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Retirement PLAN news

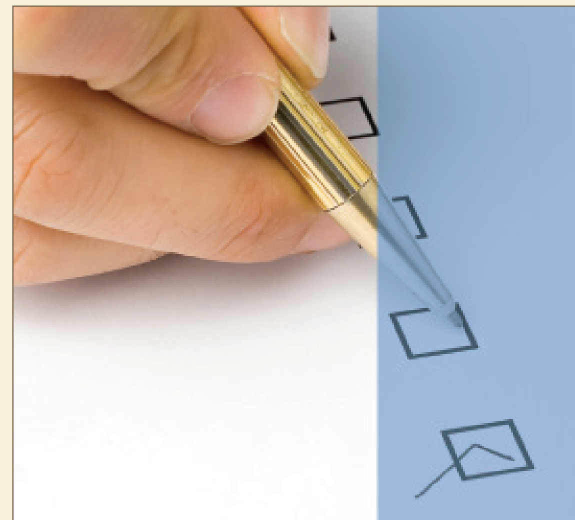
401(k) questionnaire: The final IRS report

Millions of Americans participate in 401(k) plans, making them the most common type of retirement plan. Not surprisingly, the IRS is concerned about whether plans are in compliance with the Internal Revenue Code, with IRS regulations, and with each individual plan's document.

Those concerns led to the 401(k) Compliance Check Questionnaire, which was created to help the IRS understand the compliance challenges facing plan sponsors and then determine the best ways to allocate IRS resources in promoting voluntary compliance. In 2010, the electronic questionnaire was sent to randomly selected 401(k) plan sponsors (chosen from the 2007 Form 5500 filings) and completed by 1,060 of them. The questionnaire was administered by the IRS's Employee Plans Compliance Unit (EPCU), responses were analyzed by the Tax Exempt and Government Entities Division (TE/GE), and the final report was published earlier this year.

Objectives

There were several key objectives: to measure the health (overall compliance levels) of 401(k) plans, identify the principal tax compliance issues affecting 401(k) plans, evaluate the effectiveness of the IRS Employee Plans Compliance Resolution System (EPCRS) voluntary compliance program (VCP) and tools, and determine how the IRS can foster greater compliance.



Information was gathered in the following areas: participant demographics; plan participation; employer and employee contributions; top-heavy, actual deferral percentage (ADP), and actual contribution percentage (ACP) testing; distributions and plan loans; other plan

Data grouped in four strata based on plan size (number of participants)

Plan size	Number of participants	Reported number of plans	Proportion of 401(k) segment	Percent in questionnaire
Small	1 – 5	77,154	17%	14.20%
Medium	6 – 100	319,026	70%	58.33%
Large	101 – 2,500	56,465	12%	10.83%
Very large	2,501+	3,235	1%	16.67%
	Total	455,880	100%	100%

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operations; automatic contribution arrangements (ACA); designated Roth features; plan amendments; Form 5500; plan administration; and the plan sponsor's awareness of the IRS compliance and correction programs.

Results

The IRS will use the questionnaire findings to modify and improve 401(k) plan compliance tools, produce outreach materials to benefit plan sponsors, improve the VCP, assess the need for additional guidance, and define upcoming projects and enforcement activities. Following are several key findings:

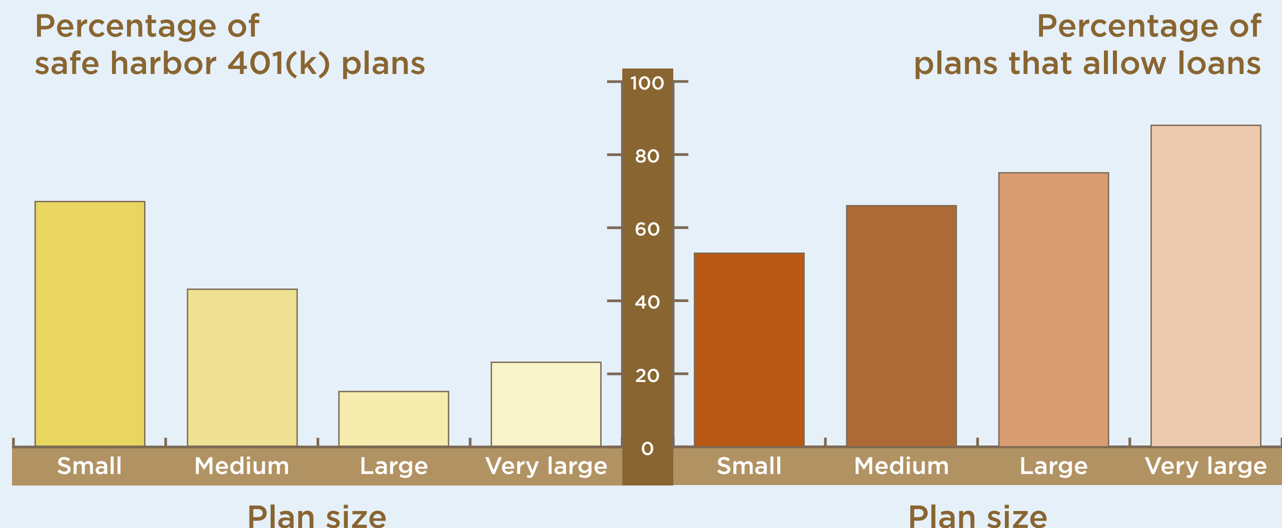
- **Top-heavy plan issues:** 20% of the 401(k) plans in the survey were top heavy. Of those, 79% provided nonkey employees with top-heavy contributions and 19% admitted they do not provide a top-heavy contribution. This leads one (and the IRS) to wonder: Why are there so many employers who are not making the required top-heavy contribution? This is not entirely surprising. The IRS did a study several years ago and found the two most common failures employers make are 1) failure to obtain a bond and 2) failure to comply with the top-heavy rules. Between the research a few years ago and the recent final 401(k) questionnaire results, it would not be surprising if the IRS decides to focus on providing outreach and education about the top-heavy rules. It is also notable that 2% of the top-heavy plan sponsors indicated they satisfied the minimum contribution requirement in another plan.
- **Employee Plans Compliance Resolution System:** 65% of plan sponsors are aware of EPCRS, and 6% of plan sponsors have used it. Sponsors of very large plans are more likely to be aware of or use EPCRS than small, medium, or large plan sponsors. Because these results indicate that 35% of plan sponsors are not aware of EPCRS, the IRS may become more proactive in educating small, medium, and large plan sponsors about the benefits of EPCRS and encouraging the overall retirement plan industry to file under EPCRS.
- **Nondiscrimination testing:** The majority of 401(k) plan sponsors correct excess contributions within 2½ months following the end of the year of the excess, thus avoiding IRS penalties for issuing late test refunds. More than three quarters of 401(k) plan sponsors correct nondiscrimination testing failures by distributing excess contributions instead of making additional contributions to avoid refunds. 60% of plans used current year ADP/ACP testing, while only 31% used prior year ADP/ACP testing. The remaining 9% answered that they were exempt from testing.
- **Hardship distributions and loans:** 76% of the 401(k) plans responding to the questionnaire permit hardship distributions, and 65% allow participant loans. Sponsors of very large plans are more likely than small, medium, or large plan sponsors to offer hardship distributions and loans.

Self-audits

The IRS recommends that sponsors periodically perform an internal self-audit of plan operations and administration to ensure their plan is compliant with applicable requirements and the plan document. Self-auditing typically results in establishing internal controls and practices to help avoid failures and to provide prompt correction for failures when they do arise. Performing self-audits may also help demonstrate to the IRS (in the event of an examination) that the plan is being operated with a concern for compliance.

To help plans stay in compliance, the IRS has announced that additional internal control questions will be added to the 401(k) questionnaire later this year, and it will be repackaged as the Questionnaire Self-Audit Tool (QSAT). The QSAT will help plan sponsors find, fix, and avoid costly mistakes and will ultimately strengthen internal controls over plan operations.

The full 401(k) Compliance Check Questionnaire Final Report can be found at *www.irs.gov/file_source/pub/irs-tege/401k_final_report.pdf*.



Safe harbor 401(k) plan options for 2014

Sponsors who make employer contributions to their 401(k)s can reap additional benefits by using a safe harbor plan design. Now's the time to consider whether a safe harbor design is right for your plan.

What are the additional benefits? Plans that use a safe harbor design are exempt from the nondiscrimination tests that apply to employee deferrals and matching contributions: the actual deferral percentage (ADP) test and, if applicable, the actual contribution percentage (ACP) test. Being exempt from testing allows highly compensated employees (HCEs) to defer the maximum amount of compensation permitted by law. Another advantage is that safe harbor plans that adhere to certain rules are exempt from the top-heavy rules.

Safe harbor rules

Plan sponsors may satisfy traditional safe harbor contribution requirements either by making a nonelective contribution (NEC) or by using a matching formula.

Nonelective contribution: The contribution must be 3% (or more) of compensation, and it must be made to all eligible non-highly compensated employees (NHCEs) who are participants, regardless of whether they make elective deferrals to the plan. The plan may also be designed to provide the safe harbor contribution to highly compensated employees (HCEs) who are participants. The NEC may be either *guaranteed* or *flexible*. An employer who provides a guaranteed 3% NEC is required to make that contribution. A flexible NEC permits the employer to decide each year whether to provide the NEC. If the sponsor chooses not to provide the NEC, the plan will be subject to the nondiscrimination testing requirements that apply to non-safe-harbor plans.

Matching contribution: The employer may elect either a *basic* or an *enhanced* match. The formula for a basic safe harbor matching contribution is a 100% match on the first 3% of deferred compensation plus a 50% match on deferrals between 3% and 5%. An enhanced matching contribution must be *at least* as much as the basic match at each tier of the match formula. The rate of match may not increase as the percentage of deferrals increases. And the rate of match for *any* HCE may not exceed the rate of match for *any* NHCE group. Additionally, matching contributions may not be made on deferrals that exceed 6% of compensation.

Safe harbor contributions must be 100% vested, and no conditions — such as requiring that participants be employed on the last day of the plan year or work a minimum number of hours (1,000 hours, for example) during the plan year — may be placed on allocations.

QACA safe harbor rules

QACA stands for "qualified automatic contribution arrangement," a type of safe harbor plan with an automatic enrollment feature. QACA safe harbor provisions are different from those of a traditional safe harbor plan. The differences are:

- The QACA safe harbor matching contribution formula is a 100% match on the first 1% of compensation deferred and a 50% match on deferrals between 1% and 6%;
- A two-year cliff vesting schedule may be applied to QACA safe harbor contributions; and
- Unless the participant elects otherwise, the deferral rate starts at no less than 3% and increases at least 1% annually to no less than 6% (with a maximum of 10%).

The bottom line

When deciding between a QACA and a traditional safe harbor plan, employers need to consider at least two issues:

- Will employee turnover in the first two years result in savings due to the two-year cliff vesting schedule permitted for safe harbor matching contributions?
- Will the QACA's maximum match of 3.5% for those who are automatically enrolled or elect to defer cost more than the traditional safe harbor's maximum match of 4% for only those who actually elect to defer?

Safe harbor plan designs are very popular and, in many cases, provide valuable plan design options. In a recent survey, the IRS found that 43% of 401(k) plans are safe harbor plans. However, employers should consider the cost of maximizing HCE deferrals as well as the advantages. Expectations, finances, and demographics should all be carefully weighed.

Timing and notices

All eligible employees must be provided with an annual safe harbor notice between 30 and 90 days before the beginning of each plan year. For a newly eligible employee, the safe harbor notice may be provided between 90 days before the employee's entry date into the plan and the actual entry date. (There is a rule to coordinate notices for employees who enter during the 30 to 90 day period before the beginning of the plan year.) The safe harbor notice for a brand-new 401(k) safe harbor plan may be provided between 90 days before the plan's effective date and its actual effective date.

Calendar-year plans that want to begin safe harbor provisions for the 2014 plan year must provide a safe harbor notice between October 2, 2013, and December 2, 2013. The plan must also be amended so that safe harbor provisions are added to the plan effective January 1, 2014.

RECENT developments

GAO report on rollovers

Earlier this year, the U.S. Government Accountability Office (GAO) issued a report titled “401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants.” According to the report, many experts stated that much of the information and assistance participants receive is through the marketing efforts of service providers touting the benefits of IRA rollovers and is not always objective. Plan participants who sever employment and are seeking assistance and information about what to do with their 401(k) plan savings often receive biased information that may not serve the participants’ best interests.

The GAO also found that the current plan-to-plan rollover process is inefficient due to long waiting periods to roll savings into a new plan, complex verification procedures, and significant differences in plan paperwork. The study also found that the information participants receive describing their distribution options either lacks detail and is too generic or is too long and technical. As a result, the GAO proposed that the DOL develop a concise written summary that explains a participant’s distribution options and lists key factors to consider. The summary would be required when participants separate from their employer.

The IRS and DOL agreed with the GAO findings and will examine ways to execute the recommendations. The full report can be found at *www.gao.gov/assets/660/652881.pdf*.

PBGC premium increases

The Moving Ahead for Progress in the 21st Century Act (MAP-21) increased PBGC (Pension Benefit Guaranty Corp.) premiums for defined benefit pension plans. For single employer plans, the flat rate went from $35 to $42 in 2013 and goes up to $49 for 2014. Variable rate premiums increase from $9 per $1,000 of unfunded vested benefits to $13 for 2014 and $18 for 2015 and are subject to cost-of-living adjustments (COLAs) thereafter. The per-participant variable rate is subject to a cap of $400 for 2013 and will be indexed for COLA thereafter.

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