# GIVE YOUR 401(k) PLAN A BOOST

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## I. THE BASICS

### A. Traditional 401k Plan

1. Features

    a. Employees are permitted to make pre-tax contributions

    b. The maximum deferral permitted in 2016 is $18,000 with individuals who are age 50 or older permitted to make an additional “catch up” contribution of $6,000

    c. The plans are subject to non-discrimination testing to assure that the highly compensated employees (“HCEs”) (generally those earning more than $120,000 in 2016) do not defer disproportionately large contributions relative to the non-HCEs

2. Advantages

    a. The plans are generally funded through employee deferrals (Employer Advantage)

    b. Employer contributions are discretionary (Employer Advantage)

    c. Employees can reduce current taxable income and save for retirement (Employee Advantage)

    d. Loans and hardship distributions are often available (Employee Advantage)

e. The employer may make matching contributions to encourage participation in the plan (Employee Advantage)

f. The plan is often combined with a profit sharing feature (Employer and Employee Advantage)

3. Disadvantages

a. The Actual Deferral Percentage (ADP) Test can limit deferrals of HCEs (Employer and HCE Disadvantage)

b. The administration of the plan can be more complicated and expensive than other types of plans (Employer Disadvantage)

B. Roth 401(k) Plan

1. Features

a. Contribution limits, distribution rules and ADP Testing are identical to traditional 401(k) plans

b. Deferrals are made after tax as opposed to before tax

c. In most instances, distributions from the plan are made tax free

d. This type of feature may also be used in a traditional 401(k) plan with a before tax deferral feature

2. Advantages

a. The distributions are tax free, if qualified (Employee Advantage)

b. The distributions may be rolled into a Roth IRA and distributions postponed after age 70 ½ (Employee Advantage)

c. The plan can provide a terrific "death benefit" for younger beneficiaries (Employee Advantage)

3. Disadvantages

a. There are no current tax incentives to save through this vehicle (Employee Disadvantage)

b. There is no certainty of what future tax rates will be (Employee Disadvantage)

II. <u>HOW TO CURE ADP PROBLEMS</u>

A. What is the ADP Test?

1. Plans must meet one of two ADP Tests for the plan year:

a. Test 1. ADP for eligible HCEs is not more than the ADP of all other eligible NHCEs multiplied by 1.25; or

b. Test 2. The ADP for eligible HCEs is not more than 2 percentage points over the ADP for eligible NHCEs, and the ADP for the HCEs is not more than 2 times the ADP of eligible NHCEs

2. Example:

| | Comp. | Deferral | ADP |
|---|---|---|---|
| HCE1 | $205,000 | $13,000 | 6.34% |
| HCE2 | $180,000 | $12,000 | 6.67% |
| NHCE1 | $60,000 | $ 6,000 | 10.00% |
| NHCE2 | $40,000 | $ 3,200 | 8.00% |
| NHCE3 | $40,000 | $ 2,000 | 5.00% |
| NHCE4 | $40,000 | $ 0 | 0.00% |
| NHCE5 | $20,000 | $ 600 | 3.00% |
| NHCE6 | $20,000 | $ 300 | 1.50% |

ADP Test 1 Failed

HCE ADP% = 6.51%

NHCE ADP% = 4.58%

6.51% / 4.58% = 1.42%

Therefore ADP Test 1 Failed

ADP Test 2 Passed

6.51% - 4.58% = 1.93%

1.93% < 2% and

6.51% < 9.15 (2 times the NHCE ADP%)

Therefore ADP Test 2 Passed

B. Common Options to Pass the ADP Test

1. Refund Deferrals to HCEs

a. Most common method is to make corrective distributions of excess deferrals plus earnings

b. If an HCE has unused carryover distributions, the ADP refund may first be offset against unused catch up contributions

c. Then further distributions that are allocated to HCEs are determined by a leveling method starting with the HCE with the largest deferral

d. Refunds must be completed in 2 ½ months of the plan year end

2. QNECs or QMACs

a. The employer may make an additional plan contribution for NHCEs to raise their ADP to a level to pass ADP

i. A QNEC is a fully vested contribution allocated to the NHCEs proportional to their compensation

ii. A QMAC is a fully vested contribution allocated to the NHCEs as an additional match

b. The correction must be made by the last day of the next plan year

C. Suggestions for Curing ADP Problems

1. Adopt a Safe Harbor 401(k) Plan

a. “Safe Harbor 401(k) Plans” automatically pass the ADP Test

b. In order to qualify as a Safe Harbor 401(k) Plan, either of the two required contribution options must be provided:

i. An employer contribution of 3% of every eligible participant’s compensation; or

ii. An employer matching contribution equal to 100% of an eligible participant’s first 3% deferral and 50% of the eligible participant’s next 2% deferral

c. Additionally, participants must be notified in writing before the beginning of the plan year of the contribution methodology that will be used

2. Add or Increase Employer Matches

3. Extend Matches or Use Escalating Match Rates

a. If the plan presently provides for a 100% match on the first 2% of deferrals, consider modifying the match formula to 50% of the first 4% of deferrals

   b. If the plan presently provides for a 100% match of the first 4% of deferrals, consider modifying the match formula to 50% of the first 4% of deferrals and 100% of the next 2% of deferrals

4. Provide for automatic enrollment in the plan with a specified deferral rate (i.e. deferrals of 3% will begin automatically)

   a. This requires a new participant to make an affirmative election to either not participate or to defer another percentage

   b. Certain types of automatic enrollment arrangements allow a participant who has deferrals to “claw” them back within a specified period of time

5. Give the participants greater access to their 401(k) account balances through:

   a. Plan loans

   b. Hardship distributions

   c. In-service distributions after 59-1/2

6. Hold regular meetings with the participants to review investment options

7. Increase the opportunities for participants to change deferral elections or investment alternatives

## III. PAYMENT OPTIONS FOR PLAN EXPENSES

A. What types of expenses can/can't be paid from the plan?

1. Expenses that can't be paid by the plan and must be borne by the plan sponsor

   a. Generally, the Department of Labor does not permit expenses which relate to "settlor functions" and paid from plan assets. A settlor function is an independent business activity or decision of the plan sponsor

   b. The types of expenses referred to include:

      i. Plan design expenses such as studies of the plan's feasibility and projections

      ii. Preparation of the initial plan document

      iii. Preparation of voluntary plan amendments (required amendments due to law changes may be paid from plan assets)

      iv. Certain plan termination fees

2. Expenses that may be paid from plan assets

   a. Expenses may be paid from the plan if permitted under the plan document and they are prudent and reasonable

   b. The types of expenses that may be paid include:

      i. Participant record keeping

      ii. Non-discrimination/top-heavy testing

      iii. Preparation and distribution of benefit statements

iv. Preparation of Form 5500

v. Accountant's audit reports for large plans

vi. Summary Annual Reports

vii. Various notices such as automatic enrollment, default investments and safe harbor 401(k) plans

viii. Expenses for computing benefit payments or processing loans

ix. Plan amendments and/or restatements required by law changes or new regulations

x. IRS determination letter requests

xi. Purchase of trustees fiduciary bond

xii. Trustee fees

xiii. Investment management fees

xiv. Fees to process participant enrollment and investment elections

xv. Participant education fees

B. Which expenses can be borne directly by the Participant?

1. Generally, if authorized by the plan document, fees may be charged directly to participants for costs incurred for a particular transaction or service

2. Participants should be informed of the amount of the fee in advance

3. The types of fees typically charged directly to participants include:

    a. Fees to prepare distribution packages and consent forms

    b. Hardship withdrawal expenses

    c. Fees to prepare participant loan documents

    d. Qualified Domestic Relations Order determinations and processing fees

C. Allocating other fees among all participants

1. Plan expenses that are not charged to a specific participant's account can be allocated to all plan participants either on a pro-rata or per capita basis

2. A pro-rata allocation is done proportionately based upon account balance

3. Per capita allocation is done in a manner whereby an expense is allocated equally based upon the number of participants in the plan

4. Since the Department of Labor requires the allocation method to be prudent, it must have a rational basis with some reasonable relationship to the service provided

D. Using forfeitures to pay plan expenses

1. Some plans provide that expenses may be paid from forfeitures (created by terminating employees without full vesting)

2. If the forfeitures offset other employer contributions there is little benefit to this practice

3. If forfeitures are allocated to remaining participants as “additional contributions or benefits” this is a cost saving measure for the employer

IV. DON’T OVER LOOK ROTH OPPORTUNITIES

A. Add Roth 401(k) options to an existing traditional 401(k) plan

1. Reasons participants may select a Roth option:

a. Tax rates during retirement may be higher than their current tax rates

b. Roth deferrals diversify the future tax risk that rates will increase

c. Roth IRAs are not subject to required minimum distributions (“RMDs”)

i. RMDs are required from Roth 401(k)s; however, a Roth account could be rolled into a Roth IRA

ii. No distributions are required out of a Roth IRA until the death of the IRA owner

d. Roth deferrals/contributions allow participants to maximize retirement benefits

e. Roth deferrals facilitate estate planning by allowing for the prepayment of income taxes

2. More media coverage is occurring touting the benefits of Roth options

a. Participants may perceive they are being "short-changed" if Roth isn't available

b. The plan sponsor really incurs little additional expense by including Roth 401(k) options

B. Allow for In-Plan Roth Conversions ("Conversions")

1. What is a Conversion?

a. A provision to allow a participant to transfer a non-Roth portion of their account in a 401(k) plan into a designated Roth account

b. The amount converted is subject to Federal Income Tax in the year converted (except for any tax basis that the participant may have)

c. The ten percent early distribution penalty does not apply to amounts that are converted

d. What accounts in a 401(k) plan can be converted to a Roth account?

i. Pre-tax elective deferrals

ii. Vested matching contributions

iii. Vested non-elective employer contributions

iv. Rollover contributions

v. Earnings on any of the above accounts

2. Paying the tax created by the Conversion

    a. The big deterrent to a Conversion is the obligation to pay the tax immediately

    b. Ideally, a participant will be in a low tax bracket and have cash available to pay the tax

    c. The participant may have available other distribution opportunities from the plan such as:

        i. A plan loan

        ii. An in-service distribution of other plan assets (which will subject the distribution to taxation and penalties, if appropriate)

3. In what situations should a participant consider a Conversion?

    a. Generally, they would be the same situations where a participant determines that Roth deferrals should be made in lieu of traditional, before tax deferrals

    b. These situations would include:

        i. Participants currently in a low tax bracket

        ii. Participants who believe tax brackets will increase in future years or they will be in a higher bracket at the time of their retirement

        iii. Participants who have no need to utilize funds accumulated in the Roth account

        iv. For estate planning purpose, participants may wish to leave terrific “death benefits” to their beneficiaries (who will be able to take and then spread the distributions over their own life expectancy)