The ABCs of 401(k)

Tax Exempt and Government Entities

Employee Plans

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FORUM2004

Good morning/afternoon.

Introduce yourself and provide your qualifications for speaking.

Two years ago at the 2002 IRS Nationwide Tax Forum, Employee Plans' presentation was "Choosing A Retirement Solution for Your Small Business". During that session, we provided a brief overview of the different types of small business retirement plans available, from the simplest to the most complex.

Last year, we provided you with a more in-depth look at what is involved in "Establishing" and "Operating" the simpler "no fuss" retirement plans, such as simplified employee pensions, known as SEPs, and SIMPLE IRAs that were introduced at the 2002 Tax Forum.

Today's presentation will be focusing on the basics of 401(k) Plans.

Pension Plans

- What is a Qualified Plan?
- What are the advantages of having a Qualified Plan?
- 401(k) is a Qualified Plan
- What are the advantages of having a 401(k) plan?

Let’s start at the beginning. What exactly is a qualified plan? Section 401(a) of the Internal Revenue Code provides certain requirements that must be satisfied in order for a retirement plan to be “qualified”. If the plan meets these requirements, then it is afforded certain tax advantages. If it does not meet these requirements, then it is not “qualified” and none of these tax advantages are available.

There are several advantages of having a qualified plan. Having a qualified plan can help an employer attract and retain good employees. Employers are entitled to a tax deduction for contributions made to its employees’ retirement. Monies set aside in a retirement plan grow tax-deferred until they are distributed.

A 401(k) plan is a cash or deferred arrangement that is part of an eligible qualified plan. It allows both the employer and employee to share responsibility toward the employee’s retirement. It benefits both owner-employees and rank-and-file employees. Employees are able to defer taxation on a portion of their salaries and have the ability to determine how much or how little they wish to set aside for their retirement. A 401(k) plan may allow participants to take their benefits with them when they leave the company, easing administrative burdens on the plan sponsor. If provided for in the plan document and certain criteria are met, employees can borrow money from their retirement account or receive hardship distributions.

Pension Lingo

- Vesting
- Nondiscrimination
  - ACP & ADP Testing
  - Highly Compensated Employee
- Compensation
- Eligibility
- Coverage

In order to understand how a 401(k) plan works, we need to go over some basic terminology.

Vesting means how much ownership an employee/participant has in his or her retirement account. The Internal Revenue Code requires that employees must always be 100% vested in, or have complete ownership of, their salary deferrals. However, in a 401(k) plan, the employer is allowed to impose a vesting schedule on employer contributions that are not salary deferrals. This means an employer can require an employee to be employed for a certain length of time before they have any ownership in the employer contributions. One such vesting schedule is a graduated vesting schedule which provides for 20% vesting after 2 years of service and an additional 20% for each year of service thereafter. Different vesting rules apply to a Safe Harbor 401(k), which we will discuss in more detail later in the presentation.

A traditional 401(k) plan that provides for both salary deferrals and matching contributions is subject to special nondiscrimination tests: the actual deferral percentage and actual contribution percentage tests, commonly referred to as the ADP and ACP tests. This means that the plan has to provide comparable benefits to all employees – rank-and-file employees and highly compensated employees. A highly compensated employee is an individual who owned more than 5% of the capital or profits interest in the business at any time during the current or preceding year, or who for the preceding year, received compensation from the employer of more than $90,000 and, if the employer chooses, was in the top 20% of employees when ranked by compensation. The tests are mathematical tests that limit the amount that highly compensated employees can defer or receive under the plan when compared to the non-highly compensated employees. Traditional 401(k) plans must meet these nondiscrimination rules each year. Safe harbor 401(k) plans are not subject to these tests.

Compensation must be defined in your plan document. You must follow this definition in the operation of the plan. Typically, compensation is defined as W-2 wages. Compensation is used to determine benefits, to calculate deferral limitations, and to test for nondiscrimination. The amount of compensation that can be taken into consideration is limited by the Internal Revenue Code and is subject to annual cost-of-living adjustments. In 2004, this limit is $205,000.

Eligibility refers to which employees must be included in the plan. The Code provides for certain permitted exclusions. For example, an employee who has not attained age 21 and completed a year of service may be excluded from participation in the plan. A plan may not require more than 1 year of service to be eligible to participate in the 401(k) portion of the plan. The plan can be less restrictive, but not more. For example, it can provide that there is no age exclusion, but it cannot exclude all employees under age 30. The plan may not exclude employees based on a maximum age.

Coverage refers to another mathematical test provided in the Code that requires that a certain percentage of employees are benefiting under the plan. Again, this is a test to ensure that rank-and-file employees are covered under the plan, not just highly compensated employees.

More Pension Lingo

- Elective Deferrals
- Matching & Non-elective Contributions
- Limitations
  - Individual/Employer/Maximum
- Deductions
- Distributions

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“Elective deferrals” are the amounts that participants elect to have contributed to their 401(k) accounts rather than receive in their current salaries. The amount that an employee can defer each year is limited by the Code. These elective deferrals are also known as “salary deferrals” and “employee pre-tax contributions”. You will see all three names used interchangeably throughout this presentation and in reference materials.

Matching contributions are employer contributions that are based upon an employee’s elective deferrals or employee after-tax contributions. For example, the plan document may call for an employer match of 10% of the employee’s elective deferrals. If the employee defers $1,000, the employer will make a contribution of $100 to the employee’s matching contributions account. Non-elective contributions are employer contributions that are not contingent on an employee electing to defer a portion of his or her salary and are typically based on a percentage of the employee’s compensation. For example, if you have two employees who each earn $10,000 in compensation and one employee defers $1,000 and the other $0. Then if the employer elects to make a 15% non-elective contribution, both employees will receive a contribution in the amount of $1,500. The employer has the discretion to make or not make non-elective contributions from year to year in a traditional 401(k) plan.

“Limitations” refer to the limitations on contributions, deferrals and deductions imposed by the Internal Revenue Code. For the calendar year 2004, the maximum amount an employee can defer is $13,000. If the plan allows, an employee aged 50 or over may defer an additional $3,000. These are known as catch-up contributions and are beyond the scope of this presentation. Total employee and employer contributions for a participant are limited to the lesser of $41,000 or 100% of the participant’s compensation.

Deductions are also limited by the Code. The maximum amount that an employer can deduct for all participants in all its employee plans, excluding elective deferrals, is limited to 25% of the aggregate compensation for all participants.

Benefits in a 401(k) plan are dependent on a participant’s account balance at the time of distribution. When participants are eligible to receive a distribution, they typically can elect either to take a lump sum distribution or have the balance in their account rolled over to an IRA or to another employer’s retirement plan. Distributions from a retirement plan are reported on Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. Early distributions from a qualified retirement plan that are not rolled over to another employer’s retirement plan or an IRA are subject to a 10% additional tax.

Safe Harbor 401(k)

Employer must choose one of the following:

- (Basic) Match 100% of the first 3% of compensation, plus 50% of the next 2% of compensation OR
- (Non-elective) Contribute 3% of compensation to all eligible employees

- Reduces complicated nondiscrimination testing when you make only the required contribution
- Employees are 100% vested in employer contributions

In a typical safe harbor 401(k) plan, the employer must match each eligible employee's contribution, dollar-for-dollar, up to 3 percent of the employee's compensation and 50 cents on the dollar for the employee's contribution that exceeds 3 percent, but not 5 percent, of the employee's compensation (other matching formulas are permissible, but they must be at least as generous as this one.). Alternatively, the employer can make a non-elective contribution to each eligible employee's account of 3 percent of the employee's compensation. Each year, the employer must make either the matching contribution or the non-elective contribution.

The benefit of setting up a safe harbor 401(k) plan just described, is that the employer is not required to run the annual ADP and ACP testing that is required of the traditional 401(k) plan. This testing can be costly, time consuming and may limit the amount of elective deferrals that can be made by highly compensated employees.

In a safe harbor 401(k), the employees are always 100% vested in employer contributions. As discussed earlier, employee contributions are always 100% vested, regardless of the type of 401(k) plan adopted.

401(k) for Self-employeds

- Change in Law created new possibility
  - Limited use
  - Salary deferral plus 25% compensation contribution
- 402(g) problem

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Many of you may have heard of the "Uni-K" or "Solo-K" or "401(k) for Self-Employed". This is not a new type of plan, but a traditional 401(k) plan with only one employee. The sudden appearance of these plans is a result of a tax law change that became effective in 2002. The law change affected how salary deferral contributions are treated when calculating the maximum contribution amount for a participant. This change created an opportunity for some people to put away additional amounts toward their retirement. This type of plan is designed for business owners who do not have any employees, except for perhaps their spouse. The advantages stressed by marketers of these types of plans evaporate if the employer expands the business and hires additional employees.

We have seen practitioners marketing these plans to self-employed individuals who are also employed by another company and participating in another 401(k) or 403(b) plan. Earlier we discussed the limits on an employee's elective deferrals. These limits are by individual, not by plans. If an individual, aged 40, is employed by XYZ Company, participates in the XYZ Company's 401(k) plan and defers the maximum allowed by Code section 402(g) for 2004, $13,000, and also has his or own business with a 401(k), he or she will not be able to defer anything in the self-employed 401(k). This is because the Code section 402(g) limit is by the individual and he or she has already deferred the maximum allowed for the year.

The IRS is not promoting these plans nor are we saying these plans are bad. We simply suggest that employers use care when looking into any retirement arrangement and that they are sure the plan they decide on is right for them and that they look not only on the limits that apply to the plan but to themselves.

Steps for Setting up a 401(k)

- Execute Plan Document
- Arrange Trust
- Establish Record Keeping System
- Select Investment Choices
- Provide Information to Employees

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Plans begin with a written document that serves as the foundation for day-to-day operations. The employer is bound by the terms of the plan. The plan is not effective until the plan document has been executed.

A plan's assets must be held in trust to assure that assets are used solely to benefit the participants and their beneficiaries. The trust must have at least one trustee to handle plan investments and contributions and distributions to and from the 401(k) plan. Since the financial integrity of the plan depends on the trustee, this is one of the most important decisions the plan sponsor will make in establishing a 401(k) plan. If the plan is set up through insurance contracts, the contracts do not need to be held in trust.

An accurate recordkeeping system is necessary as it helps track the flow of money – contributions, earnings and losses in participants' accounts, plan investments, expenses, benefit distributions; and will help in preparation of the plan's annual return/report that must be filed with the Federal government.

When designing the plan, the plan sponsor must decide whether to permit the plan participants to direct investment of their accounts or whether to manage the monies on their behalf. If the plan sponsor chooses to allow the participants to direct their accounts, it will be necessary to decide what investment options to make available to the participants. The plan sponsor's role as a plan fiduciary must be taken seriously.

The plan sponsor must notify employees who are eligible to participate in the plan about the plan's benefits and requirements. A summary plan description is the primary vehicle to inform participants and beneficiaries about how the plan operates. The plan sponsor may want to provide its employees with information that discusses the advantages of joining the 401(k) plan – such as pre-tax contributions to the plan, employer contributions and compounded tax deferred earnings.

Reporting to Government Agencies

- Form 5500 Series
- Form 1099-R
- Form W-2

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Most 401(k) plans are required to file an annual return/report with the Federal government. Depending on the number and type of participants covered, most 401(k) plans must file either a Form 5500, Annual Return/Report of Employee Benefit Plan, or Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan. The Form 5500 is designed to disclose information about the plan and its operation to the IRS, the U.S. Department of Labor, plan participants and the public.

Most one-participant plans with total assets of $100,000 or less are exempt from the annual filing requirement. A final return/report must be filed when a plan is terminated regardless of the value of the plan assets.

Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., is given to both the IRS and recipients of distributions from the plan during the previous year. It is used to report distributions (including rollovers) from a retirement plan.

Employee deferrals are reported in box 12 of the Form W-2, Wage and Tax Statement.

Compliance

- Common Problems

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Several types of errors that occur commonly in 401(k) plans are:

Failure to provide participants receiving an eligible rollover distribution the option to have the distribution transferred in the form of a direct rollover to another eligible retirement plan. The Code requires that certain distributions must be allowed to be directly rolled over to another eligible retirement plan. If the eligible rollover distribution is not transferred by a direct rollover, the distribution is subject to withholding at a 20% rate. The plan administrator must provide a written explanation to the participant within a specified period of time before making the eligible rollover distribution, explaining how funds may be transferred, when the withholding of tax applies and the rollover rules.

Failure to calculate the ADP/ACP nondiscrimination tests correctly and failure to correct excesses in order to pass the tests. A common error identified was to exclude from the ADP and ACP tests eligible employees who chose not to make salary deferrals for the year. Any employee who meets the eligibility requirements must be included in the test with a $0 deferral amount. Another common error was to improperly classify highly compensated employees as non-highly compensated, causing the nondiscrimination test to fail. When the tests are failed, the regulations afford the plan the opportunity to either distribute excesses or make additional contributions in order to satisfy the tests.

Failure to satisfy the requirements of the Code with respect to participant loans. While this may or may not affect the qualified status of the plan, it can cause adverse tax consequences to the plan participants. The regulations provide that a loan from a qualified plan is treated as a deemed distribution, unless the loan meets certain requirements. These include a dollar limit, a time period for repayments, an amortization schedule and a legally enforceable loan agreement. A deemed distribution generally occurs when any of these requirements are not satisfied in form or in operation. The amount includible in income, as a result of a deemed distribution, must be reported on Form 1099-R.

Hardship distributions are another area of noncompliance. The Code allows for hardship distribution only upon the occurrence of certain events stated in the plan. After it is determined that a hardship exists, the plan, if the plan document allows, may make a hardship distribution, if certain conditions are satisfied. Under most plans, the recipient of the hardship distribution must be suspended from making elective deferrals for six months and he or she must have obtained all distributions and non-taxable loans available under the plan prior to receiving the hardship distribution.

A plan is considered top heavy if the aggregate value of the accounts of key employees (certain officers and owners) under the plan exceeds 60% of the aggregate value of the accounts of all employees. If a 401(k) plan is top heavy, then the employer contribution for the year for each participant who is a non-key employee must be the lesser of 3% of the participant's compensation or the maximum contribution rate made for any key employee. When determining the amount of contributions made for a key employee, elective and matching contributions are counted. However, elective contributions made on behalf of a non-key employee are not counted to determine if the employee received the required minimum contribution. Matching contributions, on the other hand, can be used to satisfy the top heavy minimum contribution for a non-key employee. It has

been found that elective contributions were incorrectly taken into account in determining the amount of the employer contributions for non-key employees.

It is important to know the provisions of the plan document. The terms of the plan must be followed in operation. To fail to do so is a compliance problem.

One of the most common problems encountered on audit is the late deposit of salary deferrals. They must be deposited as soon as they can be segregated from the employer's assets, which is usually the date the paycheck is issued. Unfortunately, many employers look at the DOL rules that refer to the 15th day of the following month as a "safe harbor". It isn't. Late deposits are prohibited transactions.

Find A Problem?

- IRS
  - EPCRS - Employee Plans Compliance Resolution System
- DOL
  - VFCP - Voluntary Fiduciary Correction Program

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The IRS has a comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements - but have failed - of the Internal Revenue Code.

The system – called the **Employee Plans Compliance Resolution System** or "EPCRS" - permits plan sponsors to correct most retirement plan failures and thereby continue to enjoy tax-favored status for their retirement plans. EPCRS also allows employees to continue accruing retirement benefits on a tax-favored basis. In early June 2003, the IRS came out with a new Rev. Proc. (2003-44) that details certain corrections allowable to maintain your deductions for contributions to a 401(k) plan.

Under EPCRS, employers can self-correct certain 401(k) plan failures under the self-correction program (SCP) or apply to the IRS for correction under the voluntary correction program (VCP). The application involves a payment of a fee and the IRS will provide a written approval of the correction method.

The Department of Labor's Employee Benefits Security Administration, EBSA, (formerly known as Pension Welfare Benefits Administration, or PWBA) has a correction program, the Voluntary Fiduciary Correction Program. You can visit their website for additional information on this program.

More Information

- www.irs.gov/ep
  - 401(k) Plans for Small Businesses
- 1-877-829-5500: Customer Account Services
- www.dol.gov/ebsa
  - 401(k) Plans for Small Businesses

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If you need additional information, we can help. The IRS has a website dealing with retirement plans. It can be found at www.irs.gov/ep. You can sign up to receive our electronic newsletters, the Employee Plans News or the Retirement News for Employers. We have a Customer Account Service toll-free telephone number that is staffed by Employee Plans Specialists. In addition, the Department of Labor has a website with further information on 401(k) plans. Finally, you can visit us at our booth in the exhibit hall where we can provide you with information or answer any specific questions you may have. You will want to come by and pick up our brochure, 401(k) Plans for Small Businesses.

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