THE EMPLOYEE BENEFIT
Forum
current issues in retirement benefit planning

qualified PLANS LLC

Correcting Excess 401(k) Contributions

SITUATION: When we conducted our annual nondiscrimination testing, we found that several of our highly compensated employees had contributed disproportionately more to our 401(k) plan than lower paid employees. Our plan failed the "actual deferral percentage" (ADP) test for the first time.

QUESTION: What do we need to do?

ANSWER: To avoid possible plan disqualification, you need to correct the excess contributions.

DISCUSSION: The ADP test compares the average rate at which highly compensated employees defer salary with the average deferral rate for nonhighly compensated employees. The difference between highly paid and lower paid employees must be within certain limits. If it isn't, you need to correct the excess contributions. You basically have three options.

Distribution option. The plan can return the excess contributions and any plan income attributable to those contributions to the appropriate highly compensated employees within 12 months of the close of the plan year. However, if the distributions are returned more than 2½ months following the close of the plan year, the employer is subject to a 10% excise tax. For plans that are "eligible automatic contribution arrangements," corrective distributions can be made up to six months following the end of the plan year without incurring the excise tax. The distributions are taxable to the employees.

Recharacterization option. Alternatively, the plan can recharacterize the excess contributions as after-tax contributions. To do so, your plan must have a provision allowing such contributions, and the recharacterization must occur no later than 2½ months after plan year-end. Amounts recharacterized as after-tax contributions are includable in the highly compensated employees' income for federal income-tax purposes.

Or instead, if the plan allows, an excess contribution made by an employee who is age 50 or older may be treated as a catch-up contribution to the extent the employee hasn't already made the maximum allowable catch-up contribution for the year.

Additional contributions option. Another alternative is to make qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs) for nonhighly compensated employees. Such contributions will be treated as elective contributions for ADP testing purposes.

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No COLAs Again for 2011

The 2011 plan limitations are in. And for the second year in a row, these retirement plan contribution and benefit limitations are unchanged:

- 401(k), 403(b), and 457 plan deferrals and catch-up contributions, $16,500/ $5,500
- SIMPLE deferrals and catch-up contributions, $11,500/$2,500
- The maximum annual contribution that can be made to an IRA, $5,000; $6,000 for individuals age 50 or older
- Maximum annual additions to defined contribution plan account, $49,000
- Maximum annual benefit from defined benefit pension plans, $195,000
- Maximum annual compensation used to determine qualified plan benefits or contributions, $245,000
- Dollar limit used in the definition of "highly compensated employee," $110,000
- Compensation limit for determining whether officers are key employees for top-heavy plan purposes, $160,000
- Social Security taxable wage base, $106,800

A New Roth Opportunity

Roth contribution programs have been available to 401(k) and 403(b) plans since 2006. However, plans that have a Roth feature have not been able to let participants roll over distributions from their regular plan accounts to in-plan Roth accounts — until now. Under the Small Business Jobs Act of 2010 (the "Jobs Act"), plans may now allow in-plan Roth conversions of eligible rollover distributions.

The Jobs Act also makes Roth contribution programs and in-plan Roth conversions available to governmental 457(b) plans, starting in 2011.

Not all amounts may be converted. Generally, plans may provide for in-service distribution and conversion of pretax employee deferrals (and related earnings) once a participant reaches age 59½. Different distribution restrictions may apply to employer contributions, after-tax contributions, and rollover amounts.

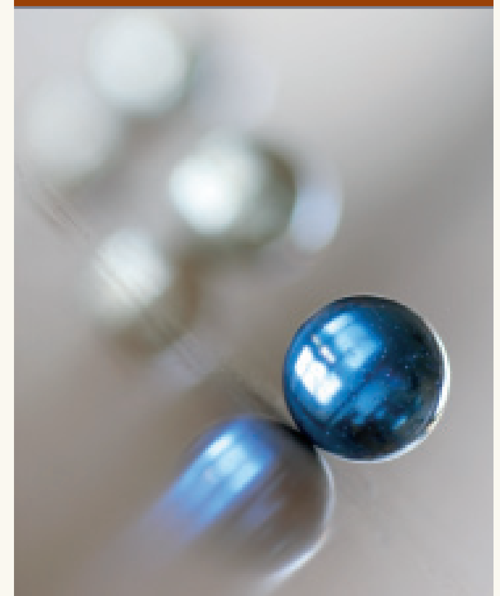
Who May Want To Convert

An in-plan Roth conversion may be attractive to employees who want to convert but prefer to keep their savings in the plan rather than roll their money into a Roth IRA. Like a Roth IRA, a designated Roth account offers the potential for tax-free distributions. Employees who elect an in-plan conversion will owe income taxes (but not the 10% early withdrawal penalty) on any tax-deferred contributions and all earnings they convert.

Not Required

Plans do not have to offer Roth contributions or conversions. However, employers may want to consider updating their plans with these features. Please contact us if you would like to discuss the new Roth rollover opportunity.

Under the Small Business Jobs Act of 2010, plans may now allow in-plan Roth conversions of eligible rollover distributions.



IRS Compliance Check

In May of last year, 1,200 401(k) plan sponsors (randomly chosen from 2007 Form 5500 filings) received questionnaires from the IRS. The goal of the project was to identify areas where 401(k) plans are most likely to be noncompliant. The IRS intends to use the questionnaire to fine-tune its techniques for selecting plans for audit. Employers not chosen for this project can use the questionnaire as a valuable self-audit tool.

What kind of information does the questionnaire ask for? The questionnaire consists of 69 questions, many of which have multiple parts. The questions cover all aspects of 401(k) plans, including participation, contributions, testing results, and distributions, as well as optional plan features, such as loans and hardship withdrawals. Some questions are straightforward and can be answered from the relevant Form 5500 filing; others are more complex. In some cases, the questions are subjective, asking sponsors to rank how various factors influence participation and give their opinion about how recent "financial conditions" affected participant behavior.

Although most of the information requested pertains to data from the 2008 plan year, employers completing the questionnaire had to retrieve data from their 2006 and 2007 plan years to fully answer some sections. You can view the questionnaire at *www.irs.gov/pub/irs-tege/epcu_401k_questionnaire.pdf.*

What happened if a problem was discovered? If an employer found a problem while filling out the questionnaire, the sponsor was able to take advantage of the self-correction or voluntary compliance programs under the IRS's Employee Plans Compliance Resolution System (EPCRS). Ideally, sponsors could remedy the situation and bring their plan back into compliance *before* the IRS took action. Opportunities to self-correct are generally not available once a plan examination is launched.

How does this examination program affect plans that didn't receive a questionnaire? The compliance check is a clear signal that the IRS is stepping up its efforts to identify noncompliant plans. The good news is that the questionnaire clearly highlights areas of IRS "interest" and provides employers with valuable insight.

If you have any concerns, or if it's been a while since you conducted a thorough review of your plan, this would be a good time — while the IRS is analyzing the information it has gathered — to conduct a self-audit using the questionnaire as a guide.

What if *we* discover a problem? Qualified 401(k) retirement plans are complex, and it's not uncommon for employers to make errors. If you discover a problem, you may be able to take steps to bring your plan back into compliance through EPCRS — before the IRS gets involved.

There are two EPCRS programs that can help 401(k) sponsors correct their plans. The self-correction program (SCP) allows certain operational errors to be corrected without contacting the IRS. Generally speaking, insignificant errors may be corrected at any time through SCP, and there is no fee involved. If your plan has a favorable determination letter from the IRS, even some errors that are considered to be significant may be self-corrected, as long as you substantially complete the correction by the end of the second plan year after the plan year of the failure.

The voluntary correction program (VCP) requires the IRS's involvement. Under the VCP, you submit your proposed corrections to the IRS for approval and then obtain the IRS's written approval to make those corrections. There is a fee for using the VCP.

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RECENT DEVELOPMENTS
In Benefit Plans

Fee Disclosure. The U.S. Department of Labor (DOL) has issued two regulations requiring retirement plan fee disclosure. The first mandates comprehensive fee disclosure by plan service providers (e.g., recordkeepers, brokers, and investment advisors), effective as of July 16, 2011. The second requires plan administrators (often the employer sponsoring the plan) to disclose plan-related fees and expenses to participants. This regulation applies to plan years beginning on or after November 1, 2011.

Change in Reporting Plan Loans. The Financial Accounting Standards Board (FASB) has clarified how 401(k) and other defined contribution plans should classify and measure the value of participant plan loans for purposes of the plans' annual financial statements. Generally effective for fiscal years ending after December 15, 2010, these loans should be classified as notes receivable from participants, which are segregated from plan investments and measured at the outstanding principal amount plus accrued but unpaid interest.

Retirement Readiness. For most age groups, the 2010 Employee Benefit Research Institute's Retirement Readiness Rating shows a notable decrease from 2003 in the percentage of employees who are in danger of not having adequate "basic" retirement income. The exceptions: the lowest earning Early Baby Boomers and lowest earning Late Boomers (only a 2 and 6 percentage point decrease, respectively). Still, 47.2% of the Early Baby Boomers (born 1948–1954), 43.7% of the Late Boomers (1955–1964), and 44.5% of Generation Xers (1965–1974) are at risk.

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