (as well as 403(b) and governmental 457 (b) plan sponsors to amend their plans to permit any amount under the 401(k) plan to be converted to a DRAC amount within the plan, even if the amount is not otherwise distributable.

Participants will now be able to do in-plan DRAC conversions from any non-DRAC vested account, without requiring that the amount being converted must be eligible for distribution and rollover from the plan.

As was discussed above, pre-Act, only amounts eligible for distribution and for rollover, such as in-service withdrawals of elective contributions after age 59½, in-service withdrawals of employer contributions after a stated age and/or stated period of time, and distributions due to disability, severance of employment, or retirement were eligible for conversion.
A conversion will not be treated as having violated IRC § 401(k)(2)(B)(i), § 403(b)(7)(A)(ii), or § 457(d)(1)(A) (pertaining to limitations on distributions). However, what remains the same (not inclusive): An in-plan DRAC conversion feature is discretionary; employers are not required to amend their plans to allow for conversions.

To allow in-plan DRAC conversions, a 401(k), 403(b), or governmental 457(b) plan must:

- Permit on-going DRAC contributions; and
- Allow conversions.

Participants who make a DRAC conversion are subject to ordinary income tax on the amount converted, but are not subject to the 10% early distribution tax.

DRAC conversions are not subject to mandatory or optional withholding. However, since the conversion amount is subject to ordinary income tax, the participant should consider increasing their withholding or making estimated tax payments outside the plan to avoid any underpayment penalties. If the plan is subject to spousal consent requirements, no spousal consent is required for a conversion.

While the availability of the DRAC deferral feature has increased relatively quickly, DRAC in-plan conversions are less common—but gaining momentum. According to the Aon Hewitt report, as of 2013, more than one-quarter (27%) of plans with a DRAC feature also allow DRAC in-plan conversions. Another 66% of respondents said they are very or somewhat likely to add DRAC in-plan conversions in 2013.

DRAC Rollovers

IRS permits DRAC-to-Roth IRA rollovers that can be accomplished by either direct rollover (trustee-to-trustee transfer) or indirect (60-day rollover). Rollover from a DRAC to a Roth IRA is permitted even if the participant is not eligible to make annual contributions to a Roth IRA or to convert his/her traditional IRA to a Roth IRA. This means that a participant can establish a Roth IRA purely for the purpose of receiving a rollover of his or her DRAC, even if their income is too high to otherwise allow him or her to contribute to a Roth IRA:

- *Direct Rollover* (trustee-to-trustee transfer) – the entire plan balance can go to an employer Roth plan or to an individual Roth IRA; or
- *Indirect Rollover* (60-day rollover) – only taxable amounts can be rolled over to another Roth employer plan or the entire plan balance can go to an individual Roth IRA and the rollover must be completed within 60 days.

If the employee does a partial indirect (60-day) rollover of a non-qualified distribution to his individual Roth IRA, the amount rolled into the Roth IRA is deemed to come first from taxable amounts distributed from the DRAC. This means that the employee is rolling the taxable earnings portion into the Roth IRA first, and the balance of the distribution comes from the tax-free part (see Table 7.3).

Table 7.3.
Allowable Rollovers from a Roth 401(k)

Direct Rollover (trustee-to-trustee transfer)	All or any part of the plan balance can go to another Roth 401(k), or Roth 403(b), if the receiving plan allows, or to a Roth IRA
Rollover to Employee (Indirect 60-day rollover)	All or any part of the balance can be rolled to a Roth IRA. Only taxable amounts (earnings) can be rolled over to another Roth 401(k) or Roth 403(b), if the receiving plan allows

Qualified DRAC Distributions

The tax rules for distributions from DRACs differ significantly from those of traditional 401(k) accounts and Roth IRAs. No income tax applies to "*qualified distributions*" from DRACs. No income tax applies to qualified distributions from a DRAC since taxes were paid at the time of the original contributions.

If a distribution is a qualified distribution, the entire distribution from the DRAC (contributions and earnings) is tax free. Two conditions (both, not either/or) must be satisfied to qualify for tax-free status:

- The DRAC participant must satisfy the "*five-year rule*;" and
- There must be a "*qualified purpose*" for the distribution.

The Five-Year Holding Period Rule

The *five year holding period rule* is satisfied at the end of the 5-year period during which the participant's deferral is first deposited to the DRAC. This means that any deferral contributed within calendar year 2011, even if the first contribution date was December 31, 2011, is considered qualified as of January 1, 2016.

DRACs have their own 5-year holding rules. Unlike individual Roth IRAs where there is only one 5-year period that starts with the establishment of the owner's first Roth IRA. DRACs have a separate 5-year holding period for each employer's DRAC. If your client works for two different employers and participates in a DRAC at each company, he/she will have two separate 5-year periods, one for each DRAC.

Also, the 5-year holding period is never carried over to an individual Roth IRA. The DRAC funds will be governed by the 5-year rule applicable to the Roth IRA. If the Roth IRA has already satisfied the 5-year period, then the employer funds are deemed to have also met the 5-year period, even if they were only in the DRAC for a year. This is just one more reason for many of your client's to establish a Roth IRA.

Qualified Purpose Rule

A distribution from a DRAC satisfies the qualified purpose rule only if the distribution is attributable to:

- The participant's attainment of age 59 ½;
- The participant's disability; or
- The participant's death.

There are no exceptions to the above rules, such as the exception for first time home buyers that applies to Roth IRAs.

Nonqualified DRAC Distributions

If your client does not meet the requirements of a *qualified distribution* discussed above, and he/she takes a distribution from a DRAC without rolling it to another DRAC, it will be considered a *nonqualified distribution*.

A *nonqualified distribution* from a DRAC must report taxable income in proportion to the accounts earnings. For example, if 80% of the funds in the DRAC are from contributions and another 20% are from earnings, the distribution will be 20% taxable even if the amount withdrawn is less than the amount of the contribution. In addition, the nonqualified distribution that is not rolled over to a Roth IRA or another DRAC may be subject to the 10% early distribution tax penalty under IRC § 72(t)(1).

Note: This rule looks only at the DRAC from which the distribution is being distributed. Some of the rules for IRAs say you can use the pro-rata from all IRAs, but those rules don't apply here.

Advisors Beware: Roth IRA Documents Must Be Amended

On May 31, 2007 IRS released Announcement 2007-55 to remind Roth IRA sponsors that Roth IRA documents will need to be amended if they are to allow for the acceptance of rollover contributions from Roth 401(k) or Roth 403(b) accounts. All advisors working with clients who are thinking of rolling over Roth 401(k) balances to Roth IRA accounts should first be sure that the Roth IRA document allows for this type of rollover. A Roth IRA that has already accepted rollover contributions from a Roth 401(k) must have been amended by December 31, 2007 (Rev. Proc. 2002-10).

Rollover of After Tax Contributions

Traditional after-tax contributions have generally fallen out of favor, as the DRAC option has typically offered employees greater benefits. However, in 2014, the IRS simplified an employee's ability to roll over traditional after-tax contributions from a 401(k) plan directly into a Roth IRA upon termination of employment (IRS Notice 2014-54). This simplification eliminated the multistep process of first receiving a distribution of the after-tax contributions and then rolling over those funds into a Roth IRA, which required the employee to have sufficient funds to cover the 20% withholding taken from the initial distribution. Rolling over after-tax contributions into a Roth IRA allows the employee to eliminate taxes on future earnings on the rolled-over amounts.

While the pre-tax and DRAC after-tax contribution options typically provide employees with greater benefits and flexibility, the recent IRS changes have made traditional after-tax contributions a potentially more attractive option than in years past. For some employees, this option could be a valuable third option for retirement savings.

Chapter 7
Review Questions

1. Which of the following Acts made the DRAC a permanent feature in a 401(k) plan?

( ) A. The American Taxpayers Relief Act of 2012
( ) B. The Economic Growth Tax Relief Reconciliation Act of 2001
( ) C. The Pension Protection Act of 2006
( ) D. The Small Business Job Protection Act of 2006

2. What is the maximum contribution amount allowed for a participant age 50 and older to contribute to his/her DRAC in 2018?

( ) A. $24,500
( ) B. $18,500
( ) C. $55,000
( ) D. $61,000

3. Which of the following statements about a DRAC in-plan conversion is FALSE?

( ) A. Participants who make a DRAC conversion are subject to ordinary income tax on the amount converted, but are not subject to the 10% early distribution tax.
( ) B. DRAC conversions are not subject to mandatory or optional withholding.
( ) C. DRAC conversions are now mandatory for all plans
( ) D. DRAC participants will now be able to do DRAC in-plan conversions from any non-DRAC vested account.

4. Distributed earnings from a DRAC will be exempt from taxes if they are part of what type of distribution?

( ) A. Required minimum distribution
( ) B. Qualified distribution
( ) C. Nonqualified distribution
( ) D. SOSEPP distribution

5. Which of the following statements about the DRAC 5-Year Holding Period is FALSE?

( ) A. DRACs have their own 5-Year Holding Period
( ) B. DRACs have a separate 5-Year Holding Period for each employer's DRAC
( ) C. DRAC funds rolled over to a Roth IRA will be governed by the 5-Year holding period applicable to the Roth IRA
( ) D. DRACs 5-Year Holding Period is carried forward to a Roth IRA

CHAPTER 8

401(k) PLAN DISTRIBUTIONS

Overview

As was discussed in Chapter 2, one of the most appealing features of 401(k) plans (and other qualified retirement plans and IRAs) is that they are tax-favored. Income and growth from assets in the accounts are allowed to accumulate on a tax-deferred basis and are not taxed until distributed to the employee (plan participant). It is the intention of Congress to make qualified retirement plans long-term investments. As a result, a plan participant will face significant tax consequences for taking early distributions from their qualified retirement plans.

This chapter will examine the rules and tax penalties pertaining to distributions to the participant prior to termination of employment, it also will also examine the specific rules pertaining to required minimum distributions, hardship withdrawals, in-service distributions, loans, and qualified domestic relations order (QDRO).

Learning Objectives

Upon completion of this chapter, you will be able to:

- Explain the rules and triggering events for distributions from a qualified retirement plan;
- Understand the tax penalty for early distributions under IRC § 72(t)(1) and the how to avoid the penalty using the exceptions under IRC § 72(t)(2);
- Identify the required beginning date (RBD) for qualified retirement plans;
- Apply the required minimum distribution (RMD) rules under IRC § 401(a)(9);
- Calculate required minimum distributions (RMDs) during the participant's lifetime prior to reaching his/her RBD and after reaching his/her (RBD);
- List the distribution rules pre-and post-retirement for hardships, policy loans and in-service distributions;
- Describe new rules for loans, hardships and in-service distributions under the new Tax Cuts Jobs Act of 2017;
- Clarify the rules and procedures for Spousal Consent and Qualified Domestic Relations Orders (QDROs); and
- Describe the rules and benefits of Net Unrealized Appreciation (NUA).

Distribution Plan Requirements

A qualified 401(k) plan must provide the amounts attributable to elective contributions (such as qualified non-elective contributions (QNECs) and qualified matching contributions (QMACs) that are treated as elective contributions) may not be distributed to a participant or beneficiary before the occurrence of one of the following events (known as triggering dates):

- The participant's severance from employment, retirement, death, or disability [IRC § 401(k)(2)((B)(i)(I)];
- The termination of the plan without the establishment of a successor defined contribution plan (other than an employee stock ownership plan or a SEP IRA) [IRC § 401(k)(10)(A)];
- The participant's attainment of age 59 ½ if the CODA is part of a profit sharing or stock bonus plan [IRC § 401(k)(2)((B)(i)(III)]; or
- The participant's hardship if the CODA is part of a profit sharing or stock bonus plan [IRC § 401(k)(2)((B)(i)(IV)].

If the amounts attributable to elective contributions (including QNECs and QMACs that are treated as elective contributions) are required by an employer to be transferred to another qualified retirement plan of any employer, the distribution restrictions continue to apply to the transferred amounts. Thus, such other plan will not be qualified if the transferred amounts are distributed before the occurrence of one of the events specified above. However, the distribution restrictions do not apply to rollovers and elective transfers by employees.

The distribution restrictions continue to apply to the sale of a corporate subsidiary to an unrelated entity (as opposed to the sale of an entire business to a different employer) with respect to an employee who continues employment with such subsidiary at the same desk. This rule doesn't apply to an employee who works at the same desk for a new employer.

Hardship distributions are exceptions to the traditional qualified plan distribution rules and are explained in great detail later in this chapter.

In contrast to the rule for elective contributions, employer non-elective contributions may be distributed after a fixed number of years, the attainment of a stated age, or upon the occurrence of an event such as a layoff or illness.

Distributions Prior to Age 59½

To discourage 401(k) plan participants from taking distributions from their qualified retirement plans (and IRAs), Congress enacted a special 10% addition to tax (often incorrectly referred to as a penalty [IRC § 72(t)(1)].

Under IRC § IRC § 4974(c), the term "qualified retirement plan" means:

- A plan described in IRC § 401(a) which includes a trust exempt from tax under section 501(a);
- An annuity plan described in IRC § 403(a);
- An annuity contract described in IRC § 403(b);
- An Individual Retirement (IRA) described in IRC § 408(a); or
- An Individual Retirement Annuity described in IRC § 408(b).

Such term includes any plan, contract, account, or annuity which, at any time, has been determined by the Secretary to be such a plan, contract, account, or annuity.

IRC § 72(t)(1) Tax Penalty

So, if a plan participant receives any amount from an above qualified retirement plans, the taxpayer's tax for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount, which is includable in gross income.

This tax (excise) penalty applies to participants who take distributions "*too early*" from their qualified retirement plans, generally before age 59½. However, under certain fact patterns the 10% distribution doesn't apply to some or all of the distribution (see Exceptions below).

IRC § 72(t)(2) Exceptions

Under IRC § 72(t)(2) the IRS allows overall 14 exceptions to avoid the IRC § 72(t)(1) 10% addition to tax (excise) penalty. They differ for qualified retirement plans and IRAs. Most of the exceptions are based on hardship and/or special use exemptions. Below are the 10 exceptions for qualified retirement plans:

- *Attainment of age 59½.* Under IRC § 72 (t)(2)(A)(i), distributions made on or after the date on which the participant (employee) attains age 59½;
- *Death.* Under IRC § 72 (t)(2)(A)(ii), distributions upon death of the participant, assets can be distributed to a beneficiary or the estate without incurring the 10% excise tax on early distributions. However, the plan distribution may be subject to federal estate taxes and or state estate or inheritance taxes;
- *Disability.* Under IRC § 72 (t)(2)(A)(iii), the 10% addition to tax does not apply to an individual who is disabled within the meaning of IRC § 72 (m)(7). IRC § 72 (m)(7) defines disability. For purposes of this section, an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration;"
- *Separation from Service.* Under IRC § 72(t)(A)(v),an employee who separates from service during or after the year the employee reaches age 55. The Pension Protection Act (PPA) of 2006 added IRC § 72(t)(10), which provides that in case of a distribution to a *qualified public safety employee* from a governmental defined benefit plan, IRC § 72(t)(2)(A)(v) is applied by substituting age 50 for age 55. Thus, the 10% additional tax

on early distributions under IRC § 72(t)(1) does not apply to a distribution from a governmental defined benefit plan made to a qualified public safety employee who separates from service after attainment of age 50. For the purposes of IRC § 72(t)(10), the term "*qualified public safety employee*" means an employee of a state or of a political subdivision of a state (such as a county or city) whose principal duties include services requiring specialized training in the area of police protection, firefighting services, or emergency medical services for any area within the jurisdiction of the state, or the political subdivision of the state. This exception to the 10 percent additional tax applies to distributions made after August 17, 2006. The Protecting Americans from Tax Hikes (PATH) Act of 2015 expands the provision to include U.S. Capitol Police officers, Supreme Court Police officers, and diplomatic security special agents. H.R. 2146, the Defending Public Safety Employees' Retirement Act, which was enacted on June 29, 2015, previously expanded the provision to cover federal law enforcement officials but inadvertently omitted the other categories of public safety officers;

- *Series of Substantial Equal Periodic Payments.* Under IRC § 72(t)(2)(A)(iv) the exception rule exists for a distribution of plan assets that are part of a *series of substanial equal periodic payments* (SOSEPP), paid not less frequently than annually, for the participant's lifetime (or life expectancy) or the joint lives (or joint life expectancies) of the participant and a designated beneficiary. Distributions from a qualified retirement plan other than an IRA or individual retirement annuity qualify for this exception **only** if they begin after the participant (employee) separates from the employer's service (see above Separation of Service);
- *Medical Expenses.* Under IRC § 72(t)(2)(B) distributions made to a participant, to the extent such distributions do not exceed the amount allowable as a deduction under IRC § 213 to the participant for amounts paid during the taxable year for medical care (>10% of AGI and 7.5% of AGI for taxpayer who has attained age 65 before the end of the tax year and phased out in 2017);
- *Qualified Domestic Relations Order.* Under IRC 72(t)(2)(C), when a court mandates funds from a participant's account go to a former spouse, child, or dependent under a QDRO;
- *Special Automatic Enrollment.* Under IRC § 414(w)(1)(B, if a participant has made contributions under special automatic enrollment rules that are withdrawn pursuant to his or her request within 90 days of enrollment;
- *Distributions to Military Reservists.* The penalty does not apply to a distribution of elective deferrals from a 401(k) plan to a qualifying military reservist. At the time of the distribution, the military reservist must be on active duty for a period of 179 days or for an indefinite period [IRC 72(t)(2)(G)]; and
- *IRS Levy.* Section 3436 of the IRS Restructuring Act added IRC § 72(t)(2(A)(vii), which provides that the additional 10-percent tax does not apply to a distribution from a qualified retirement plan, including an IRA, that is made on account of a levy under IRC § 6331 on the qualified retirement plan. However, ordinary income taxes still apply; and
- *The 2016 Disaster Relief Act.* The Tax Cut and Jobs Act of 2017, Section 11028, titled "*Relief For 2016 Disaster Areas*," allows an individual to distribute up to $100,000 of "*qualified 2016 disaster distributions*" whose principal place of abode at any time during the calendar year 2016 was located in a 2016 disaster area, and who has sustained an economic loss by reason of the events that gave rise to the Presidential disaster

declaration. Income attributable to a qualified 2016 disaster distribution (up to $100,000) can be included in income ratably over three years, and the amount of a qualified 2016 disaster distribution can be recontributed to an eligible retirement plan (includes an IRA) within three years.

Tax Planning Opportunities

If a participant is considering, or has already taken an early distribution from a qualified retirement plan, he/she should be advised of the following in order to avoid the IRC § 72 (t)(1) tax:

- If they intend to use the distribution for higher education expenses or are a first-time homebuyer, make sure the distribution is from an IRA;
- If they have already mistakenly taken funds from a non-IRA plan for higher education and the IRS is willing to allow any portion of the distribution to qualify as an exception, it might be advantageous for them to settle rather than take it to court; and
- If your client owns a qualified retirement plan other than an IRA and is going through a divorce whereby his/her spouse is entitled to a portion of his/her assets, make sure the court issues him/her a qualified domestic relations order (QDRO) as defined in IRC § 414 (p)(1). And remember, the payments cannot come from an IRA (QDROs will be discussed later in the chapter).

Planning is essential to ensure that your clients do not miss the opportunity to take advantage of the IRC § 72 (t)(2) exemptions.

Required Minimum Distributions

As discussed above, Congress intended the 401(k) plan to be used by the participant in retirement and not as wealth-transfer vehicles. To prevent the accumulation and transfer of wealth in and from qualified retirement plans (and IRAs) the Internal Revenue Service (IRS) enacted IRC § 401 (a)(9) which *requires minimum distributions* (RMDs) to be taken from a qualified retirement plans (and IRAs).

IRC § Sec. 401(a)(9)(C) and Treas. Reg. § 1.401(a)(9)-5, A-1(b) and (c) require distributions to be made from these accounts to the participant (account owner), generally beginning when the participant reaches his or her *required beginning date (RBD)*.

Required Beginning Date (RBD)

The fundamental rule for distribution of qualified retirement plan benefits (and IRAs) provides that the entire interest of each participant must be distributed to such participant not later than the *required beginning date* (RBD) [IRC§ 401(a)(9)(A)].

In the case of a 401(k) plan, the RBD is April 1 of the calendar year following the later of the calendar year in which the participant attains age 70 ½ or the calendar year in which the participant retires. The rules for extending the RBD for participant's 401(k) plan do not apply to participants who are 5% or more owners of the company sponsoring the plan. For such particicpants, the RBD is April 1 of the calendar year following the calendar year in which the participant attains age 70 ½ [IRC § 401(a)(9)(C)].

"*Five percent ownership*" means ownership of more than 5 percent of the capital or profits of the employer [IRC § 401 (a)(9)(C)(ii)(I)] or, if the employer is a corporation, more than 5% of the outstanding stock of the corporation or stock possessing more than 5% of the total combined voting power of the corporation [IRC § 416(i)(1)(B)(i)(I)].

A 401(k) plan is permitted to provide that the RBD for all participants is April 1 of the calendar year following the calendar year in which the participant attains age 70 ½ regardless of whether the participant is a five percent owner. The Advisor should review their client's Summary Plan of Description (SPDs).

Calculating Required Minimum Distribution

In general, the RMD is computed for each participant, based upon life expectancy, the idea being that distributions are spread ratably over a period (*applicable distribution period*-ADP) projected to coincide with the remaining lifetime of the participant (or the joint lives of the participant and a *designated beneficiary*-DB). Thus, the RMD payment is calculated based upon a number of years of life expectancy, determined from IRS actuarial tables (see Table 8.1). The value of the 401(k) plan assets, as of the beginning of each calendar year, beginning with the year in which age 70½ is attained, is divided by the applicable life expectancy to determine the RMD for that year. The 1987 regulations required the use of Tables V and VI in Reg. §1.72-9 for determining the life expectancy divisor. Under the new Regs., only the new Uniform Lifetime Table (discussed below), is used prior to the death of the participant, except in cases where the *designated beneficiary* (DB) is a spouse more than ten years younger than the participant. In that case, the *applicable distribution period* (ADP) will be that determined using the Uniform Life Table or the joint life expectancies of the participant and the spouse using the participant and the spouse's birthdays in the distribution calendar year [Treas. Reg. 1.408(a)(9)-5, A-4(b)].

The RMD is recalculated each year, based upon the value of the account as of the last day of the previous calendar year, divided by the applicable life expectancy factor (see RMD Formula below).

RMD Formula

This is the basic formula for calculating an RMD
using the IRS life expectancy tables:

$$\frac{\text{Account Balance, Prior 12/31}}{\text{Life Expectancy Factor}} = \text{RMD in Dollars for Current Year}$$

$$\frac{\text{Account Balance, Prior 12/31}}{\text{Uniform Life Expectancy}} = \frac{\$500{,}000}{27.4} = \$18{,}248.18$$

Once the RMD is determined it may be distributed at any time during the calendar year, in a single payment or any number of partial payments. With regard to the determination of the account value balance, it should be noted that even if the RMD for a given year is not made until December 31, the account value used in calculating the RMD is the value as of December 31 of the previous calendar year. This date is used even for the year that the participant turns 70½, when the first RMD is delayed until April 1 of the following year. In cases where the distribution for the age 70½ year is deferred until the first quarter of the following year (i.e., through April 1), the account balance used to determine the second distribution is calculated without subtracting from the account balance on the last day of the age 70½ year, any distribution made in the first quarter of the subsequent year to satisfy the RMD for the 70½ year [Treas. Reg. §401(a)(9)-5, Q&A-3(c)].

IRS Life Expectancy Tables

The *Economic Growth and Tax Relief Reconciliation Act* (EGTRRA) of 2001 instructed the Secretary of Treasury to update the life expectancy tables used for purposes of the RMD rules to reflect current life expectancy. In accordance with that instruction, the final regulations have adopted new tables incorporating improved mortality projections through 2003 [Treas. Reg. §1.401(a)(9)-9]. This has resulted in a slight increase in the life expectancy based divisors, which will produce lower RMD amounts.

Uniform Lifetime Table

The divisor for the RMD computation during the participant's lifetime using the Uniform Lifetime table can be determined from the prescribed table without regard to the beneficiary's age (an assumed 10-year age difference between the participant and the beneficiary is built into the table). The divisor is also referred to as the *applicable distribution period* (ADP) (see Table 8.1).

Calculating RMDs Using the Uniform Lifetime Table

As stated above, the RMD is based upon a calculation intended to have the account fully liquidated ratably over a period (sometimes referred to as the *applicable distribution period* (ADP) or the "*spread period*") based primarily upon the participant's remaining life expectancy. However, IRC § 401(a)(9) allows the ADP ("*spread period*") to be based not only on the participants life expectancy, but upon the joint and survivor life expectancy of the participant and a *designated beneficiary* (DB). The implementation of this joint life expectancy ADP was spelled out in detail in the 1987 regulations. These regulations contain detailed rules concerning parameters and procedures for the designation of the beneficiary for purposes of determining the joint life expectancy ADP. Once the beneficiary is identified, the payout ADP (the divisor in the annual RMD computation) is determined from an IRS-promulgated joint life expectancy table, using the ages of the participant and the beneficiary. These rules were criticized as unnecessarily complex, and they were substantially revised in the 2002 final version of the regulations.

The revised final regulations, published in April 2002, incorporate a new "*Uniform Lifetime Table*," using updated mortality data, and based upon the joint life expectancy of the participant and another person 10 years younger. Since 2003, this new table is to be used in all cases to determine the joint life expectancy payout period, regardless of whether or not a beneficiary has in fact been designated, and regardless of the actual age of the beneficiary [Reg. §1.401(a)(9)-5,Q&A-4(a)]. This was a major change from the regime of the 1987 proposed regulations, under which the ADP depended upon the actual age of the beneficiary. However, as discussed below, if the sole designated beneficiary is the participant's spouse, then their actual joint life expectancies may be used, even if the spouse is more than 10 years younger [Treas. Reg. §1.401(a)(9)-5,Q&A-4(b)]. This change from the method required under the 1987 regulations resulted in substantial simplification and potential liberalization in many situations.

Note: If a participant has more than one defined contribution plan, he/she must calculate and satisfy their RMDs separately for each plan and withdraw that amount from that plan.

Table 8.1
The Uniform Lifetime Table

Age	Life Expectancy Factor	% of Account	Age	Life Expectancy Factor	% of Account
70	27.4	3.65%	93	9.6	10.42%
71	26.5	3.77%	94	9.1	10.99%
72	25.6	3.91%	95	8.6	11.63%
73	24.7	4.05%	96	8.1	12.35%
74	23.8	4.20%	97	7.6	13.16%
75	22.9	4.37%	98	7.1	14.08%
76	22.0	4.55%	99	6.7	14.93%
77	21.2	4.72%	100	6.3	15.87%
78	20.3	4.93%	101	5.9	16.95%
79	19.5	5.13%	102	5.5	18.18%
80	18.7	5.35%	103	5.2	19.23%
81	17.9	5.59%	104	4.9	20.41%
82	17.1	5.85%	105	4.5	22.22%
83	16.3	6.13%	106	4.2	23.81%
84	15.5	6.45%	107	3.9	25.64%
85	14.8	6.76%	108	3.7	27.03%
86	14.1	7.09%	109	3.4	29.41%
87	13.4	7.46%	110	3.1	32.26%
88	12.7	7.87%	111	2.9	34.48%
89	12.0	8.33%	112	2.6	38.46%
90	11.4	8.77%	113	2.4	41.67%
91	10.8	9.26%	114	2.1	47.62%
92	10.2	9.80%	115 & Over	1.9	52.63%

Using the Joint Life Table

If the sole designated beneficiary is the participant's spouse, then, as was the case under the 1987 proposed Regs., their actual joint life expectancies may be elected, even if the spouse is more than 10 years younger [Treas. Reg. §1.401(a)(9)-5,Q&A-4(b)]. Since it is likely that in most instances the participant's beneficiary is the spouse of the 401(k) participant, and most married couples are not more than 10 years apart in age, the revised regulations benefit most couples who desire the lowest possible RMD. This is because the now-mandated Uniform Lifetime Table uses a joint life expectancy based upon a 10-year age difference between the participant and the beneficiary, whereas under the 1987 Regs., the actual joint life expectancies had to be used.

Moreover, if the beneficiary/spouse is *more than ten years younger* than the participant, a *joint life table* using the actual age of the spouse/beneficiary may be elected. This, of course, represents a substantial advantage when the spouse is the beneficiary. If the spouse is more than 10 years younger than the participant the ADP can be increased based upon the spouse's actual age, but if the spouse is less than 10 years younger, the Uniform Lifetime Table can be used, which assumes that the beneficiary is a full 10 years younger (see Table 8.2).

Table 8.2
IRS Joint Life and Last Survivor Expectancy Table [1]

		Age [2]										
		70	**71**	**72**	**73**	**74**	**75**	**76**	**77**	**78**	**79**	**80**
Your Spouse beneficiary's age	**69**	21.8	21.8	21.4	21.1	20.8	20.5	20.2	19.9	19.7	19.5	19.3
	68	22.7	22.3	22.0	21.6	21.3	21.0	20.8	20.6	20.3	20.1	20.0
	67	23.2	22.8	22.5	22.2	21.9	21.6	21.4	21.2	21.0	20.8	20.6
	66	23.7	23.4	23.1	22.8	22.5	22.3	22.0	21.8	21.7	21.5	21.3
	65	24.3	23.9	23.7	23.4	23.1	22.9	22.7	22.5	22.4	22.2	22.1
	64	24.8	24.5	24.3	24.0	23.8	23.6	23.4	23.2	23.1	22.9	22.8
	63	25.4	25.2	24.9	24.7	24.5	24.3	24.1	23.9	23.8	23.7	23.6
	62	26.1	25.8	25.6	25.4	25.2	25.0	24.8	24.7	24.6	24.4	24.3
	61	26.7	26.5	26.3	26.1	25.9	25.7	25.6	25.4	25.3	25.2	25.1
	60	27.4	27.2	27.0	26.8	26.6	26.5	26.3	26.2	26.1	26.0	25.9
	59	28.1	27.9	27.7	27.5	27.4	27.2	27.1	27.0	26.9	26.8	26.7
	58	28.8	28.6	28.4	28.3	28.1	28.0	27.9	27.8	27.7	27.6	27.5
	57	29.5	29.4	29.2	29.1	28.9	28.8	28.7	28.6	28.5	28.4	28.4
	56	30.3	30.1	30.0	29.8	29.7	29.6	29.5	29.4	29.3	29.3	29.2
	55	31.1	30.9	30.8	30.6	30.5	30.4	30.3	30.3	30.2	30.1	30.1
	54	31.8	31.7	31.6	31.5	31.4	31.3	31.2	31.1	31.0	31.0	30.9
	53	32.6	32.5	32.4	32.3	32.2	32.1	32.0	32.0	31.9	31.8	31.8
	52	33.4	33.3	33.2	33.1	33.0	33.0	32.9	32.8	32.8	32.7	32.7
	51	34.3	34.2	34.1	34.0	33.9	33.8	33.8	33.7	33.6	33.6	33.6

[1] This is a partial table. For the complete table, please refer to IRS Publication 590.
[2] For account owners who turn 70 between January and June, use the age 70 life expectancy factor to calculate the RMD. For account owners who turn 70 between July and December, use the age 71 life expectancy factor.

It is important to note that, although the concept of spreading out RMDs based upon life expectancy would theoretically produce roughly equal amounts each year until the account is exhausted at death, annual RMDs can actually vary widely from year to year, since they are based upon continually changing current market values of the remaining asset pool (see Table 8.3).

Penalties for Failure to Make RMDs

Under IRC § 4974(a), once the participant reaches his/her RBD, RMDs are required to commence, if none are made, or if they total less than the required minimum in any year, a penalty excise tax of 50% is imposed, computed as 50% of the amount by which the RMD exceeds the amount actually distributed.

If a participant does not take the proper RMD, they will need to complete IRS Form 5329 and attach a letter of explanation to their tax return for that year. Up until a couple of years ago, you were required to also send in a check for the amount of the penalty. This is no longer required. If the IRS decides not to grant a waiver, they'll send a bill.

Note: If an amount in excess of the RMD is distributed for any year, the excess may not be carried forward to reduce the RMD as calculated for any future year [Treas. Reg. §401(a)(9)-5,Q&A-2].

Table 8.3
RMD Calculation Account Balances and Required Minimum Distributions*

Age	Life Expectancy (ADP)	Required Minimum Distribution	Balance
70	27.4 (Birthday on or before June 30th)	$18,248.18	$501,751.82
71	26.5	$18,934.03	$502,887.86
72	25.6	$19,644.06	$503,359.32
73	24.7	$20,378.92	$503,114.77
74	23.8	$21,139.28	$502,100.08
75	22.9	$21,925.77	$500,258.31
76	22.0	$22,739.01	$497,529.64
77	21.2	$23,468.38	$493,962.44
78	20.3	$24,333.13	$489,387.81
79	19.5	$25,096.81	$483,866.51
80	18.7	$25,875.21	$477,345.96
81	17.9	$26,667.37	$469,772.43
82	17.1	$27,472.07	$461,091.26
83	16.3	$28,287.81	$451,247.10
84	15.5	$29,112.72	$440,184.26
85	14.8	$29,742.18	$428,049.45
86	14.1	$30,358.12	$414,813.31
87	13.4	$30,956.22	$400,449.62
88	12.7	$31,531.47	$384,936.14
89	12.0	$32,078.01	$368,255.57
90	11.4	$32,303.12	$350,682.68
91	10.8	$32,470.62	$332,239.36
92	10.2	$32,572.49	$312,956.45
93	9.6	$32,599.63	$292,875.08

94	9.1	$32,184.07	$272,406.01
95	8.6	$31,675.12	$251,627.13
96	8.1	$31,065.08	$230,627.14
97	7.6	$30,345.68	$209,506.54
98	7.1	$29,507.96	$188,378.84
99	6.7	$28,116.25	$167,797.75
100	6.3	$26,634.56	$147,875.10

*All distributions are assumed to be taken at the end of the year.
Rate of growth projected is 4%. For additional information see IRS Publication 590

Designated Beneficiary Rules

As a general rule, a "*designated beneficiary"*(DB) is an individual who is designated as a beneficiary under the plan, either by the terms of the plan, or if the plan so provides, by the affirmative election of the participant [IRC § 401(a)(9)(E); Treas. Reg. 1.401(a)(9)-4, Q&A-1].

Only individuals may be a disginated beneficiary for purposes of the distribution rules. A legal "person" that is not an individual, such as the "estate" of the participant or a charitable organization, may not be a designated beneficiary. If, a person other than an individual is designated as a beneficiary of a participant's 401(k) (or IRA), the participant will be treated as not having a designated benefiaicry [Treas. Reg. 1.401(a)(9)-4, Q&A 3].

A designated beneficiary need not be specified by name in the beneficiary form or by the participant in order to be a desigated beneficiary so long as the individual who is to be the beneficiary is identifiable under the beneficiary form as of the date the beneficiary is determined. The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible, as of the date the beneficiary is determined, to identify the class member with the shortest life expectancy (the eldest). However, as discussed above, the fact that a participant's interest in a qualified retirement plan (and/or IRA) passes to a certain individual under a will or otherwise under applicable state law does not make that individual a designated beneficiary unless the individual is properly designated as a beneficiary under the plan [Treas. Reg. 1.401(a)(9)-4, Q&A-1].

If there are two or more beneficiaries (multiple beneficiaries), only the oldest beneficiary will be treated as a designated beneficiary for purposes of determining the applicable distribution period (ADP) unless each beneficiary is entitled to a separate share or a separate account [Treas. Reg. 1.401(a)(9)-5, Q&A-7(a)1].

If there are two or more (multiple) beneficiaries, and one of the beneficiaries is not an individual, the participant will be treated as not having any designated beneficiary unless the non-individual beneficiary is entitled to a separate share or a separate account [Treas. Reg. 1.401(a)(9)-5, Q&A-7(a)(2)].

A separate account is a portion of a participant's benefit determined by an acceptable separate accounting including allocating investment gains and losses, and contributions and forfeitures, on a pro-rata basis in a reasonable and consistent manner between such portion and any other benefits [Treas. Reg. 1.401(a)(9)-8, Q&A-3]. The amounts of each such portion of the benefit will be separately determined for purposes of determining the amount of the required minimum distribution [Treas. Reg. 1.401(a)(9)-8, Q&A-3].

Once the separate accounts are actually established, the separate accounting can provide for separate investments for each separate account under which gains and losses from the investment of the account are allocated only to that account, or investment gains and losses can continue to be allocated among the separate accounts on a pro-rata basis. A separate accounting must allocate any post death distributions to the separate account of the beneficiary receiving that distribution [Treas. Reg. 1.401(a)(9)-8, Q&A-3].

Date to Determine the Designated Beneficiary

In order to be a designated beneficiary, an individual must be a beneficiary as of the date of the participant's death. The participant's designated beneficiary will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the participant's death (known as the "*beneficiary finalization date*"). Accordingly, any person who was a beneficiary as of the date of the participant's death, but is not a beneficiary as of September 30th of the calendar year following the calendar year of the participant's death (either because the person disclaimed entitlement to the benefit in favor of another beneficiary or because the person received the entire benefit to which the person is entitled before that date) is not taken into account in determining the participant's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the participant's death [Treas. Reg. 1.401(a)(9)-4, Q&A-4(a)].

In short, the designated beneficiary is determined as of the date of death. Between date of death and the beneficiary designation date a date of death beneficiary can be eliminated by disclaimer or distribution, but no new beneficiaries can be added.

Postmortem Planning

The rule that allows the designated beneficiary to be determined as late as September 30 of the calendar year following the calendar year of the participant's death creates post-mortem planning opportunities for maximizing the post-death spread period; for example, when there are multiple potential beneficiaries (e.g., a primary and a secondary beneficiary, or two or more co-beneficiaries).

Qualified Trusts as Designated Beneficiaries

Although a trust is not considered an individual, its beneficiaries may be treated as the participant's designated beneficiary in determining required minimum distributions if the trust is considered a "*qualified trust*." To be a qualified trust and be considered a designated beneficiary, the trust must satisfy five tests. The first four tests are as follows:

- The trust must be valid under state law;
- The trust must be irrevocable or become irrevocable at the taxpayer's death;
- The trust beneficiaries must be identifiable; and
- Certain documentation must be provided to the plan administrator (or IRA) custodian by October 31 of the year after the taxpayer's death.

If these four tests are met, then the trust generally will be treated as a designated beneficiary and the required minimum distribution will be based on the oldest trust beneficiary's life expectancy [Treas. Reg. § 1.401(a)(9)-5, A-7(a)(1). But there is, in essence, a fifth test for the trust to be a designated beneficiary, because all of the beneficiaries of the trust must be individuals the age of whom can be identified [Treas. Reg. § 1.401(a)(9)-4, A-5(c) and Treas. Reg. § 1.401(a)(9)-4, A-3]. Therefore, the fifth requirement is to draft the trust so that it is possible to determine the identity of the oldest beneficiary and to require that only individuals may be beneficiaries of the trust. This fifth test can create problems, especially with multi-beneficiary common pot trusts or multi-generation dynasty trusts.

It is difficult to draft a trust that only has individual and ascertainable beneficiaries because the IRS has not explained which contingent beneficiaries can be ignored. The regulations provide that if the first four tests above are met, then the IRS will treat the beneficiaries of the trust as the potential designated beneficiary of the retirement account. It then becomes necessary to determine three things:

- The identity of the beneficiaries of the trust;
- The identity of any beneficiaries of the trust that are not individuals; and
- The identity of the oldest beneficiary.

In making these determinations, the trust's "*contingent beneficiaries*" must be taken into account [Treas. Reg. § 1.401(a)(9)-5, A-7(b)]. The regulations provide that a person will not be considered a beneficiary for purposes of determining the beneficiary with the shortest life expectancy, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the participant's beneficiaries after that beneficiary's death. However, the preceding sentence does not apply to a person who has any right (including a contingent right) to a participant's benefit beyond being a mere potential successor to the interest of one of the participant's beneficiaries upon that beneficiary's death.

This rather unhelpful regulation gives the guidance that a "mere potential successor" beneficiary can be ignored. The regulation also specifically states that one cannot ignore contingent beneficiaries simply because the current beneficiary is entitled to all of the trust income, as is the case with a QTIP trust or QSST:

> *"...if the first beneficiary has a right to all income ... during that beneficiary's life and a second beneficiary has a right to the principal but only after the death of the first income beneficiary ..., both beneficiaries must be taken into account in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries."*

Although the regulation clearly contemplates that some beneficiaries can be ignored, it never really explains the circumstances in which they can be ignored [Treas. Reg. § 1.401(a)(9)-5, A-7(c)(1)]. Under Private Rev. Rul. 200438044, it takes a date-of-death look at then-living trust beneficiaries to determine which contingent remainder beneficiaries can be ignored. Under this ruling's analysis if a trust is to terminate upon a beneficiary's reaching a certain age then the only remainder beneficiaries that must be counted are the individuals that would receive the trust assets upon termination, provided those individuals are alive on the taxpayer's death and they have already attained the age for termination. This ruling is not helpful to dynasty trusts or lifetime trusts with rights of withdrawal, as the beneficiary is never required to take outright ownership of the trust assets. It will be interesting to see if the analysis of this ruling is consistently applied by the IRS. Until the IRS or Congress clarifies these rules, practitioners in this area must proceed very carefully.

RMD Rules After the Participant's Death

The rules for RMDs after the participant's death depend on whether the participant died before or after reaching his or her RBD and whether the beneficiary is a designated beneficiary. Specials rules apply if the spouse is the beneficiary.

Let's first examine the RMD rules for death prior to the participant's RBD.

Death Prior to the Participant's RBD

Under IRC § 401(a)(9)(B)(ii), if a participant dies before his or her required beginning date (RBD) the entire participant's interest in the qualified retirement plan must be distributed within five years after the participant's death (referred to as the "*5-year rule*").

The "*five year rule"* is a rule by which the employee's entire interest in a 401(k) plan must be disributed no later than December 31st of the calendar year containing the fifth anniversary of the employee's death [Treas. Reg. § 1.401(a)(9)-3, Q&As 1,2]. The five-year rule always applies to a beneficiary that is not a designated beneficiary. A designated beneficiary (as discussed above) may also be subject to the five-year rule if the plan so provides, or if the desingated beneficiary elects the five-year rule pursuant to an election premitted under the plan [Treas. Reg. § 1.401(a)(9),3 Q&A 4].

However, there is an exception to this rule if distributions are made over a designated beneficiary's life expectancy. To meet the requirements of this exception, the distributions must be made over the designated beneficiary's life expectancy or a period that does not exceed beyond the designated beneficiary's life expectancy and begins no later than one year after the participant's deathor a later date specified in the regulations [IRC § 401(a)(9)(B)(iii)].

Death On or After the Participant's RBD

If the participant dies after his/her RBD, in general, all plan proceeds would be distributed based on the identity of the beneficiary. If the participant does not have a designated beneficiary as of September 30th of the calendar year following the calendar year of death, then the applicable distribution period is based on the participant's remaining life expectancy using the participant's age as of the participant's birthday in the calendar year of his or her death.

If the participant has a designated beneficiary as of September 30 of the calendar year following the calendar year of death, then the applicable distribution period is based in the beneficiary's life expectancy using the beneficiary's age as of his or her birthday in the calendar year following the calendar year of the participant's death or, if longer, it is based on the participant's remaining life expectancy. In subsequent calendar years, the applicable distribution period is reduced by one for each year after the calendar year in which life expectancy was originally determined.

However, if the surviving spouse is the sole beneficiary, then the spouse's life expectancy is recalculated each based on his or her birthday for the year in which a minimum distribution is required. For this purpose, life expectancies are based on the Single Life Table [Treas. Reg. § 1.401(a)(9)-5, Q&As 5,6].

Special Rules for Surviving Spouse

Under IRC § 401(a)(9)(B)(iv), a surviving spouse does not have to start taking required minimum distributions until the end of the calendar year in which the participant would have reached age 70 ½, if later than December 31 of the year after the participant's death. It's important to remember that this rule does not allow the surviving spouse to wait until April 1st of the year after the participant would have reached age 70 ½, which would have been the participant's RBD.

The surviving spouse's choices also include:

- Distribute all the assets by the end of the fifth year after the year the participant died, provided the plan offers this option, otherwise the spouse could simply roll this to an inherited IRA to have this option;
- Roll to a traditional IRA;
- Roll to a Roth IRA, which would be a taxable conversion, (the RMD for the year of death may not be rolled over);
- Roll to an inherited traditional IRA or via a conversion to an inherited Roth IRA and start life expectancy payments by December 31st of the year after the participant dies; or

- Roll the deceased participant's plan assets to the plan where the surviving spouse works, where it becomes the surviving spouse's rollover source funds, provided the recipient plan accepts rollovers. IRC § 401(a)(9) regulations specifically permit this, again, provided the plan accepts rollover contributions.

Note: The surviving spouse could always accelerate the payments, unless the plan or beneficiary form overrides any acceleration.

How RMDs are Reported

RMDs are taxable as ordinary income and reported on IRD For 1099-R. They are not eligible rollover distributions. To the extent the participant has a cost basis, the exclusion ratio would be applied unless the minimum distribution is a qualified distribution from a DRAC.

Distributions to actively employed participants who are over age 70 ½ and who are not 5 percent owners are no longer considered required minimum distributions. As a result, distributions to participants in this category are considered eligible rollover distribution unless they fall within another exception to that rule [IRS Notice 97-75, 1997-2C.B.337].

Hardship Withdrawals

Under IRC § 401(k)(2)(B)(i)(IV), a retirement plan may, but is not required to, provide for hardship distributions. Many plans that provide for elective deferrals provide for hardship distributions. Thus, 401(k) plans may permit hardship distributions. If a 401(k) plan provides for hardship distributions, it must provide the specific criteria used to make the determination of hardship. Thus, for example, a plan may provide that a distribution can be made only for medical or funeral expenses, but not for the purchase of a principal residence or for payment of tuition and education expenses. In determining the existence of a need and of the amount necessary to meet the need, the plan must specify and apply nondiscriminatory and objective standards [Treas. Reg. § 1.401(k)-1(d)(3)(i)].

For a distribution from a 401(k) plan to be on account of hardship, it must be made on account of an immediate and heavy financial need of the employee and the amount must be necessary to satisfy the financial need. The need of the employee includes the need of the employee's spouse or dependent [Treas. Reg. § 1.401(k)-1(d)(3)(i)].

Under Section 826, of the Pension Protection Act (PPA) of 2006, the need of the employee also may include the need of the employee's non-spouse (including domestic partners), non-dependent beneficiary. Whether a need is immediate and heavy depends on the facts and circumstances. Certain expenses are deemed to be immediate and heavy, including:

- Certain medical expenses;
- Costs relating to the purchase of a principal residence;
- Tuition and related educational fees and expenses; ‘

- Payments necessary to prevent eviction from, or foreclosure on, a principal residence;
- Burial or funeral expenses; and
- Certain expenses for the repair of damage to the employee's principal residence.

A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee [Treas. Reg. § 1.401(k)-1(d)(3)(iii)]. A distribution is not considered necessary to satisfy an immediate and heavy financial need of an employee if the employee has other resources available to meet the need, including assets of the employee's spouse and minor children. Whether other resources are available is determined based on facts and circumstances. Thus, for example, a vacation home owned by the employee and the employee's spouse generally is considered a resource of the employee, while property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act is not considered a resource of the employee [Treas. Reg. § 1.401(k)-1(d)(3)(iv)(B)].

A hardship distribution may not exceed the amount of the employee's need. However, the amount required to satisfy the financial need may include amounts necessary to pay any taxes or penalties that may result from the distribution [Treas. Reg. § 1.401(k)-1(d)(3)(iv)(A)]. The amount of elective contributions available for a hardship distribution cannot be more than the amount of the employee's total elective contributions, including designated Roth contributions, as of the date of distribution reduced by the amount of previous distributions of elective contributions. This "maximum distributable amount" generally does not include earnings, qualified non-elective contributions or qualified matching contributions, unless the plan provides that certain grandfathered amounts are included. Other amounts under the plan, if any, such as regular matching contributions and discretionary profit-sharing contributions may also be distributed on account of hardship if the plan so provides [Treas. Reg. § 1.401(k)-1(d)(3)(ii)]. After an employee receives a hardship distribution of elective contributions from his or her 401(k) plan, generally the employee will be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution [Treas. Reg. § 1.401(k)-1(d)(3)(iv)(E)(2)].

Hardship distributions are includible in gross income unless they consist of designated Roth contributions. In addition, they may be subject to an additional tax on early distributions of elective contributions. Unlike loans, hardship distributions are not repaid to the plan. Thus, a hardship distribution permanently reduces the employee's account balance under the plan.

Note: The Tax Cuts and Jobs Act of 2017, Section 1504 provides a provision that now allows 401(k) plans to distribute qualified non-elective contributions (QNECs), qualified matching contributions (QMACs), and investment earnings on those accounts and investment earnings on elective deferrals as amounts available for a hardship distribution.

In-Service Distributions

Under IRS Rev. Rul. 68-24, a 401(k) plan may allow participants to take *"in-service"* distributions (withdrawals) from certain contributions (discussed below) made to the plan before they leave employment. This early payout provision is known as an *in-service distribution (withdrawal) option*. Income taxes and penalties may apply to these distributions.

The *in-service distribution option* allows certain plan participants to receive some or all of their retirement assets while they are still employed. Furthermore, many in-service distributions are set forth in federal pension law (ERISA and PPA of 2006). In addition, the plan documents may impose additional requirements and limitations. The plan document specifies whether an in-service distribution provision is available and the conditions under which the working participant may use the in-service distribution options.

Vanguard reports in their study, "*How America Saves, 2017*," during 2016, 3% of participants took an in-service distribution, withdrawing about one-third of their account balances. All in-service distributions during 2016 amounted to 1% of aggregate plan assets.

Rules for In-Service Distributions

Different contribution types are often subject to different in-service distribution rules. The rules are driven by both legal requirements and plan document language. The availability of in-service distributions can be conditioned upon various circumstances, including the following:

- *Attainment of a Specified Age.* Under this restriction, a participant still working for his or her employer may be eligible to take a distribution of some or all contribution types once he or she reaches the designated age that is outlined in the plan document. The in-service distribution option tied to the attainment of a specified age has gained popularity with employers. For example, generally, employee salary elective deferrals, qualified non-elective contributions (QNECs), and qualified matching contributions (QMACs) are not eligible for in-service distribution until the participant attains age 59 ½. The distribution recipient must be aware that if he or she is not age 59 ½ or is not rolling the distribution into an IRA or other retirement plan, the amount could be subject to a 10% early distribution penalty tax;
- *Completion of a Specified Period of Service.* Under this restriction, once a participant completes a specified number of years of service with an employer, certain contribution types may be available for an in-service distribution. The following represents a review of the types of plan contributions and their respective in-service distribution rules;
- *In-Service Distributions of Employer Contributions.* Some plans allow employed participants, who otherwise would not be eligible for distributions, to take withdrawals of their employer-provided contributions. Distributions of employee salary deferrals taken while still employed are only available under a separate set of rules for hardship:
    - If the plan permits, a 401(k) plan/profit sharing plan participant may take an in-service withdrawal of employer contributions. The portion of the individual's account balance attributable to employer contributions that is eligible for an in-service withdrawal depends upon the length of time the individual has

participated in the plan. Participants with fewer than five years of service may only access assets that have been in the plan for at least two years. This rule is sometimes referred to as the “two-year bake” rule. Participants with five or more years of service are not restricted by the two-year bake rule. The sponsoring employer may condition the withdrawal of employer contributions to situations of hardship, attainment of a specified age, or completion of a specified period of service.

- *In-Service Distributions of Employer Contributions Restricted to Hardship.* An employer may choose to limit in-service distributions of employer contributions to situations of hardship. In-service distributions as a result of hardship are not subject to the two-year bake rule. Instead, employers will frequently limit the amount of the in-service hardship withdrawal to the lesser of:
    - The employee’s vested balance in his or her individual account attributable to employer contributions; or
    - The amount of the employee’s immediate and heavy financial need.

  It is important to refer to the plan language for a concise definition of what circumstances constitute a hardship under the terms of the plan. Often the plan will use the same definition of hardship that applies for distributions of employee salary deferrals. **Note:** Hardship distributions are not eligible for rollover.
- *Hardship Distributions of Employee Salary Deferrals.* Typically, employee salary deferrals may not be distributed prior to severance from employment, death, disability, plan termination, attainment of age 59½ or hardship. Hardship distributions of employee salary deferrals are not subject to the two-year bake rule, but the plan must limit the amount of the distribution to the lesser of the participant’s employee salary deferrals, reduced by previous hardship distributions, plus the following pre-1989 amounts: earnings on deferrals, qualified non-elective contributions (QNECs) and their earnings, and qualified matching contributions (QMACs) and their earnings. It is important to review the plan language for a concise definition of what circumstances constitute a hardship under the terms of the plan. Hardship distributions of employee salary deferrals are not eligible for rollover;
- *In-Service Distributions of Rollover Contributions.* Another important source of in-service distribution dollars is rollover contributions. Rollover contributions are amounts a plan participant has moved into his or her current employer’s plan from a prior plan or IRA. Many plans permit in-service distributions of rollover contribution amounts at any time; and
- *In-Service Distribution of After-Tax Account.* If the plan document permits, it may be possible for a participant to request a distribution of 401(k) plan after-tax contributions while still working; the tax consequences typically depend on whether the individual rolls over the amount or whether the distribution comes from pre-1987 or post-1986 after-tax amounts. Pre-1987 after-tax contributions can potentially be recovered without associated earnings if the record keeper has tracked these dollars. Post-1986 after-tax contributions and earnings in the account are subject to special “basis recovery rules” that require the participant to treat recovered amounts as consisting of a *pro rata* share of after-tax contributions and earnings.

> **Note:** Based on the distribution treatment of pre-1987 after-tax contributions and/or the overall ratio of after-tax contributions to earnings, plan participants should consider whether to rollover an after-tax distribution to a traditional IRA or whether to make a rollover conversion to a Roth IRA or a mixture of both options.

Beaware the required minimum distributions (RMDs) from a qualified retirement plan or IRA cannot be rolled over [IRC § 402(c)(4)(B)]. The trap is that the first year distribution received in any year for which a distribution is required is considered part of the RMD for that year and thus cannot be rolled over. Another trap of this rule is that the participant first Distribution Year is not the year in which the required beginning date (RBD) occurs; it is the year before the RBD. Thus the first Distribution Year is the year the participant reaches age 70½ (or retires as the case may be), even though the first RMD does not have to be taken until April 1 of the following year. Any distribution received on or after January 1 of the first Distribution Year will be considered part of the RMD for that year (until the entire RMD has been distributed), and thus cannot be rolled over [Reg. 1.402(c)-2, A-7(a)].

Note: Stay tuned! The proposed GOP tax plan lowers the minimum age, from 62 to 59 ½ (the same minimum age as for defined contribution plans), for ins-service distributions from all defined benefit plans and defined contribuiton plans.

401(k) Plan Loans

A 401(k) plan is permitted, but is not required, to offer loans to participants. The loan must charge a reasonable rate of interest and be adequately secured. A loan from a 401(k) (as well as any tax-qualified pension) plan is treated for federal income tax purposes as a taxable plan distribution under IRC § 72(p)] and are taxable in whole or in part under IRC § 72(e). [Treas. Reg. § 1.72(p)(1), Q&A 3].

The maximum amount a participant may borrow from his or her plan is 50% of his or her vested account balance or $50,000, whichever is less [IRC § 72(p)(2)(A)(i)]. An exception to this limit is if 50% of the vested account balance is less than $10,000: in such case, the participant may borrow up to $10,000 [IRC § 72(p)(2)(A)(ii)]. Plans are not required to include this exception.

> ***Example 1:*** Bill's vested account balance is $80,000. Bill may take a loan up to $40,000, which is the lesser of 50% of his vested account balance and $50,000.

> ***Example 2.*** Sue has a vested account balance of $120,000. Sue may take a loan up to $50,000, which is the lesser of 50% of her vested account balance of $120,000 ($60,000) or $50,000.

Generally, the employee must repay a plan loan within five years and must make payments at least quarterly [IRC § 72(p)(2)(B)(i)]. The law provides an exception to the 5-year requirement if the employee uses the loan to purchase a primary residence [IRC § 72(p)(2)(A)(ii)].

Loans that exceed the maximum amount or do not follow the required repayment schedule are considered "*deemed distributions*." If the loan repayments are not made at least quarterly, the remaining balance is treated as a distribution that is subject to income tax. In addition, if the participant is under age 59 ½, the deemed distribution would be subject to a 10% early withdrawal penalty [IRC § 72(t)1)]. If the employee continues to participate in the plan after the deemed distribution occurs, he or she is still required to make loan repayments. These amounts are treated as basis and will not be taxable when later distributed by the plan. If the employee (participant) terminates employment, the plan may require the employee to repay completely the loan prior to termination. The employee can avoid the immediate income tax consequences if he or she is able to come up with the loan's outstanding balance, within 60 days and rolls over this amount to an IRA or eligible retirement plan.

If the employee is in the armed forces, the employer may suspend the loan repayments during the employee's period of active duty and then extend the loan repayment period by this period. If during a leave of absence from his or her employer, an employee's salary is reduced to the point at which the salary is insufficient to repay the loan, the employer may suspend repayment up to a year. Unlike the exception for active members of the armed forces, the loan repayment period is not extended and the employee may be required to increase the scheduled payment amounts in order to pay off the loan in the originally scheduled period.

The participant should receive information describing the availability of and terms for obtaining a loan. Some information that may be provided to a participant is as follows:

- Loans are/are not permitted;
- Minimum dollar amount required to obtain a loan;
- Maximum number of loans permitted by the plan;
- Maximum dollar amount permitted;
- Term of repayment (number of years);
- Interest rate information;
- Security for the loan;
- How repayment may be made (for instance, payroll deduction); and
- Spousal consent requirements.

The participant's spouse must give written consent to any loan secured by the employee's account balance (see Spousal Consent Rules below). This rule does not apply if the total account balance serving as security for the loan does not exceed $5,000. If consent is required, it must be given a specified number of days before the date the loans is made. [Treas. Reg. § 1.401(a)-20, Q&A 24(a)(1)].

Note: The Tax Cuts and Jobs Act provided a provision Section 13613 that allows those workers who leave their current employer with an outstanding loan from their workplace retirement plan to not be taxed on the loan amount if they contribute the loan balance to an IRA by the date their individual tax return is due. Prior, individuals only had 60 days to make that rollover before they would be taxed on the loan amount.

Spousal Rights in 401(k) Plan Distributions

ERISA provides legal protections that are extended to the spouse of a 401(k) plan participant. Protection is afforded in two contexts. First, benefits are provided upon the death to a surviving spouse unless, during the participant's lifetime, those benefits are waived by the participant with the consent of his or her spouse (see Spousal Consent below). Second, a spouse can be awarded all or any part of a participant's interst in a 401(k) plan upon the dissolution of marriage (see QDRO below).

Qualified Pre-Retirement Survivor Annuity

ERISA requires 401(k) plans to provide a qualified pre-retirement survivor annuity (QPSA). If a participant dies before the annuity starting date, benefits must be paid to the surviving spouse in the form of a QPSA.

A QPSA is an immediate annuity for the life of the surviving spouse purchased with not less than 50 percent and not more than 100 percent value of the participant's account balance determined as of the date of death [Treas. Reg. § 1.401-20, Q&A 20]. The percentage of the participant's account balance used to purchase the QPSA is specified in the plan document.

Qualified Joint and Survivor Annuity

If the participant survives until the annuity starting date, the participant's account balance must be used to purchase a qualified joint and survivor annuity (QJSA).

A QJSA is an annuity for the life of the participant with a survivor annuity for the life of the spouse. The amount of the survivor annuity is a plan-specified percentage that is not less than 50 percent and not more than 100 percent of the amount of the annuity that is payable during the joint lives of the participant and spouse [IRC 417(b)]. In the case of an unmarried participant, the QJSA is an annuity for the life of the participant [Treas. Reg § 1.401(a)-20, Q&A 25(a)].

Note: The Pension Protection Act (PPA) of 2016 imposed new distribution requirements generally effective for distributions with annuity starting dates occurring in plans year beginning after December 31, 2007 and apply to any retirement plan that is subject to the QJSA rules of IRC § 417. The new PPA rules require that married participants have a minimum of two different joint and survivor annuity forms of payment available for retirement payouts:

- One required form is the QJSA form; and
- The second required form is called a "qualified optional survivor annuity" (QOSA).

The QOSA form must be actuarially equivalent to a single life annuity and must provide to the participant's spouse, a continuation percentage of either 50% or 75% of the amount payable to the participant. If the continuation percentage specified in the plan's QJSA is less than 75%, then the QOSA must be a 75% joint and survivor annuity. Otherwise, the QOSA must be a 50% joint and survivor annuity.

Same Sex Marriage Ruling Impacts Spousal Benefits

On Friday, June 26, 2015, the Supreme Court published its ruling in *Obergefell v. Hodges*, holding (by a 5 to 4 margin) that the Fourteenth Amendment requires a state to license marriage between two people of the same sex and to recognize any such marriage that is lawfully licensed and performed out-of-state. As a result, all (remaining) state laws or constitutional amendments banning same sex marriage are now invalid. The decision comes exactly two years (to the day) after the Supreme Court's 2013 decision in *United States v. Windsor*, in which the Court struck down a portion of the federal Defense of Marriage Act that previously prohibited the federal government from recognizing marriages between individuals of the same sex.

Now, as a result of the Obergefell decision, all 50 states and the District of Columbia must issue marriage licenses to same-sex spouses, and must recognize any same-sex marriage that was lawfully performed in another state (or country). But what does this mean for employers sponsoring benefit plans? Unlike the Windsor decision, which required sponsors to extend spousal benefits under retirement plans to same-sex spouses and to change the tax reporting of certain employer provided welfare benefits, the effect of the Obergefell decision will be more indirect, and less immediate, as it may take time for currently unmarried same-sex couples living in states that previously banned same-sex marriage to obtain marriage licenses and marry. And, the effects will differ for retirement plans, fully-insured welfare plans, and self-funded welfare plans.

Spousal Consent Requirement

The guidelines around spousal consent can vary by retirement account. Defined benefit (DB) plans always require spousal consent to change a beneficiary, and defined contribution (DC) plans require spousal consent most of the time, but not always.

In 1984, President Ronald Reagan signed The Retirement Equity Act, under the law, a pension plan is allowed to specify that the spousal protection applies only after one year of marriage, but most do not do so. And the law does not apply to pension plans for state or local government employees, although a minority of the state and local plans follow it. The law does not cover Individual Retirement Arrangements, although in some states, a state property law might give a spouse some protected interest.

To be proper, a spouse's consent must be in writing, must acknowledge the effect of a participant's waiver, and must be witnessed by a plan representative or notary public [IRC § 417(a)(2)(A)]. The consent must specify the non-spouse beneficiaries who will receive benefits upon the participant's death. It must also specify, in the case of a participant's waiver of a QJSA, the particular optional form of benefit selected by the participant [Treas. Reg. § 1.401(a)-20, Q&As 31(a)(b)]. The spouse consent to the waiver may be made either on a paper document or through electronic medium that satisfies the requirements of Treas. Reg. § 1.401(a)-21(d)(6)].

In 2011, the court ruled in the case Cajun Industries LLC v. Robert Kidder, et al. that despite having previously named his three children as beneficiaries of his 401(k) plan, a deceased plan participant's 401(k) balance will pass to his new wife. The court determined that under the terms of the participant's plan, a spouse's right to plan assets is immediately vested upon marriage, and since no spousal waiver was obtained, the default beneficiary is the spouse, even though she was not the named beneficiary.

The spouse got the 401(k), and the children, who were the intended beneficiaries, were disinherited.
The court had little difficulty in determining that Beth Bennet Kidder was the rightful plan beneficiary. First, the court noted the plan's language was “clear and unambiguous” that unless a spousal waiver were executed, a deceased participant's vested interest would belong to his or her spouse. Next, the court addressed the Employee Retirement Income Security Act of 1974 issue raised by Mr. Kidder's children. In the court's view, it was clear that although ERISA allows plans to waive spousal consent requirements when a participant has been married less than a year, it does not require that they do so.

When it comes to retirement accounts, the beneficiary form is the most important document there is. It takes precedence over prenuptial agreements, postnuptial agreements and even contrary instructions on who should inherit plan assets contained in a client's will. But the decision in the Kidder case makes it clear that when it comes to ERISA plans, the beneficiary form can be trumped by spousal rights.

Had Mr. Kidder rolled his 401(k) to an IRA after leaving Cajun Industries, but before his remarriage, this unfortunate incident would have been avoided. After the previous wife (Betty) death, Mr. Kidder could have put the funds in an IRA and name his three children as beneficiaries (in the same manner as he did with his 401(k) plan). When he married his new wife (Beth), the children would have remained the beneficiaries of his account. He also could have asked his new wife to waive her rights to the 401(k) plan, but that did not happen, and there is really no way to guarantee that Beth Kidder, or any other spouse, for that matter, would waive their spousal rights to plan assets.

Advisers should make sure that clients with assets in a 401(k) (or any ERISA for that matter) plan are aware of the special rule requiring spousal consent in order to name their children (or any other non-spouse) as a beneficiary of that plan.

Qualified Domestic Relations Order

Qualified domestic relations orders (QDROs) are an exception to the general rule that prohibits benefits in a 401(k) plan from being assigned or alienated under IRC § 401(a)(13). The QDRO rules came about because of the recurring controversy between state courts, which were attempting to award qualified plan benefits in divorce proceedings, and plan trustees, who were concerned that compliance with these orders would place them in a violation of the anti-assignment rules and disqualify the plan. Enacted in 1984, the QDRO rules now make clear what a plan administrator’s or trustee’s obligations are when an order dividing benefits is received.

Alternate Payee under QDRO

Under IRC § 414(p)(1)(A), a QDRO is a court order that creates a right for an alternate payee to receive some or all of a participant's benefits in a 401(k) plan. The alternate payee can be:

- Spouse;
- Former spouse;
- Child; or
- Other dependent of participant.

QDRO Terms

Under IRC § 414(p)(2), a QDRO must clearly specify the following information:

- The name and last known mailing address of the participant and each alternate payee awarded benefits in the order. However, if the plan administrator has independent knowledge of this information, the order cannot be rejected for failing to provide it;
- The amount or percentage of benefits to be paid the alternate payee, or the manner in which such amount or percentage is to be determined. This requirement generally prohibits a QDRO from using plan benefits as a source of payment;
- The number of payments or the period to which the order applies. This generally requires that the order specify whether payments will be paid as a lump sum, as an annuity, in installments, and so forth; and
- The plan to which the order applies.

A QDRO cannot contain any provision that requires a plan to provide any type or form of benefit or any option not otherwise provided under the plan. For example, a QDRO cannot require that a segregated, self-directed account be established for an alternate payee if the plan does not permit participants and beneficiaries to segregate and direct the investment of their account.
A QDRO cannot contain a provision that would require the plan to pay increased benefits. For example, a QDRO cannot award an alternate payee a dollar amount that is in excess of a participant's vested account balance.
Finally, under IRC § 414(p)(3), a QDRO cannot require a plan to pay to one alternate payee benefits that have already been awarded to another alternate payee in a separate QDRO.

Tax Consequences of QDRO

If the alternate payee is the spouse or former spouse of a participant, the distribution is taxed to the alternate payee. Under IRC § 402(e) (1)(A) if the alternate payee is not a spouse or former spouse, the distribution is taxed to the participant. The 10 percent additional income tax penalty that generally applies to distributions made for a participant attains age 59 ½ does not apply to distributions made to a spousal alternate payee [IRC § 72(t)(2)(C)]. An alternate payee who is a spouse or former spouse of a participant may rollover his or her distribution [IRC § 402(e)(1)(B)].

Distributions under a QDRO

Distributions of all or any part of a participant's account pursuant to the provisions of a QDRO are specifically authorized. The alternate payee may receive a payment of a benefit under the plan prior to the date on which the participant is otherwise entitled to a distribution under the plan if the QDRO specifically provides for such earlier payment. If the present value of the payment exceeds $5,000, the alternate payee must consent in writing to such distribution.

The alternate payee may receive a payment of benefits under the plan in any optional form of benefit permitted other than a joint and survivor annuity. Upon receipt of an order which appears to be a domestic relations order, the plan administrator shall promptly notify the participant and each alternate payee of the receipt of the order and provide them with a copy of the procedures established by the plan administrator for determining whether the order is a QDRO. While the determination is being made, a separate accounting shall be made with respect to any amounts which would be payable under the order while the determination is being made. If the plan administrator determines that the order is a QDRO within 18 months after receipt, the plan administrator shall direct the trustee to establish an account for the alternate payee, who shall direct the investment of such account. The plan administrator shall further instruct the trustee to begin making payments from the alternate payee's account pursuant to the order when required or as soon as administratively practical or as the alternate payee otherwise directs in accordance with the order. If the plan administrator determines that the order is not a QDRO, or if no determination is made within 18 months after receipt of the QDRO, then the separately accounted for amounts shall be either restored to the participant's account or distributed to the participant (if the plan otherwise permits distribution), as if the order did not exist. If the order is subsequently determined to be a QDRO, such determination shall be applied prospectively to payments made after the determination.

Withholding on Distributions

Most 401(k) plan distributions are subject to income tax withholding, unless the employee elects out of withholding [IRC § 3405(a)]. Any other amount distributed is subject to 10 percent withholding unless the participant opts out of withholding [IRC 3405(b)].

IRC § 3405(c), provides a special rule that requires a 401(k) plan to withhold 20 percent of any distribution that is considered an eligible rollover distribution. This penalty can be avoided by doing a direct rollover of the distribution to an eligible retirement plan [IRC § 3405(c)(2)]. A participant cannot opt out of this witholding but can have more than 20 percent withheld.

Net Unrealized Appreciation

The Net Unrealized Appreciation (NUA) rules allow employees who have accumulated employer stock inside of their 401(k) plan to later distribute it out of the plan and into a brokerage account. By doing so, the employee only reports the cost basis of the securities (from inside the plan) in income for tax purposes, with the remaining "*unrealized appreciation*" deferred until the stock is sold and when the stock *is* sold, all of that unrealized appreciation that built up inside the plan is eligible for long-term capital gains treatment. By contrast, if the funds had remained inside the account, the growth would have (someday, upon withdrawal) been subject to ordinary income treatment.

Of course, if the stock had been purchased outside of the 401(k) plan, it would have been eligible for long-term capital gains treatment in the first place, but in many cases the only assets available to invest were inside of the account, or alternatively the employer stock may have been accumulated because the employer actually provided it *to* the employee in the first place (e.g., a profit-sharing contribution, as part of an ESOP, etc.). In those cases, the employee gets the preferential long-term capital gains treatment for appreciated stock, even though it was purchased inside the plan.

Notwithstanding some of the tax benefits, both regulators and legislators have been increasingly concerned about the risks to employees of having their retirement account assets concentrated in a single stock holding (especially when it's the same company which they are already counting on for employment!). Thus, beginning in 2006 the Treasury began to promulgate regulations that would require qualified plans to offer diversification choices for employees with significant stock positions.

Eligible Rollover Distributions

Departing plan participants can roll over (transfer) distributions from a 401(k) plan to an Individual Retirement Account (IRA) or to another employer's plan, if the plan accepts such transfers. If the accrued benefit is less than $5,000 when the participant leaves an employer, the plan can make an immediate distribution without the participant's consent. Amounts of $5,000 or more may be cashed out only with the written consent of the participant. For married workers, the consent of the worker's spouse is also required.

If the distribution is more than $1,000, the plan must automatically roll over the funds into an IRA that it selects, unless the participant elects to receive a lump sum payment or to roll it over into an IRA that he or she chooses. The plan must first send a notice allowing the participant to make other arrangements, and it must follow rules regarding what type of IRA can be used (for example, it cannot combine the distribution with savings the individual has deposited directly in an IRA). Rollovers must be made to an entity that is qualified to offer individual retirement plans. Also, the rollover IRA must have investments designed to preserve principal. The IRA provider may not charge more in fees and expenses for such plans than it would to its other IRA customers.

If the departing employee elects to receive a lump sum payment and does not transfer the money to another qualified employer plan or to an IRA, the participant will owe a 10% tax penalty if he or she is under age 59½ and does not meet the exceptions discussed above in IRC § 72(t).

Chapter 8
Review Questions

1. Which of the following is a triggering event for distributions from a qualified retirement plan?

( ) A. The participant's severance from employment
( ) B. The participant's death
( ) C. Neither A or B
( ) D. Both A and B

2. Under IRC § 72(t)(2), there are how many exceptions to the 10% penalty for qualified retirement plans?

( ) A. 10
( ) B. 7
( ) C. 5
( ) D. 9

3. Which of the following is **not** a true statement about a loan from a 401(k) plan?

( ) A. A loan is treated for federal income tax purposes as a taxable plan distribution
( ) B. The loan must charge a reasonable interest rate
( ) C. The plan is required to allow participants to take a loan
( ) D. The maximum amount a participant may borrow is 50% of his/her vested account balance or $50,000, whichever is less.

4. Which of the following statements about Spousal Consent is FALSE?

( ) A. Defined Benefit (DB) plans always require Spousal Consent to change a beneficiary.
( ) B. Defined Contribution (DC) plans are not required have Spousal Consent.
( ) C. The spouse does NOT have to consent to a waiver in writing.
( ) D. A spouse's consent must be in writing.

5. Distributions paid directly to the plan participant rather than being rolled over into an IRA or another qualified retirement plan, are subject to mandatory tax withholding equal to what percent of the total distribution?

( ) A. 10%
( ) B. 25%
( ) C. 50%
( ) D. 20%

CHAPTER 9

ERISA AND FIDUCIARY REPONSIBILITIES

Overview

It is very important for you, as the advisor, to have an understanding of the pension legislation enacted under the Employee Retirement Income Security Act (ERISA) of 1974, the Pension Protection Act (PPA) of 2006, and the most recent DOL Conflict of Interest Rules (the New Fiduciary Rule).

This chapter will examine the role of ERISA and its various Titles. It will also describe the fiduciary duties and responsibilities of plan sponsors as well as the advisor. In addition, this chapter will describe the required reporting and disclosure documents that the plan sponsor must provide to the participant (and/or beneficiaries). The end of the chapter will provide a review of the new DOL Fiduciary Rule.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Demonstrate an understanding of the background and purpose of the Employee Retirement Income Security Act (ERISA) of 1974;
- List the required disclosures to participants in the plan under Title I of ERISA;
- Describe the required plan sponsor reporting requirements to governmental agencies as set forth in Title I of ERISA;
- Determine fiduciary responsibilities and the role the fiduciary under ERISA;
- Outline the duties of a fiduciary;
- Identify the various levels of limiting the plan sponsors fiduciary liabilities;
- Relate the role of ERISA §§ 404(c) and 408(b)(2); and
- Explain the new DOL Conflict of Interest Rule.

ERISA

The Employee Retirement Income Security Act (ERISA) of 1974 (Pub. L. No. 93-406, codified in part at 29 USCS § 1002 *et seq.*) and signed into law on September 2, 1974 by President Gerald Ford, is a federal law which establishes minimum standards for pension plans in private industry and provides for extensive rules on the federal income tax effects of transactions associated with employee benefit plans.

Settlor vs. Fiduciary Functions

Plan sponsors must understand the important distinction between settlor decisions and fiduciary decisions.

- *Settlor Non-Fiduciary Functions.* The settlor is the individual or entity that creates the Trust, which holds employee elective deferrals and employer contributions. Settlor functions are not subject to fiduciary duty. They typically relate to plan design—for example, the establishment of a plan, determination of who the plan will cover, and design of the benefit offerings. The creation, termination, or even amendment of a plan, are also settlor functions—these decisions cannot give rise to a claim for breach of fiduciary duty. Another settlor function is the decision of what class of employees to make eligible for coverage. This type of decision may prompt IRS issues of coverage and discrimination, however, which are nonetheless not fiduciary in nature. Fiduciary functions are those that involve the control and administration of the plan. Fiduciaries exercise control or management over plan assets or have discretionary authority over the plan operation; and
- *Functional Fiduciaries.* Under ERISA anyone, no matter what that person's formal title is with the employee benefit plan, will be subject to becoming a fiduciary if h/she exercises or has any discretionary authority over the management or administration of the plan or its assets. Individuals are functional fiduciaries under ERISA by virtue of one or more functions they perform for the plan. Fiduciary classification is not an "all or nothing" concept; a person may be a fiduciary with respect to one aspect of the plan but not another. The personal liability of a fiduciary is generally limited to the fiduciary functions which the person performs with respect to the plan. Many court decisions have recognized this view.

In addition to this functional definition, ERISA also defines three specific fiduciary roles that are clearly stated in the plan document. These are called named fiduciaries.

Named Fiduciaries

Under ERISA § 402 (a), every plan must have at least one fiduciary, a person or entity, named in the written plan (or named through a process identified in the plan). This allows the participants and other interested parties to identify who is responsible for operating the plan. These named fiduciaries include:

- Plan Sponsor;
- Plan Trustee; and
- Plan Administrator.

Let's review each of these named fiduciaries in greater detail.

Plan Sponsor

The Plan Sponsor oversees all the other fiduciaries. Plan Sponsors:

- May appoint one or more fiduciaries to operate the plan;
- Monitor if fiduciaries are performing their duties as established by ERISA's prudent man standard of care and exclusive purpose rule; and
- Replace fiduciaries if they fail to fulfill their fiduciary responsibilities.

In most cases, the employer will serve as the Plan Sponsor and therefore as a fiduciary, even if an expert is hired to help with fiduciary duties under the plan. In fact, ERISA Section 404 outlines that a fiduciary must act,

> *"with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."*

This has been interpreted to mean that fiduciaries may need to hire or consult with an expert if they do not have the necessary expertise. The only case in which the employer sponsoring the plan is not a fiduciary is when there is a different named fiduciary in the plan document.

Plan Trustee

The Plan Trustee is responsible for everything to do with plan assets, The Trustee has the sole authority for:

- Safekeeping of plan assets;
- Prudent investment management;
- Pursuing monies owed to the trust, including monies distributed incorrectly and those not contributed on time;
- Following participant directions in accordance with plan document provisions in participant-directed plans, unless those directions conflict with ERISA;
- Prudently selecting and monitoring service providers, such as investment managers and custodians; and
- Ensuring that any expenses paid by the trust at the discretion of the Trustee are reasonable, and refusing to pay from the trust any fees if payment of those fees would conflict with ERISA or the plan document.

The Trustee named in the plan document can delegate some of his or her duties to a service provider, but the Trustee is always responsible for whomever they hire.

Plan Administrator

The Plan Administrator is responsible for overseeing plan operations. The Plan Administrators duties are mentioned in both ERISA and DOL regulations and include:

- Providing a variety of information and documents to participants and other interested parties on request, when required by law or regulation;
- Providing participants with summary plan descriptions and summary annual reports;
- Filing the Form 5500 Annual Report and annual audit (if applicable);
- Preparing various notices (e.g., blackout, termination, suspension of accruals);
- Determining whether a domestic relations order (DRO) is qualified (QDRO) and implementing it if so;
- Compiling and providing participant fee disclosures under DOL Regulation Section 2550.404a-5; and
- Providing participant benefit statements (Section 105).

Duties of the Plan Administrator can also be found in the plan document and the broad range of tasks include:

- Maintaining the qualified status of the plan (including the requirement to update with mandatory interim amendments and periodic restatements per IRS regulations);
- Operating the plan in accordance with its terms (a short description for a very big job, since, as mentioned, there are very many administrator "to do" items associated with operating the plan);
- Coverage, non-discrimination, and other compliance testing; and
- Properly administering loans, hardship distributions, other distributions, payroll changes affecting the plan, and any other participant events.

The Plan Administrator can be a single person or consist of a retirement plan committee. The Plan Administrator or the retirement plan committee may hire a service provider to assist with their fiduciary duties, but life the Trustee, they retain oversight of those hired service providers.

Fiduciary Liability

Plan fiduciaries may be personally liable if the fiduciary breaches a responsibility, duty, or obligation under ERISA § 409. ERISA § 409 provides that a fiduciary may be liable to a plan for any losses resulting from such breach, and may be responsible for forfeiting to the plan any profits that were made through the improper use of plan assets. Besides this monetary relief available, a court may also award "equitable and remedial relief" as it deems appropriate.

In addition, ERISA § 409(b) provides that a fiduciary is not liable with respect to a breach of fiduciary duty "*if such breach was committed before he became or after he ceased to be a fiduciary*." Courts have found that fiduciaries are not liable for losses caused by an imprudent investment made prior to when the individual assumed fiduciary responsibility. Still, a fiduciary may have an obligation to rectify breaches of fiduciary duty committed by a previous fiduciary and may be liable if he or she fails to take remedial action.

ERISA Fiduciary Rules

ERISA regulates the retirement plan industry, so it's important that you and the plan sponsor be familiar with its rules. There are three primary sets of rules that serve as the foundation of fiduciary responsibility common to all ERISA fiduciaries:

- The exclusive purpose rule;
- The fiduciary standard of care; and
- The Prohibited Transaction rules.

Exclusive Purpose Rule

Plan fiduciaries must discharge their duties for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.

ERISA Fiduciary Standards of Care

Fiduciaries have important responsibilities and are subject to higher standards of conduct because they act on behalf of plan participants and beneficiaries. ERISA § 404 establishes the duties owed by a fiduciary to participants and beneficiaries of a plan. This section identifies the following standards of conduct:

- Duties of Loyalty;
- Duties of Prudence;
- Duties to Diversify Investments;
- Duties to Monitor; and
- Duty of Follow Plan Documents.

Let's review each of these duties in greater detail.

Duty of Loyalty

ERISA § 404(a)(1)(A) provides that a fiduciary shall discharge his or her duties with respect to a plan:

> *"...solely in the interest of the participants and beneficiaries" and for the "exclusive purpose" of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan."*

ERISA § 404(a)(1)(A) is commonly referred to as the "*exclusive benefit rule"* and is considered to command a fiduciary's duty of undivided loyalty. The duty of loyalty applies in situations where the fiduciary is confronted with a potential conflict of interest, for instance, when a pension plan trustee has responsibilities to both the plan and the entity (such as the employer or union) sponsoring the plan. Any form of self-dealing is clear breach of duty of undivided loyalty. The duty of loyalty forbids a fiduciary not only from using plan assets for his or her personal interest but also from favoring the interests of a third party over the interests of plan participant, even if the fiduciary's own interests are not implicated. The duty of loyalty requires that trustees avoid placing themselves in a position where their acts as officers or directors of the corporation will prevent their functioning with complete loyalty to participants. 29 C.F.R. § 2550.408(c) (prohibitions are imposed upon fiduciaries to deter them from exercising the authority, control or responsibility which makes such persons fiduciaries when they have an interest which may conflict with the interests of the plans for which they act; a fiduciary may not use the authority, control or responsibility which makes such person a fiduciary to cause a plan to pay an additional fee to such fiduciary (or to a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as fiduciary). The duty of loyalty may require that a fiduciary disclose material information that the fiduciary knows the participant does not have and will need in order to make an informed decision. In addition to providing benefits, a plan fiduciary must *"defray reasonable expenses of administering the plan."* The DOL stated that: *"...in choosing among potential service providers, as well as in monitoring and deciding whether to retain a service provider, the trustees must objectively assess the qualifications of the service provider, the quality of the work product, and the reasonableness of the fees charged in light of the services provided."*

Duty of Prudence

ERISA § 404(a)(1)(B) provides that a fiduciary must:

> "*…act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man would use in the conduct of an enterprise of a like character with like aims*."

ERISA § 404(a)(1)(B) is commonly referred to as the "*prudent person rule*." This rule means that a fiduciary's actions will be compared against those of a hypothetical prudent person. When examining whether a fiduciary has violated the duty of prudence, courts typically examine the process that a fiduciary undertook in reaching a decision involving plan assets. If a fiduciary has taken the appropriate procedural steps, the success or failure of an investment can be irrelevant to a duty of prudence inquiry. Regulations promulgated by the DOL provide clarification as to the duty of prudence in regard to investment decisions. These regulations [29 C.F.R. § 2250.404a-1(b)(1)] indicate that a fiduciary can satisfy his duty of prudence under ERISA by giving *"appropriate consideration"* to the facts and circumstances that the fiduciary knows or should know are relevant to an investment or investment course of action. "Appropriate consideration" includes [29 C.F.R. § 2250.404a-1(b)(2)]:

- "A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio...to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment;" and

- "Consideration of the portfolio's composition with regard to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, and the projected return of the portfolio relative to the plans funding objectives."

Courts have interpreted the prudent person rule to focus on the conduct of the fiduciary, the extent of the fiduciary's diligent investigation and performance of acts consistent with the purpose of the plan. This is the doctrine of "*procedural prudence*." Whether ERISA's standard of prudence has been breached often depends on whether the fiduciary can demonstrate that it engaged in procedural due diligence before taking the questioned action.

Duty to Diversify Investments

A fiduciary must diversify investments in order to minimize risk of loss unless it would be considered prudent to not diversify investments [29 U.S.C. §1104 (a)(1)(C)]. .ERISA § 404(a)(1)(C) requires fiduciaries to diversify the investments of a plan:

> *"…so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so*."

In general, it is believed that fiduciaries should not invest an unreasonably large proportion of a plan's portfolio in a single security, in a single type of security, or in various securities dependent upon the success of a single enterprise or upon conditions in a single locality. Courts have agreed that ERISA § 404(a)(1)(C) does not create a diversification obligation in terms of fixed criteria, but instead requires a determination based on the specific facts of each individual case.

Duty to Monitor

Generally, the act of selecting plan service providers is an exercise of discretion over the management or administration of the plan or its assets. Thus the person selecting the service provider is a fiduciary within the meaning of ERISA and subject to ERISA's fiduciary standards. ERISA § 405 provides a fiduciary can be held liable for the acts or omissions of his/her delegate if he/she has knowledge of a breach of fiduciary duty by the latter. Accordingly, a fiduciary must always be ready to step in and reassume a delegated function on behalf of the best interests of the plan and participants/beneficiaries. For this reason, contracts for service providers should permit termination by a plan without penalty on reasonably short notice, so that a plan is not locked into an arrangement that is disadvantageous [29 C.F.R. § 2550.408b-2(c)]. After selection, the fiduciary is under a continuing duty to monitor the service provider's performance; to review and evaluate, at reasonable intervals, the performance of others to whom responsibilities are delegated. The review should be done in a manner that may be reasonably expected to ensure that the performance of the responsible individuals comply with the terms of the plan and all statutory standards, including ERISA's exclusive-benefit, prudence, diversification, and prohibited-transaction rules [29 C.F.R. § 2509.75-8]. Steps to monitor include the following:

- Review the service providers' performance;
- Read any reports they provide;
- Check actual fees charged;
- Ask about policies and practices; and
- Follow up on participant complaints.

Duty to Follow Plan Documents

A fiduciary must act in accordance with the plan documents but only to the extent that the plan is consistent with ERISA requirements. Thus, a fiduciary must know and act in accordance with the plan and must have sufficient knowledge of the ERISA requirements [28 U.S.C. §1104 (a)(1)(D)]. ERISA § 404(a) (1)(D) requires fiduciaries to:

> "*…discharge their duties in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with.*"

Courts have interpreted this section to apply not only to a document or instrument that establishes a plan or maintains a plan, but also to other writings that have a substantive effect on the plan. These writings have included investment management agreements, collective bargaining agreements, and even internal memoranda regarding the sale of plan assets. If a plan provision conflicts with ERISA, a fiduciary is obligated to ignore the plan provision. Courts have evaluated this requirement in the context of when compliance with a plan provision leads to a breach of other fiduciary duties. The DOL has argued that:

> *"…if obeying a plan provision requires the fiduciary to act imprudently and disloyally in violation of ERISA §§ 404(a) (1)(A) and (B) ... the provision is not consistent with ERISA, and the fiduciary has a duty to disregard it."*

This situation was addressed in *Tittle v. Enron*, in which the pension plan in question required employer contributions to be made "primarily in Enron stock." The court in *Enron* held that the plan fiduciaries had a duty to ignore this provision if it would be imprudent to follow it. In interpreting ERISA § 404(a)(1)(D), courts have also held that fiduciaries do not breach the duty to act in accordance with plan documents if their failure to follow such documents results from erroneous interpretations made in good faith. In *Morgan v. Independent Drivers Association Pension Plan*, the Tenth Circuit found that the trustees of a pension plan did not violate Section 404(a)(1)(D) because their decision to terminate the plan based on an erroneous interpretation of the effect of a new plan funding method was both considered in good faith and based on consultation with experts.

Fiduciary Liability under ERISA § 409

Plan fiduciaries may be personally liable if the fiduciary breaches a responsibility, duty, or obligation under ERISA § 409. ERISA § 409 provides that a fiduciary may be liable to a plan for any losses resulting from such breach, and may be responsible for forfeiting to the plan any profits that were made through the improper use of plan assets. Besides this monetary relief available, a court may also award "equitable and remedial relief" as it deems appropriate.

In addition, ERISA § 409(b) provides that a fiduciary is not liable with respect to a breach of fiduciary duty "if such breach was committed before he became or after he ceased to be a fiduciary." Courts have found that fiduciaries are not liable for losses caused by an imprudent investment made prior to when the individual assumed fiduciary responsibility. Still, a fiduciary may have an obligation to rectify breaches of fiduciary duty committed by a previous fiduciary and may be liable if he or she fails to take remedial action.

Limiting Plan Sponsor Fiduciary Liability

With the responsibility of a fiduciary, there is also some potential liability. Plan sponsors who go it alone can hire a service provider (a financial institution and or an investment consultant (advisor) who accepts no fiduciary responsibility for his or her advice. This does nothing to mitigate the sponsor's fiduciary risk. However, there are actions the plan sponsor can take to demonstrate that they carried out their responsibilities properly as well as ways to limit their liability.

One way to limit the liability of the plan sponsor is to hire outside fiduciaries (service providers/advisors). A survey conducted by Franklin Templeton/Chatham Partners found that 81 percent of the plan sponsors surveyed said their service providers/advisors acted as an ERISA fiduciary. But when asked what kind of fiduciary role their service providers/advisors were taking on, 63 percent of them didn't know. This can be a problem, because not knowing the nature of their fiduciary responsibility can lead to unintended liability. So, for plan sponsors who are uncomfortable with bearing the risk alone, ERISA provides them with three options to choose from. They are:

- ERISA § 3(16) Fiduciary;
- ERISA § 3(21) Fiduciary; and
- ERISA § 3(38) Fiduciary.

ERISA § 3(16) Fiduciary

The employer (plan sponsor) may hire third party administrator (TPA) firms who are willing to be named as ERISA § 3(16) plan fiduciaries for various plan administration duties. Typically, the different administrative services that these TPAs are willing to serve as fiduciaries for are listed.

As a result, the type and quality of § 3(16) offerings varies by provider. For example, there are some TPAs that are willing to serve as distributions and loans but are unwilling to make a determination on whether a Domestic Relations Order is qualified.

Other responsibilities of a § 3(16) fiduciary may include the hiring of service providers, such as a § 3(38) fiduciary. However, plan sponsors should keep in mind that choosing a § 3(16) fiduciary to be responsible for some or all of the plan administration duties does not relieve them of all fiduciary responsibility.

ERISA § 3(21) Fiduciary

The ERISA § 3(21) fiduciary is typically an investment consultant (advisor) or service provider that provides investment advice and recommendations. Often, in this type of situation, the consultant (advisor) would be a co-fiduciary with the plan sponsor or an investment committee and the plan fiduciary would work in conjunction with this investment consultant (advisor). Together, they develop and draft the investment policy statement, design the fund menu and monitor the investments. When the consultant (advisor) recommends changes and mapping strategies, the decisions are made jointly with the employer (plan sponsor). The employer (plan sponsor) retains the responsibility to appoint and monitor the service provider/consultant (advisor) and ultimately makes the investment decisions.

ERISA § 3(38) Fiduciary

The ERISA § 3(38) relationship shifts the responsibility entirely onto the service provider/ consultant (advisor). This means the service provider/consultant (advisor) is the one who drafts the investment policy statement, designs and builds the initial fund menu, and monitors the investments. The service provider/consultant (advisor) also makes whatever changes need to be made, determines mapping strategies, and provides overall documentation. In exchange for ceding total decision-making authority over the plan to the service provider/consultant (advisor), the employer (plan sponsor) relieves himself/herself of all fiduciary responsibility for the plan—with one important exception. Employers (plan sponsors) still must exercise due diligence in selecting a plan service provider/consultant (advisor). They must check out their credentials, background and track record. If they fail to do so, the service providers/consultant (advisors) § 3(38) status won't protect the sponsor from liability and litigation if the investment consultant (advisor) does something drastically wrong. The § 3(38) arrangement can be attractive to many employer (plan sponsors) who don't want to be bothered with the details of managing a 401(k) plan and are very wary of the potential for litigation. In their view, passing fiduciary responsibility onto a third party enables them to disengage from the plan and get on with their real business. However, the § 3(38) route can be very expensive. And the liability protection under a § 3(38) relationship is not without limits. Even if they've taken prudent care in selecting a fiduciary, employer (plan sponsors) still need to continuously monitor his or her activities. Employers (plan sponsors) also can't second-guess or resist the fiduciary's decisions, or they risk losing whatever liability protection the § 3(38) status affords them.

Hiring a Service Provider

As was discussed above, even if the plan sponsor hires a service provider/advisor to administer and/or manage the plan, they retain some fiduciary responsibility for the decision to select and keep that person or entity as the plan's service provider. Thus, the plan sponsor should document their selection process and monitor the services provided to determine if a change needs to be made.

Some items to consider in selecting a plan service provider:

- Information about the firm itself: affiliations, financial condition, experience with 401(k) plans, and assets under their control;
- A description of business practices: how plan assets will be invested if the firm will manage plan investments or how participant investment directions will be handled, and proposed fee structure;
    - Information about the quality of prospective providers: the identity, experience, and qualifications of the professionals who will be handling the plan's account; any recent litigation or enforcement action that has been taken against the firm; the firm's experience or performance record; if the firm plans to work with any of its affiliates in handling the plan's account; and whether the firm has fiduciary liability insurance; and once hired, these are additional actions to take when monitoring a service provider:
    - Review the service provider's performance;
    - Read any reports they provide;
    - Check actual fees charged;
    - Ask about policies and practices (such as trading, investment turnover, and proxy voting); and
    - Follow up on participant complaints.

ERISA § 404(c)

ERISA § 404(c) defines the responsibilities of plan fiduciaries. Fiduciaries that control plan investments are subject to specific statutory standards of conduct such as acting in a prudent manner and being required to diversify investments. Plan fiduciaries may be personally liable for plan losses resulting from a breach of these standards.

Under ERISA § 404 (c) it provides that where participants exercise control over assets in their own account and other requirements are met (discussed below), the participant is not considered a plan fiduciary. In addition, if the requirements of Section 404 (c) are met, other plan fiduciaries, such as plan trustee, or plan administrators, will be relieved of liability for investment decisions made by participants. Even after electing Section 404 (c) coverage, the fiduciary should adopt an investment policy (discussed below).

Types of Plans Covered Under ERISA § 404(c)

ERISA § 404 (c) applies to any plan giving certain investment information, investment choices and the ability to direct the investment assets in the account of ERISA-governed plans include defined contribution plans, such as 401(k), profit sharing, money purchase and other plans (including 403(b)), qualified under IRC § 401(a).

Note: Choosing not to comply with ERISA § 404 (c) does not automatically cause a plan to violate ERISA. Rather, plan fiduciaries might be responsible under ERISA for participant's decisions regarding investment options. This means that the plan fiduciary can be held responsible for participant's imprudent investment selection. This may be true even if the participant had requested the fiduciary to make that particular investment.

ERISA § 404(c) Protection

As mentioned above, ERISA § 404 (c) protection is only available for plans that permit participants to direct the investments. If a participant actually directs the investments (and if the plan provides the participant with appropriate investment options); the plan document then will provide participants with reasonable opportunity to give investment instructions (and to obtain written confirmation of those instructions) and certain other information. The participant will be legally responsible for his or her investment decisions. However, if those requirements are not met, the fiduciaries remain responsible. To qualify for ERISA § 404(c) relief, there are a number of requirements that must be met including:

- *Offer a broad range of diversified investments.* A plan will meet ERISA § 404(c) guidelines if participants can choose from at least three diversified investment alternatives, each of which offers significantly different risk and return characteristics. In the aggregate, the investments offered should enable the participant to achieve a portfolio with appropriate risk-and-return characteristics. The investment options should tend to minimize through diversification the overall risk of the participant's portfolio. These investment options are commonly referred to as "core" investments;
- *Allow participants to transfer among investment options.* Participants must be able to transfer between investments at least quarterly, or within a timeframe deemed appropriate based on the market volatility of the investments that are offered. The more volatile an investment option is, the greater the need for more frequent transfers to enable participants to maintain appropriate control over their account. With today's investment products, like mutual funds, these requirements are usually easily satisfied, with trading permitted on any day in which the major securities markets are open.
- *Provide participants with adequate information about their investment options:*
    - Section 404(c) requires that each participant receive the following information:
        - An explanation that the plan intends to comply with the Section 404(c) requirements and that, as a result, the plan fiduciary may be relieved of liability for losses resulting from investment directions of the participants;
        - A description of the plan's investment options, including a general description of the investment objectives and the risk and return characteristics of each investment option;
        - Identification of any investment managers for the plan;
        - An explanation of how participants can give investment instructions, including an explanation of any limits or restrictions on making purchases or sales in their account;
        - A description of any transactions or other expenses charged to participants' accounts;
        - A description of any transaction or other expenses charged to participants' accounts;

- A description of additional information that must be provided to participants upon request and the contact information of the individual responsible for providing that information; and
- For registered investments (like mutual funds) a copy of the most recent prospectus provided to the plan. The prospectus must be given to a participant immediately preceding or following the participant's initial investment in an option.

Additional information that must be provided to participants upon request (or can be provided automatically by the plan sponsor:

- A description of the annual operating expenses of each investment option;
- Copies of any prospectuses, financial statements, reports, and other information relating to an investment alternative received by the plan;
- A list of the securities and value of each asset held by each investment option that constitutes plan assets;
- Past and current investment performance of the various investment options; and
- Information about the value of shares in the investment options in the participant's account.

Note: There are additional requirements for plans offering employer stock of fixed rate investment contracts and plans that pass through voting rights.

The benefit of compliance with Section 404(c) results in plan fiduciaries not being liable "for any loss, or by reason of any breach, which results from such participant's exercise of control."

ERISA § 408(b)(2)

As was discussed above, the primary responsibility of a fiduciary is to run the plan solely in the interest of its participants and their beneficiaries. A fiduciary must administer a plan for the exclusive purpose of providing benefits and paying plan expenses. This includes ensuring that the plan pays only *"reasonable"* expenses for administering the plan and investing its assets. In the past, there was little guidance on how fiduciaries should determine if fees were reasonable.

On July 15, 2010, the DOL issued an interim final regulation under ERISA § 408(b)(2) in an effort to assist fiduciaries of *"covered plans"* in determining the reasonableness of fees. The regulation was deemed an interim final regulation due to the potential for revisions. Because the regulation contained substantial changes from the proposed regulation published in 2007, the DOL requested additional comments. The DOL considered those comments in drafting the final regulation, which was released on February 1, 2012.

The regulation became effective July 1, 2012, and applies to existing service arrangements as well as service arrangements entered into on or after that date. Accordingly, for those service arrangements in place on the effective date, the required disclosures were to be made by July 1, 2012.

Prior to ERISA § 408 (b)(2) was formulated, service providers did not have to fully disclose the fees and other expenses paid to third parties, much less make them transparently clear.

Section 408(b)2 Service Provider Fee Disclosure

The final regulation provides:

> *"No contract or arrangement for services between a 'covered plan' and a 'covered service provider,' nor any extension or renewal, is reasonable within the meaning of Section 408(b)(2) unless certain disclosures are made to the responsible plan fiduciary."*

"Covered plans" include defined contribution (DC) and defined benefit (DB) tax-qualified retirement plans subject to ERISA. The regulation does not include SEP IRAs, SIMPLE IRAs, IRAs or any other non-ERISA tax-qualified plan, such as an individual (solo) 401(k) plan.

A *"covered service provider"* is a person or entity that enters into a contract or arrangement with a "covered plan," and reasonably expects to receive $1,000 or more in direct or indirect compensation during the term of the arrangement.

"Covered Service Provider" Categories

There are three categories of services that cause a service provider to be considered a *"covered service provider:"*

- First, fiduciary services, including:
  - Services provided directly to a plan as a fiduciary under ERISA § 3(21);
  - Services provided directly to a plan as an investment advisor registered under either the Investment Advisers Act of 1940 or under state law (this includes services provided by Registered Investment Advisors (RIAs), who are not automatically fiduciaries under ERISA, but are fiduciaries under securities law); and
  - Services provided as provided as an ERISA fiduciary to an investment contract, product or entity that holds plan assets and in which the plan has a direct equity investment.
- Second, recordkeeping services or brokerage services, but only when such services are provided to a participant-directed individual account plan, and when the plan makes one or more designated investment alternatives available.
- Third, other services for which the provider receives indirect service provided need only report changes in investment-compensation, including, but not limited to: related information annually:
  - Consulting services; and
  - Third-party administrator services.

Required Disclosures

Under the regulation, written disclosures must be provided to the plan for the following:

- *Services* – a description of the service provider's services that will be provided to the plan;
- *Status* – if applicable, a statement describing services to the plan as an ERISA fiduciary and/or services to the plan as an investment advisor;
- *Compensation* – the service provider must describe all compensation it expects to receive, including:
  - Direct compensation;
  - Indirect compensation;
  - Compensation paid among related persons; and
  - Compensation for termination of the arrangement.
- *Investment Disclosure* – for certain fiduciary services or recordkeeping and brokerage services:
  - Compensation that may be directly charged against assets, such as sales loads or redemption fees;
  - Annual operating expenses, if the investment returns are not fixed; and
  - Ongoing expenses, such as wrap, mortality or expense fees.
- *Recordkeeping Services* – compensation associated with recordkeeping services or, in certain cases, an estimate of cost for recordkeeping services. Any offsets in compensation due to other sources of revenue, such as revenue sharing, must be included; and
- *Manner of Receipt* – a description of how compensation will be received such as billed or deducted from plan assets.

Timing of Disclosure Requirements

- *Initial disclosure requirements.* The information listed above must be provided *"reasonably in advance"* of the date of the arrangement. While the timing is not clear, it would be prudent to provide notices so the responsible plan fiduciary has a realistic opportunity to review the materials in advance and seek advice, as needed;
- *Changes.* A service provider must report changes in its disclosures as soon as practical, but not later than 60 days from the date the service provider is aware of the changes. However, a service provider need only report changes in investment-related information annually;
- *Existing clients.* In addition to the initial disclosure requirements for new clients, service providers also must provide existing clients with the information outlined above; and
- *Ongoing disclosure requirements.* Following the initial disclosures, service providers must provide information within 30 days following receipt of a written request.

The burden of proof for providing appropriate disclosure rests with the covered service provider.

Format of Disclosures

Service providers may select the manner and format of the disclosure, as long as it meets the regulatory time frames. However, the DOL strongly suggested that covered service providers provide a guide.

Monitoring and Assessing the Reasonableness of Plan Fees

With greater transparency around fees under ERISA § 408(b)(2), employers (plan sponsors) now have more information than ever before to evaluate the fees they are paying for plan services. This is good news for plan sponsors as they try to meet their long-standing fiduciary obligation to monitor and assess the reasonableness of their plans' fees.

However, many plan sponsors are uncertain about how best to meet their fiduciary obligations. They aren't quite sure how to use and apply the large amounts of information provided by DOL § 408(b)(2) fee disclosure regulations (discussed above). For many plan sponsors when assessing fees, they frequently focus their attention on seeking out the lowest costs for plan services and investments when fees are just one part of the story. As a result, many plan sponsors may not fully consider the quality and effectiveness of the services they are receiving and how they contribute to positive outcomes for their employees.

As the advisor, it is therefore critical for you to assist plan sponsors to develop a well-thought-out plan for fiduciary compliance. An intentional, carefully designed fiduciary process can help the plan sponsor organize and evaluate the data available to help answer questions of fairness and value. And, ultimately, following a prudent fiduciary process can also help drive better plan outcomes for their employees. To assist plan sponsors with this task, fiduciary expert Donald Trone, CEO of 3ethos, developed a four-step process that can help plan sponsors in all organizations make reasonably informed and knowledgeable assessments about fees by asking and answering the following four questions:

- *Who* is receiving compensation from the plan?
- *What* are the fees and expenses associated with the plan?
- *How* do the fees and expenses compare to other service providers or investment options?
- *Why* is the compensation warranted?

Who is Receiving Compensation from the Plan?

The first step is to identify a list of all covered service providers, which may include any plan fiduciaries, investment advisors, record-keepers, brokers, and providers receiving *"indirect compensation"* such as investment or plan consultants (advisors). The required ERISA § 408(b)(2) service and fee disclosures the plan sponsor is now required to receive from each provider should help to both assemble an initial list and validate ***who*** is being compensated.

Table 9.1 displays some considerations for best practices in identifying and evaluating each of the plan providers. Consider each of the provider's relationships, the impact they have on the fees the plan pays and any interdependencies. As the plan sponsor reviews the list, they should ask the following questions:

- Are all the plan relationships accounted for?
- Has the plan sponsor reviewed each provider recently?
- Are any providers' fees above the norm?
- Does the plan sponsor need the help of a third-party professional to evaluate the plan providers?

Table 9.1
Best Practices in Reviewing Service Providers

Task	Best Practices Considerations
Identify all "covered service providers."	Includes fiduciaries, investment advisors, record-keepers, brokers, and providers receiving "indirect compensation," such as consultants.
Gather complete information regarding your providers, services and fees.	Provider qualifications. Scope and quality of services Fees charged for services and investments
Consider indirect compensation when evaluating investments and services.	Require disclosure of all compensation arrangements. Understand any potential conflicts of interest.
Use procedural prudence when selecting a new provider or evaluating an existing one.	Thoroughly review and document the process. Regularly monitor the reasonableness of fees. Review total cost plus individual fee components
Conduct fiduciary reviews regularly and maintain supporting documentation.	Periodically audit invoices to assure compliance with agreed-upon fees. Ask for a thorough itemization if necessary

Source: TIAA-CREF Financial Services, "*Deciding what is reasonable: Assessing fees using value and outcome*, 2014

Prohibited Transactions

In addition to the general fiduciary rules discussed above, ERISA contains a "*prohibited transaction*" rule [29 U.S.C. §1106]. This rule prohibits specific types of transactions. The purpose of the rule is to prohibit transactions which offer a high potential for insider abuse. The rules fall into three categories restricting transactions between:

- A plan and participant in interest;
- Transactions between a plan and a fiduciary; and
- The transfer of property to a plan by a party in interest.

It should also be noted that ERISA provides that certain transactions such as loans to participants or beneficiaries are exempt from the prohibited transaction rule [29 U.S.C. §1108].

ERISA Civil Enforcement Scheme

ERISA provides that civil actions to obtain appropriate relief for a breach of fiduciary duty may be brought by a participant, a beneficiary, a fiduciary or the Secretary of Labor [29 U.S.C. §1132 (a)]. The statute provides the following:

- That civil actions may be brought to recover benefits due under the plan, to enforce rights under the terms of the plan or clarify rights to future benefits under the terms of the plan;
- A participant, beneficiary or fiduciary may bring a civil action to enjoin any practice which violates any provision of ERISA or the terms of the plan; and
- Attorney fees and costs may be awarded to the prevailing party [29 U.S.C. §1132 (g)(1)].

Fees and Expenses

Once the plan sponsor identifies the parties involved, the next step is to determine *what* fees and expenses the plan is paying these providers. Remember, in defined contribution (DC) plans such as 401(k) plans, a variety of fee and service arrangements exist, and they are charged in different ways, including per-participant fees, per-plan fees or a percentage of total plan assets. This variability may make benchmarking challenging, especially when the plan sponsor attempts to make comparisons with peers or other providers.

Despite the variables, it may be helpful to review the plan fees in terms of three basic categories:

- *Administrative services*. Administrative services include recordkeeping, accounting, legal and trustee services, web site, customer service phone lines and participant communications—all necessary to keep the plan up and running. Plan sponsors typically charge these expenses to participants, particularly in the 401(k) market. Plan administration fees are commonly determined on a per-participant basis; however, fee arrangements by provider may vary. For example, some administrative costs may be borne by the investment options themselves (typical in the 401(k) market); others can be captured as a per-head fee deducted from participant accounts or a combination of the two;
- *Individual services.* Fees apply to specific transactions requested by employees. If your plan allows for loans, for example, employees may pay a one-time loan initiation fee and/or annual loan maintenance charge. There may be fees for other services, such as a qualified domestic relations order (QDRO) or wire transfer. These service fees can be bundled with the total service package or charged directly to a participant's account; and
- *Investment services:* Investment management fees typically represent the largest portion of a plan's expense and are paid by employees through a reduction in net return on investments in their accounts. Known as the *"expense ratio,"* these fees support expenses associated with investing employees' assets. Expenses can vary widely depending on type of investment or retirement plan product (actively managed vs. indexed, fixed income vs. equities, annuities vs. mutual funds, etc.) and the level of plan assets.

This approach can help the plan sponsor better understand exactly what services are included in their offering and related cost drivers. It can also inform the plan sponsors discussions with providers and direct questions about what factors are driving their plan costs, such as the presence of manual processes, for example.

Comparison of Plan's Fees and Expenses

The third step is to determine *how* the plan's fees and expenses compare with industry standards. Most often, organizations turn to various forms of benchmarking. Fees are important, but plan sponsors should be aware that ERISA does not require a plan sponsor (or a non-ERISA plan sponsor who is not required to, but chooses to follow ERISA best practices) to select the lowest fee provider.

Benchmarking has taken on greater prominence in a new era of transparency and it can play an important part in the process towards informed decision-making. Available benchmarking data allows the plan sponsor to reasonably compare their plan against others, while factoring in any limitations of such data. Table 9.2 highlights resources available to help compare providers and services.

Table 9.2
Resources to Compare Providers and Services

Tactic	Consideration
Benchmarking	• Understand the metrics relevancy, realizing the plan may not align perfectly. • Ensure the plan sponsor understands their providers' fee practices and any investment related expenses beyond the "total expense ratio." Consider an "all-in" fee for a meaningful evaluation.
Issuing a request for proposal (RFP)	• Issuing an RFP is not required, but can help your organization compare services and plan pricing. • Is the plan sponsor prepared for the cost, time and resource-intensive effort required?
Using professional services	• If the plan sponsor organization lacks internal expertise, a knowledgeable plan consultant can facilitate a thorough review of fees and services, although it is up to the plan sponsor as plan fiduciary whether to act on the advice. • Make sure the plan sponsor understands the consultant's analysis and assumptions before adopting recommendations. • Understand the sources of consultant compensation. Any indirect compensation should be disclosed and reviewed.
Reviewing third-party data	• There is a wide array of independent information available to plan sponsors. Choose objective sources that include meaningful samples. • Some third-party studies use a template that may not match your plan structure or needs.

The DOL Conflict-of-Interest Rule

On April 6, 2016, the long awaited DOL Conflict of Interests in Retirement Advice (aka, the new Fiduciary Rule) was released by the Employee Benefits Security Administration (EBSA) and published in the Federal Register on April 8, 2016, with an effective date of June 7, 2016, and an applicability date of April 10, 2017.

Under the new Fiduciary Rule, it now requires all persons who provide "*investment advice*" or "*recommendations*" for a fee or other compensation, direct or indirect, with respect to assets of a ERISA qualified retirement plan or IRA, they must abide by a "*fiduciary*" standard—putting their clients' best interest before their own profits. This final rule fulfills the DOL mission to protect, educate, and empower retirement investors as they face important choices in saving for retirement in their employer sponsored retirement plans (ESRP) and IRAs.

Providing Investment Advice

Under the DOL's new Fiduciary Rule, a service provider will be deemed to be a fiduciary to the extent it provides "*investment advice*" relating to plan assets for a fee or other compensation.

The new Fiduciary Rule changes the landscape for "*investment advice*" in 401(k) plans. Previously under ERISA regulations, a five-part test determined if a financial advisor was considered an investment fiduciary. The new rule replaces this five-part test with a principles-based approach that focuses on whether the recommendation constitutes "*investment advice*." For ERISA purposes, a person renders investment advice to the plan by:

- Providing advice on the value of securities or other property or making recommendations on investing in, purchasing, or selling securities or other property; and
- Rendering any advice about the value of securities or other property on a regular basis under a mutual agreement, or understanding between the person and the plan or a plan fiduciary that:
    - Such services will serve as primary basis for investment decisions; and
    - The person will provide individualized investment advice to the plan based on its particular needs concerning such things as investment policies or strategy, overall portfolio composition, or diversification.

Limits on Fiduciary Advice

The DOL regulation provides guidelines that allow a plan to provide four categories of information and materials on investment-related matters to its participants and beneficiaries without being considered to have provided investment advice. The categories are:

- Plan information;
- General financial and investment information;
- Asset allocation models; and
- Interactive investment materials.

The regulation points out that the selection of a person or persons to provide investment educational services or investment advice to participants and beneficiaries is an exercise of discretionary authority or control with respect to plan administration. This means that whoever makes the designation must act prudently and solely in the interests of the participants and beneficiaries. In addition, an investment advisor will not be considered giving investment advice when providing any general communication that a reasonable person would view as not being a recommendation.

Examples of non-advice communication include:

- Newsletters;
- Talk shows;
- Speeches, conferences;
- News reports;
- Marketing materials (as long as they make no specific recommendations);
- General market data, price quotes; and
- Performance reports.

Rendering Investment Advice For a Fee

It is important to remember the basic rule of ERISA 3(21)(A)(ii): "*render investment advice for a fee*." Once it has been determined that the advisor is providing a recommendation to a recipient while acting in a fiduciary capacity, h/she will have to get paid for that recommendation to be an investment advice fiduciary. Fees under the regulation include:

- Direct fees or compensation received by a fiduciary or an affiliate;
- Any fee or compensation from any source directly or indirectly in connection with a purchase or sale, or the provision of investment advice services; and
- Fees such as brokerage fees, mutual fund and insurance commissions, finder's fees, revenue sharing, gifts and gratuities, and expense reimbursements.

These new rules will likely make most retirement plan advisers investment advice fiduciaries under ERISA. This makes them subject to the PT rules that govern fiduciaries. As a result, plan advisors, could commit a PT based upon how they are compensated in the connection with giving advice to plan participants, including IRA owners, and HSAs. The fiduciary regulation addresses this potential for a PT through the fiduciary regulation's Best Interest Contract Exemption (BICE).

Best Interest Contract Exemption

So how does an advisor who is a fiduciary make recommendations to individual participants and receive compensation without incurring a prohibited transaction? To address its concern but also "preserve beneficial business models for delivery of investment advice," the new Fiduciary Rule provides a new exemption called the Best Interest Contract Exemption (BICE).

Under the BICE it will allow financial institutions or advisors to receive, as result of a fiduciary investment recommendation, an increase in their compensation (in the case of a transfer to from a plan to an IRA), variable compensation, or third party payments as long as participants are protected. The BICE is intended to limit the potential for "self-dealing" transactions that would otherwise result in a prohibited transaction under ERISA.
The exemption allows entities such as RIAs, broker-dealers and insurance companies (and their agents and representatives) who are ERISA or IRC fiduciaries by reason of the provision of investment advice, to receive compensation that may otherwise give rise to prohibited transactions as a result of their advice to plan participants and beneficiaries, IRA owners and certain plan fiduciaries (including small plan sponsors).

The full BICE has detailed requirements that can be summarized as follows:

- Contracts: for IRAs and non-ERISA plans, a written contract between the financial institution, the adviser (or affiliate), and the retirement investor is required;
- Conduct: a statement of fiduciary status and Impartial Conduct Standards (ICS);
- Oversight: policies and procedures; and
- Disclosure: Best Interest Standard; Material Conflicts of Interest; proprietary products; third party payments.

Transition Period Rule

However, on March 2, 2017, in response to a February 3, 2017 presidential memorandum directing the DOL to re-examine the Fiduciary Rule, the DOL published a notice proposing a 60-day delay in the applicability date of the DOLs Fiduciary Rule. On April 7, 2017 the DOL promulgated a final rule delaying the applicability date of the Fiduciary Rule by 60 days from April 10, 2017 to June 9, 2017.

The April 7, 2017 rule also introduced a transition period regarding the exemptions associated with the Fiduciary Rule. Although exemptions would also become applicable on June 9, 2017 until January 1, 2018, fiduciaries relying upon the exemptions would have to only adhere to the "*impartial conduct standards*" to qualify for exemptive relief. The "*impartial conduct standard*" requires that advisers:

- Give advice that is in the "*best interest*" of the retirement investor;
- Charge no more than reasonable compensation; and
- Make no misleading statements regarding investment transactions, compensation or conflicts of interest.

In this context, "*best interest*" has two components:

- Prudence (i.e., meeting a professional standard of care); and
- Loyalty (i.e., the advice must be in the interests of the customer, rather than the advisor.

Then on November 27, 2017, the DOL announced an additional 18-month extension—from January 1, 2018 to July 1, 2019—of the special Transition Period for the Fiduciary Rule's BICE and the Principal Transaction Exemption, and of the applicability of certain amendments to PTE 84-24.

As discussed above, during the extended Transition Period, fiduciary advisers have an obligation to give advice that adheres to "*impartial conduct standards*." Further, between now and July 1, 2019, when the exemptions' remaining conditions are scheduled to become applicable, the DOL intends to complete its review under the Presidential Memorandum and decide whether to propose further changes.

The DOL has also announced an extension of the temporary enforcement policy contained in Field Assistance Bulletin 2017-02 to cover the 18-month extension period. Therefore, from June 9, 2017, to July 1, 2019, the DOL will not pursue claims against fiduciaries working diligently and in good faith to comply with the Fiduciary Rule and PTEs, or treat those fiduciaries as being in violation of the Fiduciary Rule and PTEs.

Chapter 9
Review Questions

1. Which of the following U.S Presidents signed into law The Employee Retirement Income Security Act (ERISA) of 1974?

( ) A. President Jimmy Carter
( ) B. President Gerald Ford
( ) C. President John F. Kennedy
( ) D. President Richard Nixon

2. Which of the following would not be considered a named fiduciary?

( ) A. Plan Trustee
( ) B. Plan Sponsor
( ) C. Accountant
( ) D. Plan Administrator

3. Which type of fiduciary service will provide full discretion over investment options for a plan and will select, monitor and replace investment options based on plans investment policy statement (IPS)?

( ) A. ERISA § 3(38)
( ) B. ERISA § 3(21)
( ) C. ERISA § 3(36)
( ) D. ERISA § 3(16)

4. Under ERISA a plan sponsor may hire which of the following plan fiduciaries to provide only administrative services for their 401(k) plan?

( ) A. ERISA § 3(21)
( ) B. ERISA § 3(16)
( ) C. ERISA § 3(38)
( ) D. ERISA § 3(36)

5. A plan will meet ERISA § 404(c) guidelines if participants can choose from at least a minimum of how many diversified investment alternatives, each of which offers significantly different risk and return characteristics?

( ) A. 1
( ) B. 3
( ) C. 6
( ) D. 9

CHAPTER 10

PLAN INVESTMENTS

Overview

The evolution of investment offerings has come full circle since the inception of 401(k) plans. The first plans generally offered a few diversified choices, but over time, many plan sponsors offered an overwhelming number of options. Today, we are again seeing plan sponsors streamline the number of investment options they offer to participants and making a shift in responsibility for investment decision-making away from the participant and back to employer-selected investment and advice programs.

This chapter will examine the broad range of investment alternatives in a participant-directed 401(k) plan. In addition, it will also examine the role of automatic enrollment and the Qualified Default Investment Alternatives (QDIAs) as required by the Pension Protection Act (PPA) of 2006 and the role of target date funds (TDFs) and qualified longevity annuity contracts (QLACs). At the end of the chapter, we will examine the issues of employees purchasing employer securities in their 401(k) plan, the benefits of investment advice, and the purpose of developing an Investment Policy Statement for the 401(k) plan.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Outline the broad range of investment alternatives in a 401(k) plan;
- List the various qualified default investment alternatives (QDIAs);
- Describe the features and benefits of target date funds;
- Apply the rules and regulations of qualified longevity annuity contracts (QLACs);
- Identify the risk and rewards of owning employer securities in a 401(k) plan;
- Recognize the role of giving investment advice to a participant of a 401(k) plan; and of providing an Investment Policy Statement.

Investing in a 401(k) Plan

When it comes to selecting funds for a 401(k) plan, determining the major asset classes (stocks, bonds, cash, etc.) and their related sub-styles is the first step for plan sponsors. This provides the basic building blocks for the asset allocation process and will have the greatest impact on the risk/return characteristics of employee portfolios.

Generally, 401(k) plans allow their participants some degree of investment control over their accounts (participant-directed). The most common method is for the employer to designate a limited number of investment alternatives among which participants can elect to invest some or all of their accounts. The typical investment vehicles in 401(k) plans include:

- Mutual funds;
- Variable annuity contracts;
- Guaranteed investment contracts (GICs);
- Stable value funds;
- Life insurance contracts; and
- Employer stock.

Recently, we have seen a number of 401(k) plans expand their investment options to various asset allocation funds, target date funds (TDFs), guaranteed income annuity contracts, REITs, alternative investment vehicles such as separately managed accounts and commingled trust funds, emerging markets, and the conversation has begun to offer ETFs.

In addition, there seems to be a shift in responsibility for investment decision-making away from the participant and back to employer-selected investment and advice programs (professional managed allocations). Participants with professionally managed allocations are those who have their entire account balance invested in a single target-date or balanced fund or a managed account advisory service.

Vanguard reports in their study, "*How America Saves, 2017,"* over half of all Vanguard participants were solely invested in an automatic investment program—compared with just 17% at the end of 2007. Forty-six percent of all participants were invested in a single target-date fund, another 3% held one other balanced fund; and 4% used a managed account program. These diversified, professional managed investment portfolios dramatically improve portfolio diversification compared with participants making choices on their own. The report projects by 2021 three-quarters of Vanguard participants will be solely invested in an automatic investment program.

Participant Directed Plans

The potential liability for plan sponsors/fiduciaries for investment decisions that do not work out for the participant can be enormous. For that reason, the DOL enacted ERISA § 404(c) which allows a participant or beneficiary to control the assets in the plan and give them discretion on how to invest the funds in their accounts.

ERISA 404(c) states that if a participant in a defined contribution plan exercises control over the assets in his or her account, the participant will not be considered a fiduciary by reason of that control, and no other fiduciary shall be held responsible for losses resulting from that control.

Under DOL regulation § 2550.404c-1(b), fiduciary protection is available to participant-directed plan only if it meets the following requirements:

- It permits participants to choose from a broad range of investment alternatives that meet certain criteria (discussed below); and if designated funds are used to satisfy the broad-range requirements, a minimum of three pooled or core funds must be selected;
- It provides, an opportunity for participants to exercise control over the assets in their accounts. For this opportunity to exist, the following conditions must be present:
  - Participants are permitted to make transfers among investment alternatives with a frequency commensurate with the volatility of the investments. For example, if three core funds are offered to satisfy the broad-range requirement, a transfer option must be offered at least quarterly for all three core funds;
  - Participants are provided with sufficient information to permit informed investment decision making; and
  - Participants can give investment instructions to an identified plan fiduciary who is obligated to comply with those instructions.

By facilitating the adoption of automatic enrollment plans, and by encouraging investments appropriate for long-term retirement savings, the DOL estimates the rule will result in between $70 billion and $134 billion in additional retirement savings by 2034.

Broad Range of Investment Alternatives

To satisfy the broad-range investment alternatives the following conditions must be met. They are:

- Participants are given a reasonable opportunity to materially affect the level of return and degree of risk to which their accounts are subject;
- Participants are given the opportunity to choose from at least three investment alternatives that satisfy the following:
  - Each alternative is diversified. (A fund that invests only in assets within the same industry may not be considered adequately diversified);
  - Each alternative is material different in terms of risk and return characteristics;
  - In the aggregate, the alternatives enable participants to achieve a portfolio with aggregated risk and return characteristic at any point within a range normally appropriate for the participants; and
  - Each of the three funds, when combined with other alternatives, tends to minimize through diversification the overall risks of loss.
- Participants must have the opportunity to diversify so as to minimize the risk of large losses, taking into account the nature of the plan and the size of participant accounts.

A plan that is self-directed—that is, one that permits participants to invest in any asset of their choice—should automatically satisfy the broad-range requirement.

Note: Under DOL Reg. 2550.404a-5(f), allowing participant control does not relieve fiduciaries of ERISA § 404(c) plans from their duty to prudently select and monitor the plan's service providers and the designated investment alternatives offered under the plan.

Providing Investment Advice

Under the DOL's new Fiduciary Rule, a service provider will be deemed to be a fiduciary to the extent it provides "*investment advice*" relating to plan assets for a fee or other compensation.

Investment Advice Defined

The new DOL Fiduciary Rule changes the landscape for "*investment advice*" in 401(k) plans. Previously under ERISA regulations, a five-part test determined if a financial advisor was considered an investment fiduciary. The new rule replaces this five-part test with a principles-based approach that focuses on whether the recommendation constitutes "*investment advice*." For ERISA purposes, a person renders investment advice to the plan by:

- Providing advice on the value of securities or other property or making recommendations on investing in, purchasing, or selling securities or other property;
- Rendering any advice about the value of securities or other property on a regular basis under a mutual agreement, or understanding between the person and the plan or a plan fiduciary that:
    - The services will be a primary basis for plan investment decisions;
    - Such services will serve as primary basis for investment decisions concerning
    - The person will provide individualized investment advice to the plan based on its particular needs concerning such things as investment policies or strategy, overall portfolio composition, or diversification.

Once the provider is deemed to be a fiduciary, the provider becomes subject to a higher standard of care under ERISA, as well as particular limitations on the conduct of fiduciaries, *i.e.*, prohibited transaction rules. The agreement does not have to be in writing.

Note: The DOL has extended the current Transition Period for the DOL Rule exemptions by 18 months. The Transition Period was scheduled to end on January 1, 2018, but now will end on July 1, 2019.

Limits on Fiduciary Advice

The DOL regulation provides guidelines that allow a plan to provide four categories of information and materials on investment-related matters to its participants and beneficiaries without being considered to have provided investment advice. The categories are:

- Plan information;
- General financial and investment information;
- Asset allocation models; and

- Interactive investment materials.

The regulation points out that the selection of a person or persons to provide investment educational services or investment advice to participants and beneficiaries is an exercise of discretionary authority or control with respect to plan administration. This means that whoever makes the designation must act prudently and solely in the interests of the participants and beneficiaries.

Qualified Default Investment Alternatives (QDIAs)

When Congress passed the Pension Protection Act (PPA) of 2006, they addressed a major problem faced by many employers sponsoring 401(k) plans: How to handle a case in which a participant is given investment options, but does not make a written investment election on how to invest his money.

PPA added ERISA § 404(c)(5) to provide relief to plan fiduciaries who invest participant assets in default investments, in cases where the participant has not made an affirmative investment election. Under this rule, if a participant fails to exercise control over their investments, they will be deemed to have exercised control if the employer defaults them into a qualified default investment alternative, or QDIA. This means fiduciaries will not be liable for any loss that is the direct and necessary result of investing in the QDIA provided that the participants are given appropriate notice and opportunity to provide affirmative investment direction. If the only plans with participant investment direction were 401(k) plans in which the participant completed a payroll withholding election, and the election was not considered valid until he also completed an investment election, this problem might not exist. However, there are a number of plans in which the participant has money in the plan even without making a payroll withholding election. For example:

- The participant may share in a non-matching company contribution (e.g., a "profit sharing" contribution); or
- The plan has an "*automatic enrollment*" provision, whereby the employee is automatically treated as deferring part of his pay into the plan, even without making any written election.

Congress assigned to the DOL the job of defining a Qualified Default Investment Alternative which can be used in these cases. On October 24, 2007, the DOL issued final regulations with an effective date of December 24, 2007. The regulations were then updated in 2008 with technical amendments that clarified certain provisions (discussed below).

QDIA Qualification

There are six conditions that must be satisfied by plan fiduciaries in order to qualify for relief:

- The investments must be put into a QDIA (defined below);
- The participants must have been given the opportunity to direct their investments, but did not give direction;
- Both an initial and an annual notice must be given to participants (discussed below);
- A fiduciary must provide the participant with investment materials related to the investment in the QDIA;
- The participant must have the option to transfer some or all of his/her money out of the QDIA, without penalty, to any available investment alternative. This option must be provided at least quarterly; and
- The plan must offer a broad range of investment alternatives.

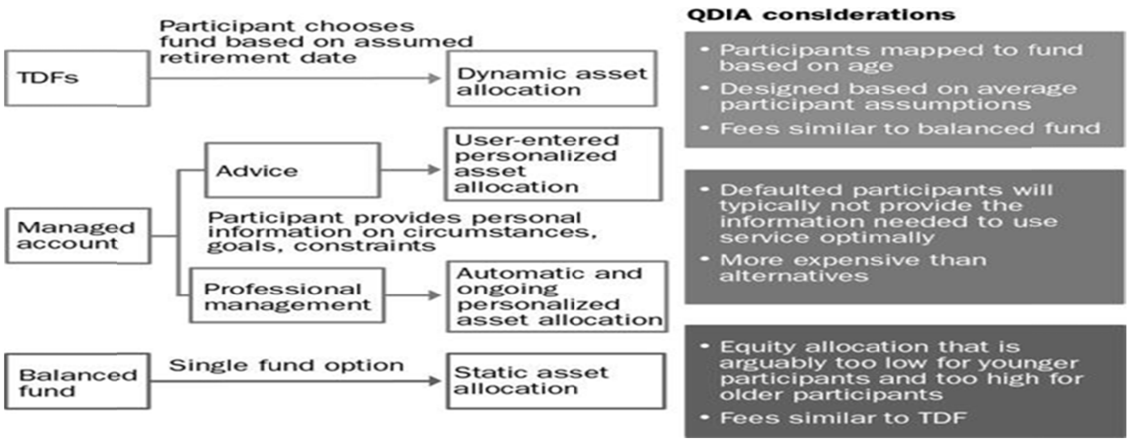
Fund Information

Some requirements must be met for the plan QDIA to be used:

- The QDIA must not hold or permit the acquisition of employer securities. (There are a couple of minor exceptions);
- There must be no penalty imposed on the participant who chooses to later move out of the QDIA;
- The QDIA must be managed by a "*permitted*" manager. A "*permitted*" manager is a registered investment company, an investment manager as defined in ERISA § 3(38), a trustee of the plan that meets the requirements of ERISA § 3(38), or the plan sponsor who is a named fiduciary within ERISA § 402(a)(2);
- The plan must offer a broad range of investment alternatives; and
- The QDIA must be either a:
    - Balanced fund;
    - Capital preservation fund (however, this fund is only allowed if the plan uses automatic enrollment and assets may not remain in the fund for any specific participant for more than 120 days);
    - Age, target retirement date, life expectancy fund or model portfolio; or
    - Professionally managed account where a mix of fixed income and equity investments are utilized.

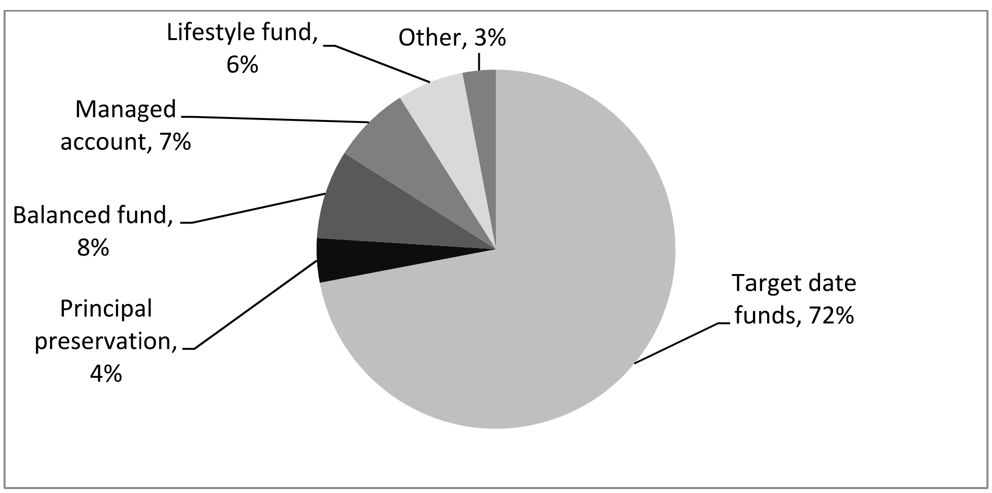
Plan sponsors recognize the vital nature of selecting the correct QDIA, and are tasked with both regulatory scrutiny and reminders to evolve how they approach the design, selection and monitoring of the default option. Figure 10.1 displays the three QDIA options.

Figure 10.1
The Three QDIA Options



According to Towers Watson 2016 Defined Contribution Survey, target date funds were the most popular default in 401(k) plans because they are relatively easy to implement (especially off-the-shelf TDFs such as mutual funds), but it's important to remember TDFs are a one-fits-all approach to investing (i.e., lack customization), are difficult to (properly) benchmark, and are often constructed using proprietary funds (See Figure 10.2).

Figure 10.2
QDIA Investment Options



Source: Towers Watson 2016 Defined Contribution Survey

QDIA Participant Disclosure

The participant whose assets will be defaulted into a QDIA must be given a notice at the beginning of the QDIA designation and annually thereafter, as well as material relating to a participant's investment in a QDIA.

Notices

The *Initial QDIA Notice* must be provided:

- At least 30 days in advance of the date of plan eligibility (for automatically enrolled participants); or
- At least 30 days in advance of the date of any first investment in a QDIA (for rollovers or actively enrolled participants); or
- On or before the date of plan eligibility, provided the participant has the opportunity to make a permissible withdrawal.

The annual notice must be provided at least 30 days in advance of each subsequent plan year if any portion of a participant's account is invested in a QDIA. The notice may not be provided in a Summary of Plan Description (SPD) or a Summary of Material Modifications. The notice may be provided with other materials, and may be combined with a Qualified Automatic Contribution Arrangement Notice.

The QDIA notice must explain the following information:

- A description of the circumstances under which assets may be invested in a QDIA;
- A description of the circumstances under which elective deferrals will be made on behalf of the participant, the deferral percentage and the right to change or opt out of the election (if the plan has an automatic enrollment feature);
- An explanation of the right to direct the investment of assets in their account;
- A description of the investment objectives, risk and return characteristics, and fees and expenses of the QDIA;
- A description of the right of participants to direct the investment of those assets to any other alternative of the plan (and the fees, restrictions, or expenses related to such transfer); and
- An explanation of where the participant can obtain investment information concerning other alternatives available under the plan.

In addition, to the QDIA notice, a plan sponsor/fiduciary must make available to the participant with material relating to a participant's investment in a QDIA. This information includes details on the QDIA assets, prospectuses, financial statements and fee disclosures similar to those for other plan investments.

Note: The "*Fee Disclosure Rules*" require that participants who are allowed to direct their investments must receive detailed investment performance and fee/expense information about all mutual funds offered by the plan, not just the QDIA. But the "*Fee Disclosure Notice"* is a separate notice requirement from the QDIA Notice.

Next, we will review some of the more favorable investment choices within a 401(k) plan, beginning with the most prominent target date funds, also referred to as lifecycle funds.

Target Date Funds

Target date retirement funds hereinafter referred to as TDFs, can be attractive investment options for employees who do not want to actively manage their retirement savings. A "set it and forget it" investment solution. TDFs automatically rebalance to become more conservative as an employee gets closer to retirement. The "target date" refers to a target retirement date, and often is part of the name of the fund.

> ***For Example:*** TDFs with names like "*Portfolio 2030*," "*Retirement Fund 2030*," or "*Target 2030*" that are designed for individuals who intend to retire during or near the year 2030.

Because of these features, many plan sponsors decide to use TDFs as their plan's qualified default investment alternative (QDIA) under Department of Labor regulations. As discussed above, a QDIA is a default investment option chosen by a plan fiduciary for participants who fail to make an election regarding investment of their account balances.

TDFs offer a long-term investment strategy based on holding a mix of stocks, bonds and other investments (this mix is called an asset allocation) that automatically changes over time as the participant ages. A TDF's initial asset allocation, when the target date is a number of years away, usually consists mostly of stocks or equity investments, which often have greater potential for higher returns but also can be more volatile and carry greater investment risk. As the target retirement date approaches (and often continuing after the target date), the fund's asset allocation shifts to include a higher proportion of more conservative investments, like bonds and cash instruments, which generally are less volatile and carry less investment risk than stocks. The shift in the asset allocation over time is called the TDF "*glide path*."

It is important to know whether a TDF glide path uses a "*to retirement*" or a "*through retirement*" approach. A "*to*" approach reduces the TDF's equity exposure over time to its most conservative point at the target date. A "*through*" approach reduces equity exposure through the target date so it does not reach its most conservative point until years later.

Within this general framework, however, there are considerable differences among TDFs offered by different providers, even among TDFs with the same target date. Available in a variety of flavors — packaged, custom, proprietary, and multi-manager — and with several different glide paths and underlying investments, TDFs are a prevalent investment choice in today's 401(k) plans. Because these differences can significantly affect the way a TDF performs, it is important that fiduciaries understand these differences when selecting a TDF as an investment option for their plan.

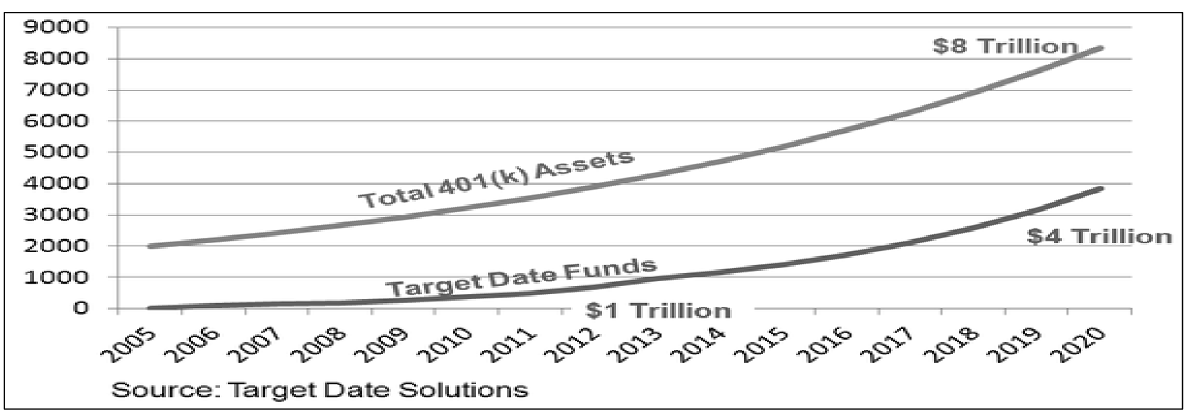
As the DOL 2007 QDIA regulation mandates, TDFs must be chosen deliberately according to the age or life expectancy of the defaulting participant group and plan demographics. Given their popularity, the fiduciary burden for retirement plan committees to prudently select and monitor the funds is high.

Growth of Target Date Funds

Since the enactment of the PPA of 2006, TDFs have become the most popular choice of Qualified Default Investment Alternatives (QDIA). According to a recent study by Vanguard titled, "*How Americans Save,*" eighty percent of plan sponsors offered TDFs at year end 2014, up 17% compared with year-end 2009. And according to the report, nearly all Vanguard participants (97%) are in plans offering TDFs. Sixty-four percent of all participants use TDFs. Sixty percent of participants owning TDFs have their entire account invested in a single TDF. Four in 10 Vanguard participants are wholly invested in a single TDF, either by voluntary choice or by default. (You can read the report at: https://institutional.vanguard.com/iam/pdf/HAS15.pdf?cbdForceDomain=true

Cerulli Associates estimates that TDFs are on a growth trajectory that will take them from their current level to $4 trillion by 2020. That's 30% per year growth over the next 6 years. On a percentage basis, TDFs will increase from 25% of all 401(k) assets to about half, and could capture almost 90% of contributions to 401(k) plans by 2020 (see Figure 10.3).

Figure 10.3
Growth of Target Date Funds



Reasons for the Growth

Fiduciaries choose TDFs rather than plan participants, so they are employer-directed, or more precisely they are advisor-directed because employers rely on their financial advisers for this choice. Advisers like TDFs for their simplicity, and the fact that everyone else is using them, although some have steered clear of TDFs. TDFs are a one-size-fits-all-set-it-and-forget-it approach to investing for the masses. There are currently 20 million participants in TDFs across 100,000 401(k) plans, and new subscribers default into TDFs every day.

TDFs Under Scrutiny

After the great recession of 2008-2009, TDFs came under great scrutiny. Record losses in many TDFs highlighted certain risks in these funds, particularly as it relates to how seemingly similar TDFs are constructed. Some TDFs designed for participants retiring in 2010 lost considerable value, just over 40 percent in one case. Further, according to some experts, many participants were unaware of the risks associated with these investments and that such losses were possible so close to retirement date. Moreover, TDFs with the same target date also exhibited wide variations in returns.

As a result of controversies surrounding TDFs and at the request of Congress, DOL and SEC held a joint hearing on TDFs. Among other issues, the agencies sought testimony regarding how TDF managers determine asset allocations, how they select and monitor underlying investments, and how such information is disclosed to investors. In October 2009, the U.S. Senate Special Committee on Aging held hearings on TDFs and issued a subsequent report, titled: "*Target Date Retirement Funds: Lack of Clarity among Structures and Fees Raises Concerns.*"

While TDFs eventually rebounded to pre-2008 performance levels, the unanticipated volatility of these funds prompted action on the part of the Securities and Exchange Commission (SEC) and the DOL. In 2010, both the SEC and the DOL published proposed rules designed to further boost QDIA disclosures and to help plan sponsors better understand and assess the risks associated with TDFs. This included a proposal requiring plan sponsors to provide participants with a description of the TDF's objectives and glide path, and a graphic illustration of how the fund's asset allocation is intended to shift over time

In January 2011, The Government Accountability Office released its report, GAO -11-118, "*Defined Contribution Plans. Key Information on Target Date Funds as Default Investments Should Be Provided to Plan Sponsors and Participants*." In this report, the GAO made three recommendations for actions by the DOL that could assist plan sponsors in selecting TDFs to best suit their employees, and to ensure that plan participants have access to essential information about TDFs. The recommendations are for the DOL to:

- Amend the qualified default investment alternatives (QDIA) regulations so that fiduciaries are required to document that they have considered, to the extent possible, whether other characteristics of plan participants, in addition to age or target retirement date, are relevant factors in choosing a QDIA;

- Provide guidance to plan sponsors regarding the limitations of existing TDF benchmarks and the importance of considering the long-term TDF investment allocations and assumptions used in developing the TDF asset allocation strategy; and
- In its final regulation on target date disclosure, expand the requirement that plan sponsors provide information regarding key assumptions concerning contribution and withdrawal rates by requiring that participants receive a statement regarding the potential consequences of saving, withdrawing, or otherwise managing TDF assets in a way that differs from the assumptions on which the TDF is based.

In response, the DOL raised a number of issues with the recommendations, but the GAO amended only the first one, concerning QDIAs. The recommendation now calls for plan sponsors to "consider whether other workforce characteristics are relevant, and to document that they have done so." The GAO noted that the DOL is developing such a requirement that would at least cause a plan fiduciary to consider whether a particular TDF is a reasonable fit for its workforce.

The report can be found at: http://www.gao.gov/new.items/d11118.pdf.

Recommendations When Choosing TDFs

So what should plan fiduciaries do when recommending TDFs:

- *Establish a process for comparing and selecting TDFs*. In general, plan fiduciaries should engage in an objective process to obtain information that will enable them to evaluate the prudence of any investment option made available under the plan. For example, in selecting a TDF you should consider prospectus information, such as information about performance (investment returns) and investment fees and expenses. You should consider how well the TDF's characteristics align with eligible employees' ages and likely retirement dates. It also may be helpful for plan fiduciaries to discuss with their prospective TDF providers the possible significance of other characteristics of the participant population, such as participation in a traditional defined benefit pension plan offered by the employer, salary levels, turnover rates, contribution rates and withdrawal patterns;
- *Establish a process for the periodic review of selected TDFs.* Plan fiduciaries are required to periodically review the plan's investment options to ensure that they should continue to be offered. At a minimum, the review process should include examining whether there have been any significant changes in the information fiduciaries considered when the option was selected or last reviewed. For instance, if a TDF's investment strategy or management team changes significantly, or if the fund's manager is not effectively carrying out the fund's stated investment strategy, then it may be necessary to consider replacing the fund. Similarly, if your plan's objectives in offering a TDF change, you should consider replacing the fund;
- *Understand the fund's investments – the allocation in different asset classes (stocks, bonds, or cash), individual investments, and how these will change over time.* Have you looked at the fund's prospectus or offering materials? Do you understand the principal strategies and risks of the fund or of any underlying asset classes or investments that may

be held by the TDF? Make sure you understand the fund's glide path, including when the fund will reach its most conservative asset allocation and whether that will occur at or after the target date. Some funds keep a sizeable investment in more volatile assets, like stocks, even as they pass their "target" retirement dates. Since these funds continue to invest in stock, your employees' retirement savings may continue to have some investment risk after they retire. These funds are generally for employees who don't expect to withdraw all of their 401(k) account savings immediately upon retirement, but would rather make periodic withdrawals over the span of their retirement years. Other TDFs are concentrated in more conservative and less volatile investments at the target date, assuming that employees will want to cash out of the plan on the day they retire. If the employees don't understand the fund's glide path assumptions when they invest, they may be surprised later if it turns out not to be a good fit for them;

- *Review the fund's fees and investment expenses.* TDF costs can vary significantly, both in the amount and types of fees. Small differences in investment fees and costs can have a serious impact on reducing long term retirement savings. Do you understand the fees and expenses, including any sales loads, for the TDF? If the TDF invests in other funds, did you consider the fees and expenses for both the TDF and the underlying funds? If the expense ratios of the individual component funds are substantially less than the overall TDF, you should ask what services and expenses make up the difference. Added expenses may be for asset allocation, rebalancing and access to special investments that can smooth returns in uncertain markets, and may be worth it, but it is important to ask;
- *Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan.* Some TDF vendors may offer a pre-packaged product which uses only the vendor's proprietary funds as the TDF component investments. Alternatively, a "custom" TDF may offer advantages to your plan participants by giving you the ability to incorporate the plan's existing core funds in the TDF. Non-proprietary TDFs could also offer advantages by including component funds that are managed by fund managers other than the TDF provider itself, thus diversifying participant exposure to one investment provider. There are some costs and administrative tasks involved in creating a custom or non-proprietary TDF, and they may not be right for every plan, but you should ask your investment provider whether it offers them;
- *Develop effective employee communications.* Have you planned for the employees to receive appropriate information about TDFs in general, as a retirement investment option, and about individual TDFs available in the plan? Just as it is important for the plan fiduciary to understand TDF basics when choosing a TDF investment option for the plan, employees who are responsible for investing their individual accounts need information too. Disclosures required by law also must be considered. The Department published a final rule that, starting for most plans in August 2012, requires that participants in 401(k)-type individual account retirement plans receive greater information about the fees and expenses associated with their plans, including specific fee and expense information about TDFs and other investment options available under their plans. The Department of Labor is also working on regulations to improve the disclosures that must be made to participants specifically about TDFs. For example, in addition to general information about TDFs, the proposed regulations call for disclosures to include an explanation that an investment in a TDF is not guaranteed and that participants can lose money in the

fund, including at and after the target date. Check the EBSA website for updates on regulatory disclosure requirements;

- *Take advantage of available sources of information to evaluate the TDF and recommendations you received regarding the TDF selection.* While TDFs are relatively new investment options, there are an increasing number of commercially available sources for information and services to assist plan fiduciaries in their decision-making and review process; and
- *Document the process.* Plan fiduciaries should document the selection and review process, including how they reached decisions about individual investment options.

Notice Requirements for Target Date QDIAs

In late 2010, the DOL issued rules that would expand the required content of QDIA notices. The QDIA notices include:

- The name of the investment issuer;
- A description of the investment's objectives, principal strategies and risks;
- A description of the investment's historical performance data; and
- A description of the investment's attendant fees and expenses.

In addition, if the QDIA is a target date fund, the notice must also include an explanation of the asset allocation.

Treas. Reg. Notice 2014-66

In order to help retirees manage their savings and ensure they have a stream of regular income throughout retirement, the U.S. Department of the Treasury and the Internal Revenue Service (IRS) issued guidance designed to expand the use of income annuities in 401(k) plans. The guidance (Notice 2014-66) makes clear that plan sponsors can include deferred income annuities in target date funds used as a default investment, in a manner that complies with plan qualification rules. This option is voluntary for plan sponsors and participants.

This guidance provides plan sponsors an additional option to make it easier for employees to consider using lifetime income. Instead of having to devote all of their account balance to annuities, employees use a portion of their savings to purchase guaranteed income for life while retaining other savings in other investments.

Under the guidance, a target date fund may include annuities allowing payments, beginning either immediately after retirement or at a later time, as part of its fixed income investments, even if the funds containing the annuities are limited to employees over a specified age. The guidance makes clear that plans have the option to offer target date funds that include such annuity contracts either as a default or as a regular investment alternative.

In an accompanying letter, the Department of Labor also confirmed that target date funds serving as a QDIA may include annuities among their fixed income investments. The letter also describes how ERISA fiduciary standards can be satisfied when a plan sponsor appoints an investment manager that selects the annuity contracts and annuity provider to pay the lifetime income. You can view the notice at: https://www.irs.gov/pub/irs-drop/n-14-66.pdf

Target Risk Funds

Target risk funds target a certain risk level that participants can choose. Like target date funds, they also represent easy-to-use, one-stop, well-diversified investment solutions that automatically rebalance. It is also common to find them in a fund of funds structure. They differ from target date funds in one aspect: target risk funds do not become more conservative over time, while target date funds do. Many fund families offer target risk funds. Table 10.4 illustrates a typical suite of target risk funds looks like the following:

Table 10.4
Suite of Target Risk Funds

Style	Asset Allocation
Aggressive Moderately	100% stocks / 0% bonds
Aggressive Moderate	80% stocks / 20% bonds
Moderately	60% stocks / 40% bonds
Conservative	40% stocks / 60% bonds
Conservative	20% stocks / 80% bonds

There is one potential drawback with target risk funds and that is they do not change their asset allocation formula. Given the inertia seen with participants who make an investment election and then never change, the concern here is that participants will choose an aggressive style target risk fund when they are younger, and then never change it. They then become older, and still have the same aggressive-style fund, which may no longer be appropriate. Therefore, if plan sponsors/fiduciaries select Target Risk Funds as their QDIA, they should educate participants on the risk of not changing their asset allocation.

Balanced Funds

A balanced fund is very similar to a moderate-style target risk fund. Balanced funds tend to target an asset allocation between 40% to 60% stocks and 40% to 60% bonds that can vary – with some stretching even beyond these parameters. They are typically well-diversified, and they have been popular because of their favorable return/risk profile over the years. Most are managed to avoid significant losses in adverse times by altering their allocation to stocks and bonds within the allowed prospectus parameters. In contrast, a target risk fund would remain relatively true to allocation between stocks and bonds and be less likely to avoid such movements.

Stable Value Funds

One year after the SEC money market fund reform rules went into effect, there has been a meaningful movement away from money market funds as a capital preservation option in 301(k) plan, with just over half of plan sponsors now offering money market as a capital preservation option. That's down from 62 percent in 2015, according to MetLife's 2017 Stable Value Study. Additionally, there has been almost 10 percent growth in stable value funds, with sponsors adding stable value funds to their plans in the past two years.

A stable value fund attempts to maintain a constant price, or principal value, regardless of stock market or interest rate environments. A stable value fund offers an attractive combination of income generation and share-price stability that stands in stark contrast to riskier assets that are available in most 401(k) plans. These funds are sometimes referred to as "*Fixed Accounts*" or "*Fixed Income Accounts*" and they typically offer interest rates that are 1 to 2% higher than ordinary money market accounts.

A stable value fund may seem like mutual funds, but they are structured and managed slightly differently. They come in a few types:

- *Separately managed accounts*: These are customized investment accounts designed to meet a specific goal for a single retirement plan. Returns are backed by assets in another account, and the returns can be fixed, indexed, or may adjust annually according to the performance of the market;
- *Commingled funds*: These types combine assets from a variety of sources, just like a mutual fund. This helps smaller plans gain economies of scale;
- *Guaranteed Investment Contracts (GIC)*: This is an account where the manager invests in an annuity, and the investors in the retirement plan are the beneficiaries. So there is a guaranteed amount of principal and interest; and
- *Synthetic GIC:* The account invests in a portfolio of fixed-income investments "wrapped" in insurance contracts that protect the underlying value of the investment. These make up a good percentage of today's stable value funds.

Because they can be structured differently, stable value funds are regulated by various agencies. They are run by laws set up by Financial Accounting Standards Board, the Government Accounting Standards Board and the DOL. Comingled funds are also regulated by the SEC.

Stable Value Fund as a QDIA

Certain funds (referred to collectively as Stable Value Funds) that do not qualify as a Target Date Fund, Balanced Fund or Investment Management Service may nevertheless be used as a QDIA in certain circumstances. Most stable value funds are CIFs, and only the plan types that may hold CIFs may hold most stable value funds. Other plan types may hold stable value funds only if those funds are not CIFs, which generally means that the stable value contracts must be plan-specific, stand-alone contracts.

There are two types of Stable Value Funds: A Short-Term Fund and a Grandfathered Fund.

The use of "*Short Term Fund*" is limited to those participants who have been enrolled through an automatic contribution arrangement (ACA) and is intended to allow the plan to "park" a participant's contribution during the initial stages of the contribution arrangement. If investments remain in a "*Short Term Fund*" after the 120-day period has expired, fiduciary relief is no longer available. A "*grandfathered fund*" is a stable value fund that have assets invested prior to December 24, 2007, are considered a "*grandfathered*" QDIA.

Managed Accounts

While the adoption of managed accounts as a QDIA has been relatively low, the percentage of plans offering them as a broad investment option outside of the QDIA role has generally increased over the past few years. This usage can largely be attributed to the evolution of the idea of personalization (the mantra of "one size does not fit all") in the retirement industry. Managed accounts are viewed as the most "personalized" option.

Managed accounts are a full fiduciary service provided by third-party investment advisers. Some act as a discretionary, investment manager under ERISA 3(38), meaning that they have exclusive authority over investment decisions and accept full fiduciary responsibility for their discretionary investment decisions. These managers provide a custom asset allocation for the participant and rebalance the portfolio periodically. This type of vehicle is most popular with participants with high account balances and outside resources. Monitoring managed accounts from a fiduciary perspective is based on reviewing the service provider, methodology of the model, integrity of the asset allocator rather than on the

Separate Accounts

If a plan is large enough, instead of purchasing mutual funds or other institutional funds such as insurance separate accounts or standard bank CIFs, the plan may instead offer Managed Separate Accounts. The solution might be structured as follows:

- Large money managers are chosen to manage style-specific pools of money. For example, a manager may be chosen to manage the large cap value investment option. Managers may also be chosen to mimic an existing mutual fund at an overall lower cost to the plan;
- For a fee, the recordkeeper or a separate vendor unitizes the portfolio so that it can be traded like a mutual fund within the plan;
- Alternatively, the manager may offer a CIF, or the plan itself may build a CIF in which participants in multiple plans may invest;
- The manager accepts investment manager status as defined by ERISA §3(38); and
- A consultant assists with vendor searches, investment policy, and drafting investment guidelines to which the managers must adhere.

Contrast this with the use of mutual funds or other investment types. With a mutual fund, the ability to trade electronically already exists, whereas the separate account or CIF is actually a pool of stocks and bonds that must be unitized before it can be traded efficiently. Once it has been unitized, however, there is no effective difference between the managed separate account and the mutual fund from the participant's investment standpoint, though reporting portfolio information and transparency may vary.

Separate accounts allow large participant-driven plans to offer professionally managed investments to their participants with varying investment strategies. These separate account are managed by a professional investment manager, one who often takes on a 3(38) fiduciary role. The investment manager will follow an investment strategy that is either passive, active or a mix of both. It is important to remember that it is the fiduciary's duty to determine if the investment strategy of the separate account manager is prudent. As with mutual funds, understanding the fees and revenue sharing in the separate account is also a fiduciary responsibility.

Collective Investment Funds

Collective Investment Funds (CIFs), also referred to as Collective Investment Trusts (CITs), are a common or collective trust fund or pooled investment fund maintained by a bank or trust company, and regulated by the Office of the Comptroller of the Currency rather than the Securities Exchange Commission. According to Cerulli Associates, the Boston-based research and consulting firm, reported that CITs grew sharply in 2016, reaching $2.8 trillion, representing an 11.6% annual increase from 2015.

The underlying assets of a CIF are plan assets, which makes the bank trustee or investment manager a fiduciary. This is different than the fiduciary definition of the underlying assets of a mutual fund, which technically are not plan assets (the shares of the fund are the plan assets.

One of the major advantages of a CIT is that they have lower operational expenses than mutual funds. They're restricted from advertising to the public (only sold inside retirement plans) and don't have to file prospectuses, shareholder reports and proxy statements.

Active vs. Passive Investments

Once the asset allocation policy is set, the focus can turn to implementation…and so begins one of the fiercest debates in the investment industry: Should the menu be built around actively managed funds or low-cost index-tracking (i.e., passive) funds, or both?

- *Passive Management*. Funds that use a passive strategy do not attempt to "beat the market." Instead, they select a market benchmark, such as the S&P 500 for large U.S. stocks and the Russell 2000 for small U.S. stocks, and try to track the index closely without incurring high expenses. Index funds are typically chosen on the basis of having the lowest fees and tracking error relative to the index; and
- *Active Management*. Funds that use an active strategy will select an asset class benchmark and then attempt to outperform that benchmark by making better investment

decisions. These funds have a larger range of potential outcomes—the possibility of significantly outperforming, or underperforming, the benchmark—and will have higher fund management fees (i.e., expense ratios).

The debate on the superiority of active or passive management is one that will never be fully settled as there will always be market participants who have a strong view either way. Importantly, there are many investment situations where it is beneficial to use active, passive or a combination of the two. In the end, it is the fiduciary's duty to evaluate all the investment choices in light of the goals of the plan and the participant demographics, and work with an expert adviser to assist in this process. There is no one right answer.

Employer Securities

Employer securities have a long tradition in retirement plans. In fact, it was often the only retirement savings option employers offered before the growth of defined contribution (DC) plans as we know them. Today, on the one hand, employer securities remain a valued investment option for many plan sponsors and participants. Company shares can help align participants with their employer's goals, while providing employees with a sense of ownership.

But on the other hand, holding employer securities in a 401(k) plan can pose a significant retirement risk. One of the most common examples cited when discussing dangers of holding employer stock in a 401(k) plan is Enron, which collapsed in 2001. At Enron, 62% of 401(k) plan assets were invested in shares of Enron stock (on the basis of 11-K filing at the end of 2000), which fell in value by 98.8%. Not only did Enron employees lose their jobs, many lost a significant portion of their retirement savings, if not their entire balance.

While employer securities is still common in 401(k) plans, it is becoming less so. According to Vanguard's report, "*How America Saves, 2017*," it reported a shift away from employer securities first observed in 2006 continued into 2016. Among plans offering employer securities, the number of participants holding a concentrated position of more than 20% of their account balance fell from 32% in 2007 to 24% in 2016. In addition, the number of plans actively offering employer stock to participants declined to 9% in 2016 from 11% in 2007. As a result only 6% of all Vanguard participants held concentrated company stock positions in 2016, compared with 12% at the end of 2007.

IRC § 401 (a)(35) Diversification Requirement

On May 18, 2010, the IRS and the Treasury Department released final regulations on IRC § 401(a)(35) investment diversification requirements for certain defined contribution plans with publicly traded employer securities. Defined contribution plans holding publicly traded employer securities are considered "*applicable defined contribution plans*" and subject to the diversification requirements of IRC § 401(a)(35), which apply to employee contributions and employer contributions allocated to participants (or their beneficiaries) with at least three years of service.

The diversification requirements for participant directed plans with employer stock are as follows:

- The rule only applies to publicly traded stock;
- Participants must be permitted to diversify deferrals and employee contributions (i.e., after-tax contributions made at the election of the employee) at any time;
- The funds available for diversification must meet requirements similar to ERISA §404(c)'s broad range requirement—at least three funds with materially different risk and return characteristics;
- Participants must be permitted to diversify employer contributions in employer stock after three years of service.

It is important to note that there are two potential reasons to purchase employer stocks or to continue holding it:

- Discounts; and
- Tax benefits.

Net Unrealized Appreciation

In some instances it's possible to purchase employer securities at a discount. This could be advantageous depending on the holding period requirements and the level of the discount. The second reason is potential tax benefits, something known as net unrealized appreciation (NUA).

With an NUA strategy, individuals can request a distribution of employer stock from their qualified plan be moved into a taxable account, at which time ordinary income tax is due on the basis of the shares. The difference between the cost basis and the market value of the securities is what's known as net unrealized appreciation (NUA) and is taxed at long-term capital gains rates when the stock is sold, regardless of the holding period. This results in more favorable tax treatment, since some of the potential gains in the employer securities are taxed at long-term capital gains rates versus ordinary income rates. NUA is a complex strategy, though, that should only be made after consultation with an experienced financial advisor, accountant, or tax attorney.

Here are some general guidelines that plan sponsors and participants should be aware with respect to employer securities in a 401(k) plan:

- Having employer stock in a 401(k) plan increases the fiduciary risk to the plan sponsor, therefore, the perceived benefit of including from an employee morale or corporate culture perspective must outweigh these risks;
- Limiting the total allocation to employer stock in an employee's account makes sense. For example, mandating that no individual can hold more than 25% of employer securities as a core investment option, reduces the risk of holding securities in the 401(k) to both the employer and the employee. Using an even more conservative maximum target (e.g., 10%) should also be considered;

- For those plans with employees that have high allocations to employer stock, especially those employees near retirement, it would likely make sense to implement a "phased approach" to reduce each employee's allocation to employer stock;
- Employees holding employer stock should likely take less risk in other areas of their portfolio. A participant with a 100% allocation to employer stock does not have the same risk characteristics as someone with a 100% allocation to a diversified equity portfolio; and
- Employees with employer securities should regularly be notified about the risks of such a strategy, potentially beyond the IRS mandated disclosures.

Employer Securities and ERISA 404(c)

ERISA §404(c) protection is available in the following circumstances:

- The stock must be publicly traded on a recognized market, and trading volume must be sufficient for transactions to be executed promptly;
- Shareholder information must be provided; additionally, voting and similar rights must be passed through to participants;
- Information relating to the purchase, holding or sale of employer securities, as well as the exercise of voting rights must be maintained in accordance with procedures designed to safeguard the confidentiality of such information, except to the extent necessary to comply with relevant federal and state laws; and
- The plan must designate a fiduciary to be responsible for ensuring the confidentiality procedures mentioned above are being followed.

Also, an independent fiduciary must be appointed to carry out activities involving a potential for undue employer influence upon participants with regard to exercising their shareholder rights.
If the employer stock fund fails to meet the above requirements, the plan may still obtain ERISA §404(c) compliance for the other investments available under the plan. However, plan fiduciaries would not be relieved of the liability for participants' directions relative to investments in the employer stock fund. Bottom line is that 404(c) compliance requirements increase when employer stock is included in a plan.

Qualified Longevity Annuity Contracts

In July of 2014, the Treasury Department and the Internal Revenue Service (IRS) issued final rules on the use of qualified longevity annuity contracts (QLACs), a type of deferred income annuity that begins at an advanced age in 401(k) plans (and IRAs) as part of a broader coordinated effort with the DOL to encourage lifetime income and enhance retirement security.

QLAC Eligibility Requirements

To be eligible as a QLAC, a longevity annuity must meet the following requirements:

- Only 25 percent of any employment retirement plan (or 25 percent across all pre-tax IRAs aggregated together) can be invested into a QLAC;
- The cumulative dollar amount invested into all QLACs across all retirement accounts may not exceed (in 2018) the lesser of $130,000 (original regulations were only $100,000), or the aforementioned 25 percent threshold. The $130,000 amount will be indexed for inflation, adjusted in $10,000 increments (was $125,000 in 2017);
- The limitations will apply separately for each spouse with their own retirement accounts;
- The QLAC must begin its payouts by age 85 (or earlier);
- The QLAC must provide fixed payouts (not variable or equity-indexed), though it may have a cost-of-living adjustment (COLA); and
- The QLAC cannot have a cash surrender value once purchased (i.e., it must be irrevocable and illiquid), but it can have a return-of-premium death benefit payable to heirs as a lump sum or a stream of income.

If the longevity annuity meets the above requirements to be deemed a QLAC, then the value of the QLAC is excluded when calculating RMDs (for other retirement assets), and the payments from the QLAC (whenever they begin) are implicitly assumed to satisfy their RMD obligation (though the QLAC payments will not satisfy RMDs for any other retirement accounts).

> ***For Example:*** Jeremy purchased a $50,000 QLAC at age 65 that will begin payments of $15,937/year at age 85. In addition, he has $400,000 of other IRA assets. By age 70½, his IRA has grown to $600,000, and he must begin to take RMDs from the account. His RMDs will be calculated only on the $600,000 account balance, and not include any implied value from the QLAC. Moreover, when Jeremy turns 85 (and we'll assume his IRA is up to $900,000), he will begin to receive his $15,937/year payments from the QLAC, he will still have to take RMDs from his $900,000 IRA (and cannot count any of the $15,937/year QLAC payments towards his IRA's RMD). The $15,937/year payments from the QLAC itself will automatically (because the QLAC was qualified in the first place) be deemed to meet the RMD rules for that portion of Jeremy's assets.

Notably, longevity annuities purchased in Roth accounts are not considered QLACs, for the simple reason that Roth IRAs do not have RMDs to comply with in the first place; as a result, an unlimited amount of longevity annuities could be purchased within a Roth IRA (if desired), and the account balances and longevity annuities inside Roth IRAs are not counted towards the 2018 limit of $130,000 and 25 percent limits.

For contracts purchased in traditional retirement accounts (IRAs or employer retirement plans), the dollar and percentage limits do apply. In practice, most investors will be limited to 25 percent of retirement accounts, until they have at least $500,000 of retirement accounts the 25 percent limit will hold (only with accounts greater than $500,000 would the $130,000 limit be the lesser of $130,000 or 25 percent). On the other hand, each spouse could invest this much into a QLAC, effectively doubling the longevity annuity amount for a couple (if desired).

For additional information, you can download the federal register document on QLACs, at: https://www.federalregister.gov/articles/2014/07/02/2014-15524/longevity-annuity-contracts.

Investment Policy Statement (IPS)

The increasing emphasis on plan investment issues by the Department of Labor (DOL) increases the need for a written "*investment policy statement*" (IPS). ERISA § 402(b)(1) requires that a retirement plan provide:

> *"…a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan."*

An (IPS) defines the processes that a company has adopted to make investment-related decisions with respect to the assets of a 401(k) plan. The IPS identifies the investment goals and objectives of the plan, establishes how decisions will be made regarding the selection of investments and specifies the procedures for measuring investment performance. While the law does not require that a plan adopt an IPS, it may be the single most important task that a fiduciary performs for the following reasons:

- An IPS documents that there is a defined process by which the 401(k) is being managed;
- It helps prevent fiduciaries from making unsteady investment decisions when markets are turbulent;
- It clearly identifies plan fiduciaries and helps them manage their responsibilities;
- An IPS defines roles and responsibilities of trustees, advisors, custodians and investment managers;
- It explains how to hire, monitor and replace investment managers when necessary;
- It provides evidence that a clear process and a methodology exist for selecting and monitoring plan investments; and
- It is a well-articulated, documented procedure for investment selection and ongoing investment evaluation, which are fiduciary obligations.

The first step in developing an IPS is to gather all of the plan documents (trust documents, summary plan descriptions, printed minutes, current vendor service agreements, investment performance reports, enrollment reports, participant educational material, procedural manuals and Form 5500) and review them to determine whether:

- The plan documents identify the trustees and named fiduciaries;
- The plan is intended to be ERISA Section 404(c)-compliant;
- There is a clear understanding of the plan expenses and whether they are reasonable;
- There is a formal process for making investment-related decisions;
- There is a clear paper trail relative to the process being followed;
- It is clear who has the authority to make investment decisions; and
- The trust documents prohibit certain asset classes.

While no single approach is appropriate for everyone, a typical IPS may cover the following:

- *The Plan* – General explanation of the purposes and goals of the IPS; acknowledges applicability of ERISA fiduciary standards and rules; addresses whether the plan is intended to be ERISA section 404(c)-compliant;
- *Purpose of the IPS* – Identifies the objective of the investment policy statement and states the intention to review the policy quarterly, or at least annually, and to amend it as necessary;
- *The Investment Objectives* – Identifies the plan investment philosophy and the processes for the selection, monitoring and evaluation of plan investments;
- *Duties, Roles and Responsibilities* – Generally defines the roles of the parties involved in the management of plan assets and administration of the plan. If there is an investment committee, the members are identified and their roles stated;
- *Investment and Manager Selection* – Identifies the policies and guidelines to be followed when selecting investments and managers;
- *Investment Monitoring and Reporting* – Provides a process by which investment options are regularly reviewed and evaluated for continuing appropriateness;
- *Investment Manager Monitoring and Termination* – States how investment managers will be monitored and how often. Explains how underperforming managers will be evaluated and replaced if necessary;
- *Coordination with the Plan Document* – Clarifies that in event of conflict between the IPS and the plan document, the plan document controls; and
- *Controlling and Accounting for Investment Expenses* – Defines the process by which expenses will be reviewed for reasonableness.

It is important to remember, it is not enough for the plan sponsor to simply write an IPS. They must also follow it, communicate it and review it. An ignored IPS is evidence that the plan sponsor is not managing or using the plan the way it was intended.

Communicating the IPS is important for making sure everyone – participants, managers and service providers – is aware of what the plan involves and whether it is in compliance with the law. The needs and expectations of the plan and participants can change over time, which is why the IPS also needs to be reviewed and, if necessary, revised regularly. With any plan document, an IPS should be reviewed by legal counsel prior to implementation.

Chapter 10
Review Questions

1. Another term used for automatic enrollment is:

( ) A. Negative election
( ) B. Payroll deferral
( ) C. Opt-out mechanism
( ) D. None of the above

2. All of the following are requirements that must be met for the plan QDIA to be used, EXCEPT?

( ) A. The QDIA must permit the acquisition of employer securities
( ) B. There must be no penalty imposed on the participant who chooses to later move out of the QDIA
( ) C. The plan must offer a broad range of investment alternatives
( ) D. The QDIA must be managed by a "permitted manager"

3. The QDIA Notice must be provided at least within how many days in advance of plan eligibility?

( ) A. 3 days
( ) B. 7 days
( ) C. 10 days
( ) D. 30 days

4. Which of the following has become the most popular QDIA?

( ) A. Balanced funds
( ) B. REITs
( ) C. Alternative investments
( ) D. Target date funds

5. In order to constitute a QLAC, the amount of the premiums paid for the contract under the plan on a given date could not exceed the lesser of $130,000 in 2018, or what percent of the employee's account balance on the date of payment?

( ) A. 10%
( ) B. 15%
( ) C. 50%
( ) D. 25%

This page left blank intentionally

CHAPTER 11

LIFE INSURANCE IN 401(k) PLANS

Overview

As the advisor, you understand that life insurance should be an integral part of every financial plan. However, determining the type of insurance, comparing the costs, and deciding the most economical way to purchase the protection may continue to be open for debate. Some advisors may recommend that life insurance be bought within a 401(k) plan, if used correctly. Others may say that wrapping up insurance inside a 401(k) plan makes little sense.

This chapter will examine both the pros and cons of purchasing life insurance inside a 401(k) plan. Then we will examine the amounts of insurance that can be purchased in a 401(k) plan under the incidental benefit rules, review the various income tax rules for owning life insurance inside a 401(k) plan. And, finally at the end of the chapter, we will review the distribution rules for a life insurance policy inside a 401(k) plan, and how to properly calculate the life insurance policy's fair market value (FMV).

Learning Objectives

Upon completion of this chapter, you will be able to:

- Identify the pros can cons of owning a life insurance policy inside a 401(k) plan;
- Apply the incidental benefit rules and calculate the percentage test and determine the seasoned money exception;
- Describe the income tax consequences of owning a life insurance policy inside a 401(k);
- Relate the economic benefit rules and how to create basis in the life insurance policy;
- Describe distribution tax rules of the life insurance policy at death prior to retirement, at retirement, or at termination; and
- Determine the fair market value of a life insurance contract inside a 401(k) plan.

Pros and Cons of Purchasing Life Insurance in a 401(k) Plan

First, let's state upfront that life insurance must be purchased in good faith and the insured must have a need for the protection before making a recommendation to purchase a policy inside a 401(k) plan or outside (individually owned). Once you have met those suitability requirements, the next question should be what is the most cost-effective way to purchase life insurance?

I know you have heard the argument, that a 401(k) plan is an investment and life insurance is not, and that the excess costs of insurance are considerably more than similar investments. "Buy term insurance outside your 401(k) plan, and invest inside your 40(k) plan." Sound familiar?

The Pros

However, there are some advantages of purchasing life insurance for a plan participant inside a 401(k) plan that should not be overlooked. They are:

- *Tax-Deductible Contributions*. The contributions made to the participant's 401(k) by the employer are fully deductible by the employer and the participant does not need to report such contributions on their tax return. Within certain limits (as we will discuss below), premiums paid to buy life insurance within a 401(k) may also be deductible;
- *Cost Can be Significantly Less.* The current cost to the participant may be significantly less than the actual premiums. If the benefits end up being too large, the participant will be taxed on what the IRS considers "excess." The positive side of this is that the table used to determine the taxable portion of such contributions, known as the P.S. 58 Table, downplays the real economic benefit of such excess (see Table 10.1). This means that if there are taxes due, it is normally a bargain compared to the value of the insurance the participant bought (see Economic Benefit Value discussed below); and
- *Death Benefits Pass income Tax-Free to the Beneficiary.* Life insurance proceeds pass to a beneficiary income tax-free to the extent they exceed the policy's cash surrender value [IRC § 101].

The Cons

While using pre-tax money for needed coverage is helpful, there are also disadvantages to using plan assets to purchase life insurance. They are:

- *Fees*. There are relatively high costs of setup and implementation, especially if the plan does not yet exist or allow for the purchase of life insurance;
- *Income Taxes*. The participant must recognize the economic benefit value of the death benefit as taxable income, and the cost of unwinding the coverage can be high;
- *Valuation*. The fair market value of the policy must be ascertained to avoid severe tax consequences; and
- *Estate Taxes*. Life insurance is estate taxable if left in the 401(k) plan.

Next, let's examine the incidental benefit rule set forth by the Internal Revenue Service (IRS).

The Incidental Benefit Rule

Under Treas. Reg. § 1.401-1(b)(ii)], life insurance is allowed to be part of a 401(k) plan, but only if it is *incidental* to the retirement plan. This means that it represents less than a certain percentage of the total cost of the retirement plan. The total cost is measured by adding together all contributions.

The Premium Percentage Test

According to the IRS, the "*incidental death benefit rule*," has been refined over time through a number of revenue rulings, beginning with Rev. Rul. 54-51, to mean the following:

- Premiums for life insurance must be less than 50 percent of the contributions for the participant [Rev. Rul. 73-501]; and
- It also required that, at or before the participant's retirement, the policy's full cash surrender value (CSV) must be converted to provide periodic income and not portion used to continue life insurance coverage.

Under IRS Rev. Rul. 60.83, it was determined by the IRS that the use of plan contributions or funds for current benefits, including life insurance protection, as a distribution from the plan.

Then in 1961, IRS issued Rev. Rul. 61-164 which has developed two practical tests for life insurance in a 401(k) plan. If the amount of insurance meets either of the following tests, it is considered incidental:

- The participant's insured death benefit is no more than 100 times the expected monthly normal retirement age benefit (for defined benefit plans); or
- The aggregate premiums for any insured death benefit is less than the following percentages of the overall cost to provide plan benefits for that participant:
    - For term and universal life insurance, the aggregate total premiums paid must be 25 percent or less of the aggregate employer contributions and forfeitures allocated to the account over time; and
    - For whole life insurance, the aggregate total premiums paid must be less than 50 percent of the aggregate employer contributions and forfeitures.

Note: Universal life insurance policies (which led to the marketing of variable universal life and index universal life policies) were developed after publication of Rev. Rul. 54-51. Looking for guidance today on those types of policies, we would look to the only guidance provided by the IRS with FSA 1999-633, which concludes that the 25 percent test applies to Universal Life policies. Keep in mind that there is an exception to the 25% rule, for "*seasoned money*."

Seasoned Money Exception

In a series of Revenue Rulings, the IRS has stated that a profit-sharing plan may permit in-service distributions of funds that have been in the plan for at least two years or all of the funds if the participant has participated in the plan for at least five years. In a profit sharing plan permitting such in-service distributions, participants may pay premiums using the "*seasoned money*" without regard to the incidental death benefit limit. The plan document must permit in-service withdrawals.

If the plan provides that life insurance can be purchased with funds that have been on deposit for two years or more, there is no limit as to how much can be used to purchase life insurance.

Note: The seasoned money rule does not apply to 401(k) salary deferrals or employer qualified matching contributions.

Income Tax Consequences

The fact that life insurance premiums in a 401(k) plan are tax-deductible is very compelling for certain participants in high income tax brackets or whose premiums are more expensive because of health issues or risky pastimes. Although the portion of the employer's contribution that is attributable to life insurance is deductible to the company, the participant insured is required to annually include in income the value of the "*pure insurance protection*" [IRC § 72(m)(3)(B; Reg 1.72-16(b)].

Economic Benefit Value

The amount of pure insurance protection provided to the participant is known as the *economic benefit value.* The calculation of economic benefit value (the taxable benefit) is calculated on the amount at risk—that is, the difference between the policy's cash value and its death benefit. The amount at risk is taxed annually to the participant at the lower of:

- The IRS Table 2001 (see Table 11.1) cost, the so-called "P.S. 58 Cost" [Rev. Rul. 55-47]; or
- The life insurance company's actual rates for individual one-year term policies available to all standard risks [Rev. Rul. 66-10].

For Example: Bob, age 50 is covered by $100,000 of life insurance coverage offered through his employer's 401(k) plan. The policy's cash surrender value at the end of the calendar year is $15,000, making the net insurance amount provided to be $85,000. Based on the IRS Table 2001 (see Table 10.1), the value of the life insurance for a 50 year-old is $2.30 per thousand of coverage. Bob must recognize income of $195.50 for the value of the insurance protection ($100,000 - $15,000)/1,000 x $2.30 = 85 x $2.30 = $195.50. This creates $195.50 of basis in the policy.

Although Table 2001 increases as the insured ages, it's a good deal until around age 70. If the policy in question is a survivorship contract (covering two lives), as long as both insureds are alive, the imputed income is less than under a single life contract.

Creating Basis in the Contract

The economic benefit value included in the participant's taxable income creates basis in the contract [Treas. Reg. § 1.72-16(b)(4]. The participant will be allowed to recover the basis in the contract when the contract is either surrendered or distributed to the participant.

Table 11.1
IRS Table 2001 Interim Table of 1-Year Term Premiums for $1,000 of Life Insurance Protection

Attained Age	Sec. 79 Extended Interpolated Annual Rates	Attained Age	Sec. 79 Extended Interpolated Annual Rates	Attained Age	Sec. 79 Extended Interpolated Annual Rates
0	$0.70	34	$0.98	68	$16.92
1	$0.41	35	$0.99	69	$18.70
2	$0.27	36	$1.01	70	$20.62
3	$0.19	37	$1.04	71	$22.72
4	$0.13	38	$1.06	72	$25.07
5	$0.13	39	$1.07	73	$27.57
6	$0.14	40	$1.10	74	$30.18
7	$0.15	41	$1.13	75	$33.05
8	$0.16	42	$1.20	76	$36.33
9	$0.16	43	$1.29	77	$40.17
10	$0.16.	44	$1.40	78	$44.33
11	$0.19	45	$1.53	79	$49.23
12	$0.24	46	$1.67	80	$54.56
13	$0.28	47	$1.83	81	$60.51
14	$0.33	48	$1.98	82	$66.74
15	$0.38	49	$2.13	83	$73.07
16	$0.52	50	$2.30	84	$80.35
17	$0.57	51	$2.52	85	$88.76
18	$0.59	52	$2.81	86	$99.16
19	$0.61	53	$3.20	87	$110.40
20	$0.62	54	$3.65	88	$121.85
21	$0.62	55	$4.15	89	$133.40
22	$0.64	56	$4.68	90	$144.30
23	$0.66	57	$5.20	91	$155.80
24	$0.68	58	$5.66	92	$168.75
25	$0.71	59	$6.06	93	$186.44
26	$0.73	60	$6.51	94	$206.70
27	$0.76	61	$7.11	95	$228.35
28	$0.80	62	$7.96	96	$250.01
29	$0.83	63	$9.08	97	$265.09
30	$0.87	64	$10.41	98	$270.11
31	$0.90	65	$11.90	99	$281.05
32	$0.93	66	$13.51		
33	$0.96	67	$15.20		

Death of Participant Prior to Retirement

If the participant/insured dies prior to retirement, the death benefit of the life insurance along with the other account will be paid to the named beneficiary. This is where the greatest downside associated with life insurance in a 401(k) plan (or any type of DC plan or DB plan for that matter) surfaces. The death benefit in excess of cash value is income tax free, but the amount attributable to the cash value less the participant/insured's basis in the contract is taxable income to the beneficiary. The income taxation of an insured death benefit paid to the participant's beneficiary is as follows:

- The death benefit less any cash value is income tax free to a participant's beneficiary;
- The total of all economic benefit costs paid by the participant can be recovered tax free from the cash value part of the death benefit; and
- The remainder of the distribution is taxed as a qualified plan distribution;

Contrast this to the situation where the insured owned the life insurance personally: the death benefit would have been entirely income tax free. Again, some clients may consider this a relatively small cost to pay for life insurance purchased with tax-deductible dollars.

From an estate tax perspective, the death benefit paid under the plan including the life insurance will be included in the decedent's estate if the decedent-insured possessed any incidents of ownership in the policy [Rev. Rul. 82-199]. Under IRC Section 2042, incidents of ownership include the ability to:

- Name or change the beneficiary;
- Surrender the policy;
- Pledge policy cash values; or
- Borrow against the policy.

Thus, the qualified plan death benefits are generally includible in the participant's taxable estate for federal estate tax purposes if he or she possessed any of these incidents of ownership at death or received a distribution of the policy and transferred it by gift within the three years before death (IRC § 2035). To the extent the beneficiary is either the deceased participant's spouse or a qualified charity, the estate should be entitled to an offsetting estate tax deduction.

Distribution Options at Retirement or Termination

Upon retirement or termination of the plan, the participant has the following options:

- *Option 1—Cash-out (Surrender) the Policy***.** Direct the plan trustee to surrender the policy and distribute its fair market value along with other funds in the account as a lump sum. Because the policy no longer exists following surrender, immediate tax on the distribution can be avoided by rolling over the distributed funds to an IRA;
- *Option 2—Direct the plan trustee to distribute the policy to him or her*. The life insurance policy is distributed to the participant directly from the 401(k) plan and the participant (insured) continues to maintain the policy on a non-qualified basis. At the time of the distribution income tax is due on the fair market value of the policy less the accumulated one year term (P.S. 58) costs;
- *Option 3—Exchange the Policy.* Several carriers have an exchange option feature allowing the policy inside the plan to be exchanged for a new policy outside the plan. The participant's insurability will remain the same as that of the 401(k) policy, regardless of the participant's current health;

- *Option 4—Purchase the policy from the trustee*. The life insurance policy is purchased for its FMV. The assets of the plan are not depleted; the insurance is maintained outside of the plan unchanged. This purchase is not a taxable event. However, this requires the participant to come up with the value of the policy out of pocket, but again this may be a small price to pay if the participant needs the insurance and/or is uninsurable due to health problems. One concern with purchasing the policy from the plan is that the purchase could be construed as a prohibited transaction (discussed below) if the client is an owner or executive of the company. Fortunately, a prohibited transaction exemption is available so long as the client files the appropriate paperwork; and
- *Option 5—Transfer to an Insurance Trust (ILIT)*. An irrevocable life insurance trust (ILIT) is created. The trust purchases the policy from the 401(k) plan. The dollars used to purchase the policy roll over to the participant's IRA while the policy itself transfers to the insurance trust. Properly structured the policy proceeds will be income and estate tax free. Or, the ILIT could purchase the policy from the profit-sharing plan using regulations included in Rev. Proc. 2005-25 (discussed below).

The next major question is how to determine the *"fair market value"* of the life insurance policy.

Determining Fair Market Value

Theoretically, fair market value (FMV) is the standard of value used for federal estate and gift purposes. FMV is generally defined as the price at which a property would change hands between a willing buyer and willing seller, with neither under compulsion to buy or sell, and both having reasonable knowledge of the relevant facts. When conducting an FMV analysis of a particular asset, valuation experts will typically use market, asset or income approaches. Other than instances in which cash surrender value is used, it doesn't appear as though insurance companies are paying attention to FMV in their efforts to value life insurance policies. This disconnect may provide a legitimate opportunity to dispute high valuation numbers:

- *Market approach.* A valuation expert will consider pricing and financial metrics of market transactions involving similar policies to estimate the value of the subject policy. As such, the availability of relevant transaction information is critical to the process. Currently, there's no transparent market that discloses important details of life insurance policy transactions. Consequently, use of the market approach is difficult to employ;
- *Asset approach.* A valuation expert will typically consider the liquidation value or replacement cost of the subject policy. For newly issued policies, FMV will generally be the premiums paid to date. For one-time, single premium policies that are paid up, the value of the policy will be an estimate by the insurance carrier of the replacement cost of an identical policy. For policies that have been in force for some time, and on which additional premiums are due, the greater of the CSV, ITR or PERC methods may be relevant (discussed below). In certain circumstances, it may be beneficial to retain a valuation expert to value the insurance policy when the number provided by the insurance company is substantially greater than the CSV. This approach may permit the opportunity to challenge some of the analytical assumptions used by the insurance company to determine the ITR or PERC value; and

- *Income approach.* A valuation expert will model the future cash flows of the policy and discount them back to the valuation date using an appropriate risk adjusted discount rate. Life insurance policies are essentially financial instruments with characteristics and features that lend themselves to valuation using the income approach. Like many other types of financial instruments, life insurance policies require a stream of payments, have a cash reserve value, pay dividends and/or interest, are subject to tax consequences and provide a terminal payment. Each of these characteristics may affect the projected cash reserves, premium payments, dividends, interest income, income tax, capital gains tax and the eventual net death benefit.

Each policy has a unique set of characteristics, including the timing of cash receipts and payments, as well as the expected remaining life of the insured and credit quality of the insurance carrier. In other words, a life insurance policy is an illiquid financial instrument with characteristics that a valuation expert can model to determine FMV.

Next, let's review the various valuation methods used to calculate the FMV of a life insurance policy.

Life Insurance Valuation

Often, the value of a life insurance policy becomes an issue when there's a contemplated or actual transfer of a policy. The transfer may involve an estate or gift matter or moving a policy to an irrevocable life insurance trust (ILIT), as was discussed above. When an estate or gift matter is involved, the Internal Revenue Service (IRS) requires that IRS Form 712 Life Insurance Statement be included in the returns. This form is a statement prepared by an insurance company that provides policy values as of the date of transfer. So, a trustee or advisor will likely request an IRS Form 712 from the subject insurance company.

Currently, life insurance companies and valuation experts use a variety of methods and analytical assumptions to determine the value of life insurance policies. These tools can have a material effect on the value of the policy. Consequently, it's important for advisors and trustees to have a basic understanding of the various techniques used in life insurance valuation, including Form 712 policy valuations.

In general, insurance companies estimate the FMV of life insurance policies using one of the following three methods:

- Cash surrender value (CSV);
- Interpolated terminal reserve (ITR); or
- Premiums plus earnings less reasonable charges (PERC).

Let's review each of these FMV methods in greater detail.

Cash Surrender Value (CSV)

The CSV is the value for which the policyholder could surrender his/her policy to the insurance carrier and receive cash back. Insurance companies will often reduce the CSV for surrender charges.

> ***For Example***: If a policy shows cash or accumulated value of $5,000 and a surrender value of $3,000, the carrier has reduced the CSV for surrender charges of $2,000 for early cancellation. If the CSV doesn't reflect surrender charges, an advisor or trustee may wish to inquire about whether surrender charges are applicable to the subject policy.

Once a policyholder cancels and surrenders the policy, most insurance companies pay out the net CSV within a few weeks. However, many states allow insurance companies to defer payment for up to six months after cancellation. When this is the case, a valuation discount for the lack of liquidity of the CSV may be appropriate.

Interpolated Terminal Reserve (ITR)

Interpolated terminal reserve (ITR) is the most common method for valuing life insurance policies. Insurance companies typically use this method when the valuation date falls between anniversary dates of the subject policy. Whenever a policy must be valued on other than its anniversary date, the reserve value must be "approximated" (that is, interpolated). This worked fine for whole life (WL). For a WL policy, the reserve value at the next anniversary date is known in advance, so the terminal reserve value can be "interpolated" to reflect a valuation before the next anniversary date. The analysis involves making a pro rata adjustment between the previous terminal reserve and the subsequent terminal reserve, plus the unearned premiums paid during the partial period. The terminal reserve of a policy is essentially the amount that—when combined with future premiums and investment income—will pay the future maturities (death benefit) of the policy computed using mortality rates and an assumed dividend or interest rate.

However, with the constantly evolving landscape of insurance policy types this has left room for interpretation of the primary components used in the ITR method. For example, variable universal life (VUL) policies have valuation issues related to future reserve value because stock or bond market performance can affect the investment return of these policies. Consequently, the insurance company doesn't know the terminal reserve value until the next anniversary date.

In addition, the definition of "*reserve*" used in the analysis can materially affect the value of a life insurance policy. That definition is subject to different calculations and interpretations, including:

- Statutory reserve;
- Tax reserve used for federal tax reporting;
- Actuarial Guideline 38 Reserve; and
- Deficiency reserve.

It's important to obtain and understand the definition of "reserve" used by the insurance carrier and ascertain the impact it has on the estimated value of the policy.

Premiums, Earnings, and Reasonable Charges (PERC)

The PERC method is generally calculated as follows:

- Premiums paid from the date of issue;
- Plus dividends used to purchase paid-up insurance prior to the valuation date;
- Plus amounts credited to the policyholder from premiums and interest;
- Minus reasonable mortality charges and other charges; and
- Minus distributions, withdrawals or partial surrenders taken prior to the valuation date.

According to Revenue Procedure 2005-25 (discussed below), the general rule is to value the policy at the greater of the ITR or PERC. Other language in the Treasury regulations appears to leave the door open for alternate methods of life insurance policy valuation for federal tax related matters, such as estate and gift.

Rev. Rul. 2005-25

In reaction to perceived abuses in undervaluing policies, the IRS issued Revenue Procedure 2005-25, which applies to qualified plan distributions (IRC § 402), employer distributions to service providers (IRC § 83) and distribution of permanent group term policies (IRC § 79). Rev. Proc. 2005-25 provides guidance on how to determine the FMV of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection for purposes of applying the rules of IRC §§§ 79, 83, and 402. It provides two safe harbor formulas that, if used to determine the value of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection that is distributed or otherwise transferred from a qualified plan, will meet the definition of fair market value.

FMV of Non-Variable Insurance Contracts

The FMV of a non-variable insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection may be measured as the greater of:

- *Formula Option A:* The sum of the interpolated terminal reserve (ITR) and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, (This formula resembles the one commonly used in the gift tax valuation context under Reg. 25.2512-6.); or
- *Formula Option B:* The result of multiplying the PERC amount (the amount described in the following sentence based on Premiums, Earnings, and Reasonable Charges) by the applicable Average Surrender Factor (ASF).

Note: In the case of Universal Life (UL) contracts, since there is no interpolated terminal reserve (ITR), the "A" option will not be available and this forces the use of the "B" option. In other words, there is no substitute for "interpolated terminal reserve."

FMV of Variable Insurance Contracts

If the insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection being valued is a variable contract, the fair market value may be measured as the greater of:

- *Formula Option A:* The sum of the interpolated terminal reserve and any unearned premiums plus a pro rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience; or
- *Formula Option B:* The product of the variable PERC amount (the amount described in the following sentence based on premiums, earnings, and reasonable charges) and the applicable Average Surrender Factor described below.

The variable PERC amount is the aggregate of:

- The premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums; plus
- Dividends applied to increase the value of the contract (including dividends used to purchase paid-up insurance) prior to the valuation date; plus (or minus)
- All adjustments (whether credited or made available under the contract or to some other account) that reflect the investment return and the market value of segregated asset accounts; minus
- Explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date and those charges are not expected to be refunded, rebated, or otherwise reversed at a later date; and minus
- Any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

Average Surrender Factor

The *Average Surrender Factor* (ASF) for purposes of IRC Code §§§ 79, 83, and 402(b) (for which no adjustment for potential surrender charges is permitted) is 1.00. In other words, no adjustment for potential surrender charges is permitted with respect to IRC §§§ 79, 83, and 402 (b).

As noted above, in the case of a distribution or sale from a qualified plan, if the contract provides for explicit surrender charges, the *Average Surrender Factor* is the un-weighted average of the applicable surrender factors over the 10 years beginning with the policy year of the distribution or sale. For this purpose, the ASF for a policy year is equal to the greater of:

- 70%; or
- Projected amount of cash that would be available if the policy were surrendered on the first day of the policy year) / (Projected (or actual) PERC amount as of that same date). (In the case of the policy year of the distribution or sale, use in place of the projected amount, the amount of cash that was actually available on the first day of that policy year. If there is no surrender charge, the applicable surrender factor for a year is 1.00).

To further prevent abuse, a surrender charge is permitted to be taken into account only if it is contractually specified at issuance and expressed in the form of non-increasing percentages or amounts.

The numerator of the fraction is the amount remaining after surrender charges are deducted.

> ***For Example***: If the PERC amount was $100,000 and the surrender charge was $20,000, the numerator would be $80,000. Since the fraction is the proportion the amount received after surrender ($80,000) bears to the PERC amount ($100,000), the fraction would be $80,000/$100,000, i.e., .8. Here, the fraction is greater than the alternative factor, .7, so it becomes the ASF. However, if the surrender charge were much larger, for instance, $40,000, the result of subtracting $40,000 from $100,000 would be $60,000 and the fraction would be $60,000/$100,000, i.e., .6, and the alternative factor would be chosen. So if the amount received is reduced to .7 or less of what it would have been, the fair market value is .7; if not, it is whatever is received.

The ASF is the non-weighted average of ten years of applicable surrender factors from the year of distribution. If there is no surrender charge in a given year, the applicable surrender factor is 1. And as noted above, surrender charges can be taken into account only if the surrender charge is contractually specified at issuance and expressed in the form of non-increasing percentages or amounts.

This of course, is to prevent the use of springing cash value contracts. At this point, the ASF is multiplied by the PERC amount. It is then measured against the "A" formula (interpolated terminal reserve plus premiums plus dividends. The greater of the two must be used as the fair market value of the insurance contract.

The 2005 Rev. Proc. requires that the two formulas be interpreted in a "reasonable manner", consistent with the purpose of identifying the fair market value of a contract. For instance, if income is calculated with respect to premiums paid under the contract, that amount must be included in the formulas, even if the income can only be realized through an exchange right that gives rise to a springing cash value under another policy. Similarly, if a mortality charge or other amount charged under a contract can be expected to be directly or indirectly returned to the contract holder (whether through the contract, a supplemental agreement, or under a verbal understanding and regardless of whether there is a guarantee), the charge is not permitted to be subtracted under the formulas. In addition, a surrender charge cannot be taken into account in determining an ASF if it may be waived or otherwise avoided or was created for purposes of the transfer or distribution.

Furthermore, at no time are these rules to be interpreted in a manner that allows the use of these formulas to understate the FMV of the life insurance contracts and associated distributions or transfers.

> ***For Example****:* If the insurance contract has not been in force for some time, the value of the contract is best established through the sale of the particular insurance contract by the insurance company (i.e., as the premiums paid for that contract).

In the case of a distribution or sale of a contract from a qualified plan, the date as of which the FMV is to be determined is the date of that distribution or sale. The date of determination in the case of the provision of permanent benefits subject to IRC § 79 is the date those benefits are provided. The date of determination in the case of a transfer of an insurance contract subject to IRC § 83 is the date on which fair market value must be determined under the rules of IRC § 83. The date of determination in the case of a non-exempt employees' trust under IRC § 402(b) is the date on which fair market value must be determined under the rules of IRC § 402(b).

If a loan (including a loan secured by the cash value of a life insurance contract) is made to an employee or other service provider in connection with the performance of services, to the extent the debt owed by the employee or other service provider is terminated upon distribution or transfer of the collateral, the terminated loan or debt amount constitutes an additional distribution to the employee or service provider at that time. For this purpose, it is irrelevant whether the loan is described as having been forgiven, cancelled, satisfied, extinguished, or otherwise offset, provided that the loan no longer exists after the distribution or transfer.

Let's assume, for example, that a life insurance contract has a FMV of $100,000 (without regard to any debt). The policy serves as collateral for a policy loan of $30,000 (borrowed by the employer, who then lends the $30,000 to the employee) prior to the distribution or transfer of the contract. If the loan to the employee no longer exists after the distribution or transfer so that the amount distributed is $70,000 ($100,000-$30,000), the entire $100,000 must be taken into account by the employee. If a participant receives a loan from a life insurance contract held by a qualified plan (or other plan subject to the rules of IRC § 72(p)) and the contract is subsequently distributed to the participant in satisfaction of the participant's benefit under the plan, the reduction in the value of the distribution in order to repay the participant's loan from the plan constitutes a plan loan offset amount, which is treated as a distribution from the plan.

The bottom line is that, by introducing a minimum of 0.7 for the ASF and by measuring the ASFs for a period of 10 years beginning in the year of the sale or distribution, most, if not all, gimmicks will be eliminated. In addition, the IRS has strengthened the "fair market value" standard by targeting three "innovative" techniques (exchanging the existing policy for a new springing cash value policy, refunding mortality charges, and waiving surrender charges) and by not allowing the rules to be interpreted in a way that would understate fair value.

For estate and gift tax purposes, the Treasury regulations provide that FMV is determined by applying the "*willing buyer-willing seller*" rule. Before about 2000, there was no secondary market for the sale of life insurance policies. Even with the advent of this new market, it's often limited to sales of policies by older, less healthy insureds; this market is generally unavailable to many insureds.

The estate and gift tax regulations indicate that the value of a policy is based on the cost of a hypothetical "comparable contract." For newly issued policies, the value is the cost of the policy (that is, premiums paid). For one-time, single premium policies that are "paid up," the value is the carrier's current cost for an identical policy. For policies in force for some time on which additional premiums are due, the regulations say that the FMV of the policy can be "approximated" by using the ITR amount plus unearned premiums unless this method isn't reasonably close to full value (for example, the insured is terminally ill).

Unisex Rates

If there is any situation in which sex discrimination seems to be justified, it is in the pricing of life insurance and related products. Women live longer than men on the average. It is therefore cheaper for an insurance company to insure the life of a woman because the benefits will be paid out later, and the present value of the payoff is therefore lower. Thus, the insurance industry and numerous commentators have argued that to charge men and women of the same age the same price for life insurance would constitute a subsidy running from women (who would pay too much) to men (who would pay too little). As a result, men would buy too much insurance and women would buy too little. Similarly, an annuity should cost more for a woman than for a man because the longer an annuitant is likely to live; the more costly it is for the insurance company to pay the annuity. With unisex pricing women would buy too much in annuities and men would buy too little. Or so the argument goes.

Despite this compelling argument, the Supreme Court of the United States (SCOTUS) has held that gender-based insurance rates constitute illegal sex discrimination in connection with employer-sponsored pension programs. First in 1978, with *City of Los Angeles, Department of Water and Power v. Manhart* (435 U.S. 702) and then in 1983, *Arizona Governing Committee for Tax Deferred Annuity and Deferred Compensation Plans v. Norris* (463 U.S. 1073).

Both of these SCOTUS rulings prohibit insurance companies from taking into consideration gender when developing insurance classifications, rates or types of coverage for certain types of insurance. When unisex rates apply, all people, regardless of gender, must be given the same rates and types of coverage.

Prohibited Transaction Rules

Another important issue involves prohibited transactions. ERISA generally prohibits transactions between a qualified plan and a party in interest even if the transaction is at arm's length and for fair market value. A party in interest includes the following:

- The Employer;
- The Participant;

- A fiduciary of the plan; or
- A relative of any of the above or a corporation or other entity owned more than 50 percent by any of the above.

Fortunately, the DOL (which administers ERISA) has granted several exemptions to the prohibited transactions rule.

In 1977 an exemption was granted for sales of individual life insurance policies owned by the plan. This exemption was updated and clarified in Private Transaction Exemptions (PTE) 92-6. This exception permits the sale of a policy by a qualified plan if several conditions are met:

- Policy must first be offered to the participant before it can be sold to any other party;
- Plan can only sell the policy if it would otherwise be surrendering it;
- Sale must produce cash proceeds to the plan at least equal to what it would have realized upon a surrender of the policy; and
- Sale must be to:
    - Plan participant insured under the policy;
    - Relative of such participant who is a beneficiary under the policy;
    - Employer whose employees are covered by the plan; or
    - Another employee benefit plan.

PTE 92-6 has been updated in Advisory Opinion 98-07A and Advisory Opinion 2006-03A. These updates permit the sale of a second to die policy insuring the participant and his or her spouse to an ILIT created by the participant.

Bottom Line

Life insurance in a DC plan is not for everyone, but it can be for those clients (especially small business owners) needing large amounts of life insurance the cost can be made more affordable with tax deductible dollars.

Chapter 11
Review Questions

1. True or False. The Table used to determine the taxable portion of premium paid for an individual life insurance contract inside a 401(k) plan is known as P.S. 38:

   ( ) A. True
   ( ) B. False

2. According to the IRS, the percentage test of the "*incidental death benefit rule*," requires premiums for life insurance be less than what percent of the contributions for the participant?

   ( ) A. 25%
   ( ) B. 70%
   ( ) C. 40%
   ( ) D. 50%

3. To be considered incidental, the aggregate total premiums paid for a term or universal life insurance policy must be what percent or less of the aggregate employer contributions and forfeitures allocated to the account over time?

   ( ) A. 25%
   ( ) B. 50%
   ( ) C. 75%
   ( ) D. 40%

4. The Average Surrender Factor (ASF) is the un-weighted average of the applicable surrender factors over the how many years beginning with the policy year of the distribution or sale?

   ( ) A. Five
   ( ) B. Ten
   ( ) C. Two
   ( ) D. Seven

5. Which of the following would NOT be considered "a party in interest"?

   ( ) A. The Employer
   ( ) B. The Participant
   ( ) C. Accountant who is not a fiduciary of the plan
   ( ) D. A fiduciary of the plan

CHAPTER 12

DOL AND IRS REPORTING REQUIREMENTS

Overview

Under ERISA § 101 through 111, it requires employers (plan sponsors) with extensive reporting and disclosure requirements to be made to plan participants and beneficiaries, as well as reporting of plan information to governmental agencies. Some of the reporting and disclosure requirements provide that certain materials must be disseminated or made available to participants and beneficiaries at reasonable times and places. Other requirements arise only upon the written request of a plan participant or beneficiary or upon the occurrence of a specific event.

This chapter will examine those required reporting and disclosure documents. It will begin with the types of disclosures required and then list the various documents that must be disclosed to participants and beneficiaries. The end of the chapter will discuss the specific reporting requirements for plans sponsors to report to the government.

Learning Objectives

Upon completion of this chapter, you will be able to:

- List the reporting and disclosure requirements required by plans sponsors as set forth by the DOL and IRS; and
- Describe the required plan sponsor reporting requirements to governmental agencies as set forth in Title I of ERISA;

Reporting and Disclosure

ERISA § 2(b) states that it is the policy of ERISA:

> "*…to protect ... the interests of plan participants and their beneficiaries by requiring disclosure and reporting of financial and other information*."

ERISA requires three different types of disclosures. First, certain material must be provided to participants at stated times or if certain events occur. Second the plan administrator must provide certain material to participants upon request. Finally, the plan administrator must make certain material available to participants for inspection at reasonable times and places.

Below is a list of documents that are required to be made available to participants and beneficiaries at a stated time or upon certain events. They are:

- Summary Plan Description (SPD);
- Summary of Material Modification (SMM);
- Summary of Annual Report (SAR);
- Notice of Preretirement Survivor Benefit;
- Notice of Joint and Survivor Benefit;
- Notice of Terminated Vested Participants; and
- Notice of Freedom to Divest Employer Securities.

Plan disclosure documents keep participants informed about the basics of plan operation, alert them to changes in the plan's structure and operations, and provide them a chance to make decisions and take timely action about their accounts (Table 12.1).

Methods of Complying with the Disclosure Requirements

If reports, statements, notices, and other documents are required to be furnished, either automatically or upon request, the documents must be current, readily accessible, and clearly identified. Sufficient copies must be available to accommodate the expected number of inquiries.

The documents do not have to be maintained at each employer establishment, union hall, or office but must be available at any such location within ten (10) calendar days after the day on which a request for disclosure is made. A plan administrator that sets out a procedure to request such plan documents and communicates it to plan participants does not have to comply with requests that do not follow that procedure. The procedure must allow requests to be made in a reasonably convenient manner to the plan administrator and at each location where the documents must be made available. Under DOL Reg. § 2520.104b-1(b) (3), if a reasonable procedure has not been established, a good faith effort to request examination of plan documents will be considered a request to the plan administrator.

For other documents required to be furnished to plan participants and beneficiaries, the plan administrator must use measures reasonably calculated to ensure actual receipt of the material by the plan participants, beneficiaries, and other specified individuals. Material required to be furnished to all participants and beneficiaries receiving benefits must be sent by a method likely to result in full distribution. In-hand delivery to an employee at their worksite is sufficient while simply placing copies in a location frequented by participants is not [DOL Reg. § 2520.104b-1(b) (1)]. If a participant or beneficiary makes a written request for materials, they must be mailed to an address provided by the requesting participant or beneficiary or personally delivered to the participant or beneficiary [DOL Reg. § 2520.104b-1(b) (2)].

Electronic Delivery

The Department of Labor (DOL) and the Internal Revenue Service (IRS) have separate rules for disclosing certain retirement plan information. The DOL has established safe-harbor rules for all retirement plans covered by ERISA.

The DOL safe-harbor rules apply to the following:

- Summary plan descriptions (SPDs);
- Summary of material modifications (SMMs);
- Summary annual reports (SARs);
- Notices required by the Sarbanes-Oxley Act when a blackout — defined as a suspension of participants' and beneficiaries' rights to diversify or direct investments, or obtain a loan or distribution — will last for three consecutive business days or more;
- Individual benefit statements;
- Investment-related information in participant directed individual account plans that intend to comply with ERISA section 404(c);
- Qualified domestic relations order (QDRO);
- Notifications Information that ERISA requires to be furnished or made available upon participant or beneficiary request; and
- Participant fee disclosures intended to comply with ERISA section 404(a)(5).

The DOL requirements for electronic delivery are:

- Style, format and content;
- Delivery;
- Notice;
- Confidentiality; and
- Consent.

As you can see, electronic delivery of notices, reports and documents involves more than sending to a participant as an email with an attachment. It is important that plan sponsors have adequate procedures and processes in place to ensure they satisfy these requirements.

Summary Plan Description (SPD)

As a mechanism for informing plan participants of the terms of the plan and its benefits, ERISA requires that plan administrators furnish to participants a *summary plan description* (SPD). A SPD is a written summary of the provisions of an employee benefit plan that contains the terms of the plan and the benefits offered. Under ERISA § 102(a), the SPD must be written in a manner that can be understood by the average plan participant and be sufficiently accurate and comprehensive to reasonably apprise participants and beneficiaries of their rights and obligations under the plan.

Contents of the SPD

The SPD must include the following information:

- The name of the plan and, if different, the name by which the plan is commonly known by its participants and beneficiaries [DOL Reg. § 2520.102-3(a)];

- The name and address of the employer or employee organization maintaining the plan [DOL Reg. § 2520.102-3(b)];
- The name, business address and business phone number of the plan administrator [DOL Reg. § 2520.102-3(f)];
- For a collectively-bargained plan established or maintained by one or more employers and one or more employee organizations, detailed information about the employers and organizations involved and that additional information will be provided upon written request and is available for inspection [DOL Reg. § 2520.102-3(b)(3)];
- In the case of a plan established or maintained by two or more employers, the association, committee, joint board of trustees, parent or most significant employer of a group of employers all of which contribute to the same plan, or other similar representative of the parties who established or maintain the plan, and how additional information can be obtained [DOL Reg. § 2520.102-3(b)(4)];
- The plan's Employer Identification Number (EIN) and the plan number assigned by the plan sponsor [DOL Reg. § 2520.102-3(c)];
- The type of pension plan [DOL Reg. § 2520.102-3(d)];
- The type of administration of the plan, e.g., contract administration, insurer administration, etc. [DOL Reg. § 2520.102-3(e)];
- The plan's designated agent for service of legal process, and the address at which process may be served on such person, and, a statement that service of legal process may be made upon a plan trustee or the plan administrator [DOL Reg. § 2520.102-3(g)];
- The name, title, and address of the principal place of business of each trustee of the plan [DOL Reg. § 2520.102-3(h)];
- If a plan is maintained pursuant to one or more collective bargaining agreements, a statement that the plan is so maintained, and how a copy of any such agreement may be obtained or examined by participants and beneficiaries [DOL Reg. § 2520.102-3(i)];
- The plan's requirements for eligibility for participation and for benefits, including any condition that must be met before a participant is eligible to receive benefits and circumstances that could result in the participant not receiving benefits they might expect based on the SPDs description of benefits [DOL Reg. § 2520.102-3(j)];
- Any joint and survivor benefits provided under the plan, including any requirements that an election is required to select or reject the joint and survivor annuity [DOL Reg. § 2520.102-3(k)];
- The participant's rights to self-direct the investment of their account and whether the plan is designed to qualify for the exception to the ERISA fiduciary duties for accounts directed by the participant [DOL Reg. § 2550.404c-1(b)(2)(i)(B)];
- A statement that the plan benefits are not insured by the Pension Benefit Guaranty Corporation and the reason why [DOL Reg. § 2520.102-3(m)];
- A description and explanation of the plan provisions for determining years of service for eligibility to participate, vesting, and breaks in service, and years of participation for benefit accrual. It must include the service required to accrue full benefits and the manner in which accrual of benefits is prorated for employees failing to complete full service for a year [DOL Reg. § 2520.102-3(n)];

- The source of contributions to the plan—for example, employer, employee organization, employees—and the method by which the amount of contribution is calculated [DOL Reg. § 2520.102-3(p)];
- The identity of any funding medium used for the accumulation of assets through which benefits are provided. The SPD must identify any insurance company, trust fund, or any other institution, organization, or entity that maintains a fund on behalf of the plan or through which the plan is funded or benefits are provided [DOL Reg. § 2520.102-3(q)];
- The date that the plan's fiscal year ends [DOL Reg. § 2520.102-3(r)];
- The procedures governing claims for benefits, including, filing claim forms, providing notification of benefits determinations, and reviewing denied claims, time limits, and remedies for appealing denied claims [DOL Reg. § 2520.102-3(s)]; and
- A statement of ERISA rights, containing information included in a model statement provided in the regulations. It may include an explanatory and descriptive provision in addition to the model statement provisions. The statement must comply with the SPD style and format rules. The plan may mention certain rights elsewhere in the SPD but the statement of ERISA rights must appear as one consolidated statement [DOL Reg. § 2520.102-3(t)(1)].

A plan may delete any item that does not apply [DOL Reg. § 2520.102-3(t) (2)].

Timely Delivery of the SPD

The SPD must be provided to each participant and beneficiary of the plan on or before the latter of:

- 90 days after an employee becomes a participant or a beneficiary first receives benefits; or
- Within 120 days after the plan becomes subject to ERISA's reporting and disclosure requirements [DOL Reg. § 2520.104b-2(a) (3)]. This is generally the first day an employee is credited with an hour of service. Special rules apply to plans that have prospective or retroactive effective dates [DOL Reg. § 2520.104b-2(a)(3)].

Under DOL Reg. § 2520.104b-2(b)(1), an updated SPD must be provided every five years if any plan amendments were made since the last SPD was provided. Even if no amendments were made to the plan, a new SPD must be provided every 10 years [DOL Reg. § 2520.104b-2(b)(2)].

Summary of Material Modification

Under ERISA § 104(b) (1), a plan administrator must provide a S*ummary of Material Modification* (SMM) in the terms of the plan as well as any change in information required to be included in the SPD. This summary must be provided, in most cases, within 210 days after the close of the plan year in which the modification was adopted, and also must be furnished to the Labor Department upon request. Similar to the SPD, the materials must be written in a manner that can be understood by the average plan participant [DOL Reg. § 2520.104b-3(a)]. While ERISA does not define "material modification" and does not specifically cover what changes warrant an SMM, courts have addressed this issue. Courts have held plan amendments such as the establishment and elimination of benefits are material modifications. However, as courts have also pointed out, not all plan amendments are material modifications.

Timely Delivery of the SMM

The SMM is required to be provided to participants and beneficiaries of the plan within 210 days after the close of the plan year in which the modification or change occurred, regardless of the change's effective date. Changes that are retroactive to a prior year do not affect the disclosure date. Under DOL Reg. § 2520.104b-3(a), an SMM is not required if the material modification or change does not take effect, whether it is rescinded or otherwise.

If a plan incorporates the material modification or changes in a timely SPD, no SMM is required [DOL Reg. § 2520.104b-3(b)]. However, when a SPD is furnished, it must be accompanied by all SMMs that are required to be included in the SPD but that are not reflected in the SPD furnished [DOL Reg. § 2520.104b-3(c)].

Summary Annual Report (SAR)

ERISA § 103 provides that certain employee benefit plans must file an annual report with the Department of Labor. The annual report is considered to be a primary source of information concerning the operation, funding, assets, and investments of employee benefit plans. It is regarded as a compliance and research tool for the DOL and a source of information and data for use by other federal agencies, Congress, and private groups in assessing employee benefit, tax, and economic trends and policies. While the SAR can also be an important disclosure document for plan participants and beneficiaries, participants and beneficiaries must request a copy from the plan administrator.

Contents of the SAR

The SAR must include a detailed financial statement containing information on the plan's assets and liabilities, an actuarial statement, as well as other information, depending on the type of the plan and the number of participants. Plan administrators must make copies of the annual report available at the principal office of the plan administrator and at other places as may be necessary to make pertinent information readily available to plan participants.

Obligation to Furnish

The SAR must be filed within nine months after the close of a plan's year. The annual report is to be filed with the DOL on Form 5500 series. In 2006, the DOL published a rule requiring electronic filing of Form 5500 series reports for plan years beginning on or after January 1, 2008.

Under DOL Reg. § 2520.104b-10(c), if the IRS has granted the plan an extension to file its Form 5500 series with the DOL, the SAR must be filed within two months after the end of the extended filing period.

Individual Benefit Statements

Under ERISA § 105, plan administrators are required to periodically furnish an *individual benefit statement* (IBS) to participants and beneficiaries.

Contents of IBS

An *individual benefit statement (IBS)* shows the total plan benefits earned by a participant, vested benefits, the value of each investment in the account, information describing the ability to direct investments, and (for plans with participant direction) an explanation of the importance of a diversified portfolio.

For plans that allow participants to direct the investments in their accounts, plan and investment information, including information about fees and expenses, must be provided to participants before they can first direct investments and periodically thereafter – primarily on an annual basis with information on the fees and expenses actually paid provided at least quarterly The initial plan-related information may be distributed as part of the SPD provided when a participant joins the plan as long as it is provided before the participant can first direct investments. The information provided quarterly may be included with the IBS.

Timely Delivery of IBS

For 401(k) (and other defined contribution) plans, an IBS must be provided:

- Every calendar quarter to participants and beneficiaries who have the right to direct the investments of the account, or
- Once each calendar year for participants and beneficiaries who have accounts with the plan, but do not have control over the investment in the account.

Automatic Enrollment Notice

If a plan automatically enrolls employees, the *Automatic Enrollment Notice* (AEN) details the plan's automatic enrollment process and participant's rights. The notice must specify the deferral percentage, the participant's right to change that percentage or not make automatic contributions, and the plan's default investment. The participant generally must receive an initial notice at least 30 days before he or she is eligible to participate in the plan. Employers that provide for immediate eligibility can provide this initial notice on an employee's first day of employment if they allow participants to withdraw contributions within 90 days of their first contribution. An annual notice also must be provided to participants at least 30 days prior to the beginning of each subsequent plan year.

Blackout Period Notice

The *Blackout Period Notice* requires at least 30 days (but not more than 60 days) advance notice before a 401(k) or profit sharing plan is closed to participant transactions. During blackout periods, participants (and beneficiaries) cannot direct investments, take loans, or request distributions. Typically, blackout periods occur when plans change.

Notice of Freedom to Divest Employer Securities

The PPA amended the disclosure provisions of ERISA to require plan administrators to provide participants with a notice of their eligibility to divest employer securities held in a defined contribution plan. ERISA § 101(m) requires plan administrators to provide this notice to applicable individuals at least 30 days before the date on which the individual is eligible to divest these securities. The notice must inform the participant that he/she has the right to direct divestment of the employer securities and informed of the importance of diversifying the investment of retirement account assets. The notice must be written in a manner that can be understood by the average plan participant. It may be delivered in written, electronic, or other appropriate form that is reasonably accessible to the recipient.

Reporting to Government Agencies

In addition to the disclosure documents that provide information to participants, plans must also report certain information to government entities.

Annual Return/Report of Employee Benefit Plans

Under IRC § 6058(a) and Treas. Regs. §§§ 101(b)(1), 103, 104, plans are required to file an annual return/report with the federal government, in which information about the plan and its operation is disclosed to the IRS and to the Department of Labor. These reports are made available to the public.

Depending on the number and type of participants covered, the plan must file one of the following forms:

- *Form 5500*, Annual Return/Report of Employee Benefit Plan is generally used for 401 (k) plans that have 100 or more participants;
- *Form 5500-SF*, Short Form Annual Return/Report of Small Employee Benefit Plan can be used by plans that meet the following requirements:
  - Qualify as a small plan; a plan qualifies if it had less than 100 participants at the beginning of the current plan year;
  - Not hold any employer securities at any time during the year;
  - Not be required to have an annual audit;

    - All of its assets held for investment purposes were invested in assets that have a readily determinable market value; and
    - Is not a multi-employer plan.
- *Form 5500-EZ*, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan is generally used by plans that cover only the business owner and their spouse or only partners and their spouses and does not provide benefits for anyone else. If the total plan assets of the plan and any other one-participant plan maintained by the employer are less than $250,000 at the end of the plan year and it is not the plan's final plan year, no return needs to be filed. If the total assets exceed $250,000, Form 5500-EZ must be filed for all of the employer's one-participating plans, regardless of the amount of a plan's assets.

Form 5500

Under DOL Reg. § 2520.103-1(a) a 401(k) plan that covers 100 or more participants can elect a limited exemption or alternative method of compliance. If a plan does not elect a limited exemption or alternative method of compliance, the following information must be provided:

- Financial statements, providing the detail specified in ERISA § 103(b)(3) and an accountant's opinion [ERISA § 103(a)(1)(B)]. Under ERISA § 103(b)(2) the financial statements must include the following:
    - A statement of assets and liabilities;
    - A statement of changes in net assets available for plan benefits, including details of revenues and expenses and other changes aggregated by general source and applications; and
    - In the notes, ERISA directs the accountant to consider disclosures concerning such things as significant changes to the plan during the period and their impact on benefits; the funding policy and any changes to the policy; contingent liabilities; agreements and transactions with persons know to be parties of interest; whether a tax ruling or determination letter has been obtained; and any other matters necessary to fully and fairly present the financial statements.
- The number of employees covered by the plan [ERISA § 103(c)(1)];
- The name and address of each fiduciary [ERISA § 103(c)(2)];
- The name of each person who rendered services to the plan and received compensation from the plan directly or indirectly, the amount of the compensation, and details about the services provided, the relationship to the employer or covered , and any other relationship with any party in interest [ERISA § 103(c)(3)];
- The reason for any change in plan trustee, accountant, insurance carrier, administrator, investment manager, or custodian [ERISA § 103(c)(4)];
- Any financial and actuarial information that the Secretary requires, including the financial statement information described above [ERISA § 103(c)(5)];
- 401(k) and other profit sharing plans do not have to provide actuarial information [ERISA § 103(d)(A)]; and
- If any benefits under the plan are purchased or guaranteed by an insurance company, the insurer must provide a report with specific information [ERISA § 103(e)].

Plans that elect the limited exemption or alternative method of compliance must include the following information:

- Form 5500 and any statement or schedules to be attached, including:
  - Schedule A (Insurance Information);
  - Schedule C (Service Provider Information);
  - Schedule D (Direct Filing Entity (DFE)/Participating Plan Information;
  - Schedule G (Financial Transaction Schedules);
  - Schedule H ((Financial Information);
  - The following financial schedules [(DOL Reg. § 2520-103-10(b)]:
    - Assets held in investments;
    - Assets acquired and disposed within plan year;
    - Party in interest transactions;
    - Obligations in default;
    - Leases in default; and
    - Reportable transactions.
  - Separate financial statements (in addition to those described above) if any are prepared for the audit and notes to the financial statement, complying with the requirement of DOL Reg. § § 2520.103-1(b)(3) and 2520.103-1(b)(4) [(DOL Regs. §§ 2520-103-1(b)(2), 2520.103-1(b)(3)];
  - Financial statements for the account or trust (if some or all of the plan's assets are held in a pooled separate account maintained by an insurance company or a common or collective trust) [DOL Reg. § 2520-103-1(b)(4)];
  - The opinion of an independent qualified accountant [DOL Reg. § 2520-103-1(b)(5)] that states:
    - if the audit was made in accordance with generally accepted auditing standards [DOL Reg. § 2520-103-1(b)(5)(ii)];
    - any omitted auditing procedures deemed necessary and the reason for their omission [DOL Reg. § 2520-103-1(b)(5)(ii)];
    - whether the accounting principles were consistently applied between the current year and the preceding year [DOL Reg. § 2520-103-1(b)(5)(iii)];
    - any changes in principles that have a material effect on the financial statements [DOL Reg. § 2520-103-1(b)(5)(iii)]; and
    - a clear identification of any matters to which the accountant takes exception clearly specifying the exception and the effect of the matters subject to the exception on the financial statements, and whether the matters are the result of DOL regulations or otherwise [DOL Reg. § 2520-103-1(b)(5)(iv)].

Form 5500-SF

For 401(k) plans that qualify to file Form 5500-SF must complete that form and attach any required statements and schedules. One participant plans can file a Form 5500-SF instead of a Form 5500-EZ if they meet the following requirements:

- The plan is a one-participant plan. This means either:
    - The plan only covers the owner (or the owner and their spouse) and the owner (or the owner and their spouse) own the entire business (which may be incorporated or unincorporated; or
    - The plan only covers one or more partners (or partner(s) and spouse(s)) in a business partnership.
- The plan does not provide benefits for anyone except the owner or the owner and their spouse, or one or more partners and their spouses;
- The plan covered fewer than 100 participants at the beginning of the plan year; and
- A plan that does not meet ALL the listed conditions is not a one-participant plan filer eligible to file Form 5500-SF instead of Form 5500-EZ. It must file a paper Form 5500-EZ with the IRS if it meets the first two conditions but does not meet the third condition.

Eligible one-participant plans need complete only the basic questions about the plan, its finances, and operation.

Filing Requirements and Timing

Under IRC § 6058, the plan must file Form 5500, 5500-SF, or 5500-EZ by the last day of the seventh calendar month following the end of the plan year. The plan may be allowed a 2 ½ month extension by filing Form 5558, Application for Extension of Time to File Certain Employee Plan Returns with the IRS [Treas. Reg. § 1.6081-11(a)]; failure to do so subjects the plan to a $25 per day penalty, up to a maximum of $15,000 per return [IRC § 6652 (e)]. In addition, the DOL can impose a penalty of $1,100 per day for failure to file appropriate Form 5500 [ERISA § 502(c)(2) and DOL Reg. §2575.502c-2].

Under DOL Reg. § 2520-104a-2, for plan years beginning on or after January 1, 2009, Form 5500 or 5500-SF and all statements and schedules must be filed electronically using the ERISA Filing Acceptance System (EFAST2). Filers may file online using EFAST2's web-based IFILE filing system, or filers may file through an EFAST2-apporved vendor. All delinquent and amended filings of Title 1 plans (includes 401(k) plans) must also be submitted electronically through EFAST2.

The Form 5500-EZ cannot be submitted electronically through EFAST2. However, one-participant plan that is eligible for file the Form 5500-EZ may elect to file the Form 5500-EZ electronically with EFAST2 rather than filing a Form 500-EZ on paper with the IRS.

IRS Form 1099-R

Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, etc.* is used to report distributions (including rollovers) from a retirement plan. It is given to both the IRS and recipients of distributions from the plan during the year.

Table 12.1
Key Information Plan Administrator Must Provide Automatically

What	Description	When
Summary Plan Description (SPD)	A summary version of the plan document and other important plan information, in easier-to-understand language.	Within 90 days of becoming a participant in the plan; and An updated copy every 10 years (5 years if the plan has been amended).
Automatic Enrollment Notice	For plans with automatic enrollment, a description of the automatic enrollment process, the percentage of salary being deferred, the default investment used for automatic contributions, the right to opt out of the plan, the right to change deferral percentage and investments, and how to find information about the plan's other investments.	Generally, at least 30 days before you are eligible to participate; and 30 days before the beginning of each subsequent plan year.
Individual Benefit Statement	Statement providing information about your account balance and vested benefits. Depending on the type of plan you have, the statement may also include the value of the investments in the account and information describing your right to direct investments.	At least quarterly for participant-directed defined contribution plans; At least annually for non-participant-directed defined contribution plans; or At least every 3 years for defined benefit plans.
Plan and Investment Information for Participant-Directed Plans	Plan and investment related information, including information about fees and expenses, so participants can make informed decisions to manage their individual accounts. The investment related information must be provided in a format, such as a chart, that allows for comparison among the plan's investment options.	Before a participant can direct investments for the first time; At least annually thereafter; and At least quarterly for fees and expenses actually paid.
Summary of Material Modifications	A summary of significant plan changes or changes in the information required to be in the SPD.	Within 7 months of the end of the plan year in which the changes were made.

What	Description	When
Summary Annual Report	A summary of financial information filed by the plan on its Form 5500 Annual Return/Report. If your plan is required to provide an annual funding notice, your plan is not required to provide this report.	Within 9 months after the end of the plan year or 2 months after the annual report filing deadline.
Notice of Significant Reduction in Future Benefit Accruals	Notice of any significant reduction in the rate of future benefit accruals, or the elimination of or significant reduction in an early retirement benefit or retirement-type subsidy. Applies to defined benefit plans and certain defined contribution plans.	At least 45 days before the effective date of the plan amendment.
Blackout Notice	Notice of a period of more than 3 consecutive business days when there is a temporary suspension, limitation, or restriction on directing or diversifying plan assets, obtaining loans, or obtaining distributions. Applies to most 401(k) or other individual account plans.	Generally, at least 30 days before the blackout date.
Annual Report (Form 5500) – most recent report	Financial information about the plan that most plans are required to file with the government within 7 months of the end of the plan year.	Reasonable copying charge

Chapter 12
Review Questions

1. Documents do not have to be maintained at each employer establishment, union hall, or office but must be available at any such location within how many calendar days after the day on which a request for disclosure is made?

( ) A. 7 days
( ) B. 10 days
( ) C. 20 days
( ) D. 30 days

2. The Summary Annual Report (SAR) must be within how many months after the close of the plan's year?

( ) A. 3 months
( ) B. 6 months
( ) C. 9 months
( ) D. 12 months

3. The *Blackout Period Notice* requires at least how many days advance notice before a 401(k) is closed to participant transactions?

( ) A. 30 days
( ) B. 45 days
( ) C. 90 days
( ) D. 180 days

4. The *Automatic Enrollment Notice* (AEN) must be provided to the eligible participant at least within how many days before he or she is eligible to participate in the plan?

( ) A. 7 days
( ) B. 10 days
( ) C. 20 days
( ) D. 30 days

5. If the total assets exceed what amount, Form 5500-EZ must be filed for all of the employer's one-participating plans?

( ) A. $100,000
( ) B. $500,000
( ) C. $1,000,000
( ) D. $250,000

CHAPTER REVIEW
ANSWERS

Chapter 1 1. A 2. A 3. C 4. C 5. B	**Chapter 2** 1. A 2. D 3. C 4. B 5. D	**Chapter 3** 1. D 2. C 3. A 4. D 5. B
Chapter 4 1. B 2. C 3. A 4. B 5. D	**Chapter 5** 1. C 2. D 3. A 4. B 5. A	**Chapter 6** 1. C 2. D 3. A 4. B 5. A
Chapter 7 1. C 2. A 3. C 4. B 5. D	**Chapter 8** 1. D 2. A 3. C 4. C 5. D	**Chapter 9** 1. B 2. C 3. A 4. B 5. B
Chapter 10 1. A 2. A 3. D 4. D 5. D	**Chapter 11** 1. B 2. D 3. A 4. B 5. C	**Chapter 12** 1. B 2. C 3. A 4. D 5. D

This page left blank intentionally

CONFIDENTIAL FEEDBACK

The Advisors Guide to 401(k) Plans
(2018 Edition)

Date:____________________

Please feel free to use this Confidential Feedback Form to submit your comments to Broker Educational Sales and Training, Inc.

How would you rate this course?

CONTENT – Complete & accurate?

☐ **Excellent** ☐ **Good** ☐ **Adequate** ☐ **Poor**

FORMAT – easy to use, understandable?

☐ **Excellent** ☐ **Good** ☐ **Adequate** ☐ **Poor**

How much time did it take you to complete the course?______________Hours

Would you recommend this course to others? Yes ☐ No ☐

If you have any additional comments on this course please use the space below and be as specific as you can. (*Please use back of this sheet if more space is required)*

Broker Educational Sales & Training, Inc. relies on feedback from people like you who take our courses. We welcome both compliments and criticism. Your comments are the most direct means we have of checking the quality and effectiveness of the programs we publish. Please complete the personal information below so we can contact you if necessary.

Name:____

Company Name:____________________________________

Street:____

City, State, ZIP:__________________________________

Telephone:______________________________________

Telephone number: 800-345-5669 Fax number: 727-372-7585 www.brokered.net