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The IRS Meets Letterman

Anyone who has ever watched late night television is familiar with the ubiquitous Top 10 List, counting down humorous examples of whatever is in the news. Not to be upstaged, the IRS has its own Top 10 List—the top 10 plan compliance failures found in voluntary correction filings.

While not nearly as entertaining, the IRS list is much more instructive. Due to the frequency of these errors, the IRS makes a point to look into these items when auditing plans. Taking steps to prevent or correct these problems can save quite a bit of time, money and frustration. So, without further ado here are the top 10 failures the IRS has identified in voluntary correction filings.

1. Failure to timely adopt amendments required by tax law changes

All qualified plans are required to have written plan documents describing their provisions. From time to time, Congress or a government agency, e.g., IRS or Department of Labor, will issue new rules or change existing ones. If these changes impact the language in the plan document, the plan must be amended to reflect the law change. Since these amendments do not follow a set schedule and deadlines vary, it is easy to overlook a deadline.

Quite often, the service provider that prepared your plan document will notify you when one of these so-called interim amendments is required. Depending on the type of plan document you use (prototype, volume submitter or custom), you may be required to sign the amendment; other times, your document provider can sign on your behalf. Regardless of these details, the IRS considers it to be your responsibility to maintain timely adopted copies of all interim amendments.

The interim amendment rules can be counter-intuitive, so it is a good idea to work with your service providers to clarify responsibilities. This is especially important when you change service providers. Taking a few minutes to identify roles and responsibilities can save hours of consternation down the road.

2. Failure to follow the plan's definition of compensation when determining benefits

There are many variations on this theme, but the gist is that plan contributions must be based on compensation as defined in the written plan document. A common definition is the amount reported in box #1 of Form W-2, grossed up for any pre-tax deferrals to a 401(k) plan and/or a cafeteria plan. That is essentially gross compensation, so failure to consider that cash bonus handed out at the company holiday party or the commissions paid to those sales people would run afoul of this definition.

Another common oversight is to calculate contributions based on an incorrect time frame. For example, many employers calculate their matching contribution each pay period; however, if the terms of the plan indicate the match should be based on activity for the entire year, it is necessary to perform a true-up calculation at the end of the year to make sure all employees receive the full match to which they are entitled.

One possible way to minimize compensation errors is to work with your payroll provider to confirm that the various pay codes they use in their system are consistent with your plan document.

3. Failure to include eligible employees or exclude ineligible employees

This one probably seems self-explanatory, but there are a number of details that can complicate matters. These errors often arise due to a misunderstanding of the plan's eligibility provisions. For example, if a plan provides for immediate eligibility, your employees' high school and college kids who come to work part time over the summer are eligible for the plan. Although they probably wouldn't make contributions anyway, if they are not given the opportunity to enroll, they are treated as being improperly excluded, and the company must contribute on their behalf to correct the error.

It is also a problem to include someone the plan or the law says should be excluded. A newly hired executive cannot be allowed to join the plan right away if the eligibility requirements specify a one-year waiting period.

4. Failure to follow the rules related to participant loans

The loan rules are complex and rigid. Regulations limit the amount, duration and payment terms for participant loans and even the slightest misstep creates a compliance failure. Even worse, loan errors cannot be self-corrected; any corrections must be submitted to the IRS for formal review and approval which can be a costly undertaking. Examples of loan errors include failing to timely set up payroll to withhold payments for a new loan, allowing a participant who has fallen on hard times to suspend payments and approving a loan for too much or too long.

A loan that does not follow the rules or remain within the prescribed limits is treated as a taxable distribution to the participant in question. Although it may be tempting to "help" an employee who is having trouble making payments or needs a few extra dollars, that favor can do more harm than good.

5. Failure to follow rules related to in-service withdrawals

A plan document will specify whether and under what conditions in-service withdrawals are permitted. For example, a plan may offer hardship distributions and/or other in-service distributions on attainment of age 59½. However, there are additional restrictions. IRS rules provide a "safe harbor" definition of what constitutes a financial hardship and many plans incorporate that definition. If an employee needs money for a car repair so that he can get to work, it might sound like a hardship; but it does not fit within the IRS definition. A plan sponsor that does this employee a favor puts the entire plan in jeopardy.

In addition, there are legal restrictions on money types that are available for in-service distributions. Safe harbor 401(k) contributions cannot be withdrawn during employment prior to age 59½ even if the plan otherwise permits hardship distributions. Amounts attributed to money purchase pension plans or defined benefit plans are not available before age 62.

6. Failure to satisfy the rules related to required minimum distributions (RMDs)

Once a participant reaches age 70½, he is required to take a distribution of a portion of his account each year. The amount is based on the participant's account balance and IRS life expectancy tables. Participants who are not owners of the company that sponsors the plan can generally

postpone their RMDs until they retire. Failure to timely take an RMD subjects the participant to an excise tax equal to 50% of the RMD.

Since RMDs are based on account balances at the end of the preceding year, it is a good idea to notify participants early in the year if they are required to take a distribution. This gives them adequate time to submit any necessary paperwork so that the RMD can be processed well before the deadline.

7. Failure to satisfy the rules related to eligibility to sponsor a certain type of plan

Certain types of businesses are eligible to sponsor certain types of plans. Perhaps the most obvious example is that only not-for-profit organizations and certain governmental entities (such as public schools) can sponsor 403(b) plans while for-profit organizations cannot. Similarly, many government entities cannot sponsor 401(k) plans.

8. Failure to pass the ADP and/or ACP test

It is actually not a problem to fail the ADP/ACP test as long as that failure is corrected by the end of the following year. In other words, a calendar year plan that fails the ADP test for 2012 has until December 31, 2013, to correct the failure by refunding contributions to highly compensated employees, making additional contributions to non-highly compensated employees or some combination of the two.

If the failure is not corrected within the one-year time frame, the plan's tax-favored status is in jeopardy. It is still possible to correct, but the options become much more restrictive and expensive. One way to minimize the likelihood of this eventuality is to provide your employee census information to the service provider that prepares your testing as soon as possible after the end of the year. This gives them time to review your information, perform the tests and advise you of any corrective actions while there is still plenty of time to implement them.

9. Failure to provide top-heavy minimum benefits to non-key employees

When more than 60% of plan assets are in the accounts of certain owners and officers (known as key employees), the plan is top heavy. Top-heavy plans must provide contributions to non-key employees, generally up to 3% of their compensation, no later than the end of the following year.

Sometimes plan sponsors will fail to provide these contributions because they do not realize they are required to do so. Safe harbor 401(k) plans can be particularly vulnerable. Such plans are generally deemed to satisfy the top-heavy requirements. However, if the company makes contributions beyond the safe harbor contributions, the top-heavy exemption is lost. In addition, there can be misunderstanding in plans that do not otherwise provide for any company contributions. However, even deferral-only plans can become top heavy, triggering the required company contribution.

10. Failure to cap benefits at the annual additions limit

In a defined contribution plan, a participant's total contributions for a given year are limited to the lesser of \$51,000 (2013 indexed limit) or 100% of compensation. Due to the higher limits, this failure is less common than it used to be. However, it does still arise occasionally, especially when the goal of a plan is to maximize contributions for one or a group of employees. Although there are mechanisms in place to correct excess annual additions, plan sponsors should avoid the temptation to intentionally "force" an excess allocation, knowing it can be corrected, to accomplish some other objective.

While it is unlikely to make the rounds amongst late night talk shows, paying attention to the items on this list will help ensure you are sleeping soundly rather than lying awake worrying about your plan's compliance.

IRS and Social Security Annual Limits

Each year the U.S. government adjusts the limits for qualified plans and social security to reflect cost of living adjustments and changes in the law. Many of these limits are based on the "plan year." The elective deferral and catch-up limits are always based on the calendar year. Here are the 2013 limits as well as the 2012 limits for comparative purposes:

Limit	2013	2012
Maximum compensation limit	\$255,000	\$250,000
Defined contribution plan maximum contribution	\$51,000	\$50,000
Defined benefit plan maximum benefit	\$205,000	\$200,000
401(k), 403(b) and 457 plan maximum elective deferrals	\$17,500	\$17,000
Catch-up contributions	\$5,500	\$5,500
SIMPLE plan maximum elective deferrals	\$12,000	\$11,500
Catch-up contributions	\$2,500	\$2,500
IRA maximum contributions	\$5,500	\$5,000
Catch-up contributions	\$1,000	\$1,000
Highly compensated employee threshold	\$115,000	\$115,000
Key employee (officer) threshold	\$165,000	\$165,000
Social security taxable wage base	\$113,700	\$110,100

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