THE EMPLOYEE BENEFIT
Forum
current issues in retirement benefit planning

qualified PLANS LLC

Amended Your Plan Lately?

SITUATION: I recently read that one of the most frequent errors IRS examiners find when conducting Employee Plan (EP) Examinations is the failure of 401(k) plan sponsors to amend their plan documents to comply with current law. This got me thinking about our company's plan and whether it might need amending.

QUESTION: How do we know when we should amend our plan and what amendments are required?

ANSWER: 401(k) plans must be updated periodically to conform to changes in the federal tax law and pension laws and to reflect official guidance issued by the IRS. At the end of each year, the IRS publishes a *Cumulative List of Changes in Plan Qualification Requirements* that includes amendment requirements and deadlines.

DISCUSSION: Currently, the most common law changes that employers have failed to amend their plans for are GUST (an acronym for several tax laws), the good faith amendments for the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), and the final and temporary required minimum distribution regulations under Internal Revenue Code Section 401(a)(9).

Individually designed 401(k) plans must be routinely amended and restated every five years, and preapproved plans every six years. There is a revolving remedial amendment cycle for amending and restating a plan. Between remedial amendment cycles, interim and good faith amendments are required to keep a written plan current. Discretionary amendments are used for nonrequired plan changes made between amendment cycles, such as adding or changing plan features.

COMMENT: The following are some suggestions for staying on top of required amendments and avoiding possible plan disqualification:

- Keep a calendar or tickler file of when amendments must be completed.
- Review your plan document each year for possible amendments.
- Check that your plan is operating in accordance with your plan's documents. If it isn't, amendments may be in order.
- Make sure the plan document and Summary Plan Description (SPD) match. If you've amended the plan document, compare the new language against your old SPD language and make any necessary changes to the SPD.
- Regularly review your plan with your employee benefit plan advisor.

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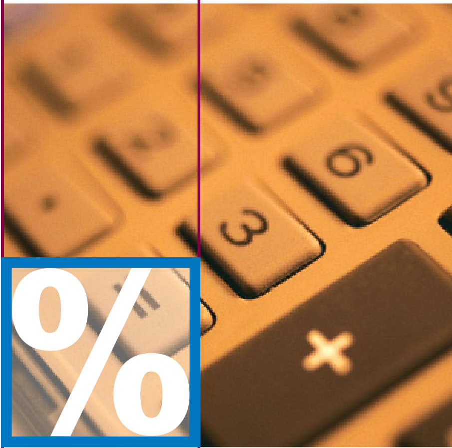

Interest Rates for Participant Loans

If your plan allows participants to borrow against the balance of their retirement plan accounts — 88.8% of 401(k) plans do* — those loans have to bear a “reasonable rate of interest.” What is considered a reasonable interest rate?

According to the U.S. Department of Labor (DOL), the interest rate charged on a participant loan is reasonable if the rate is equal to commercial lending interest rates under similar circumstances. Check the rates local banks are currently charging for loans of similar amount and duration to individuals with similar creditworthiness and collateral. If your plan’s rate for new participant loans is consistent with local rates, the plan’s rate should be considered reasonable under DOL regulations. As a point of reference, the average plan loan rate for the 2010 plan year (most recent data available) was 4.28%.*

Participant loans that don’t have a reasonable interest rate may result in a prohibited transaction.

* PSCA’s *54th Annual Survey of Profit Sharing and 401(k) Plans*, 2011

Retirement Income Reality Check

Good news. The Social Security Administration (SSA), which briefly stopped mailing annual earnings and benefit statements to workers (to reduce costs), has resumed sending paper statements to certain older workers.* It has also launched an online service that provides all eligible workers with secure and convenient access to their Social Security earnings and benefit information. The SSA’s new online statement is available at *www.socialsecurity.gov/mystatement*.

The Income Gap

Social Security benefit statements are a useful retirement planning tool because they provide estimates of a person’s monthly benefit amount at age 62, full retirement age, and age 70. However, a quick look at the figures will show that, for most people, Social Security alone will not provide all the income they’re going to need when they retire. Most employees will need additional income from other sources, such as their employer-sponsored retirement plan.

One of the most important things plan participants can do is calculate their income gap — the difference between the amount of retirement income they’re going to need and the amount of income they expect to receive from Social Security (and similar sources, such as a traditional pension, if available). Using that information, they can then set a realistic savings goal. Unfortunately, employees often skip this important planning step.

Plan Solutions

A 401(k) or other retirement savings plan is an excellent opportunity for employees to address the income gap dilemma. You can provide an extra nudge by addressing retirement income planning in employee communications (seminars, workshops, Internet/intranet sites, e-mails, newsletters, etc.).

* Workers age 60 and older who are not yet receiving Social Security benefits

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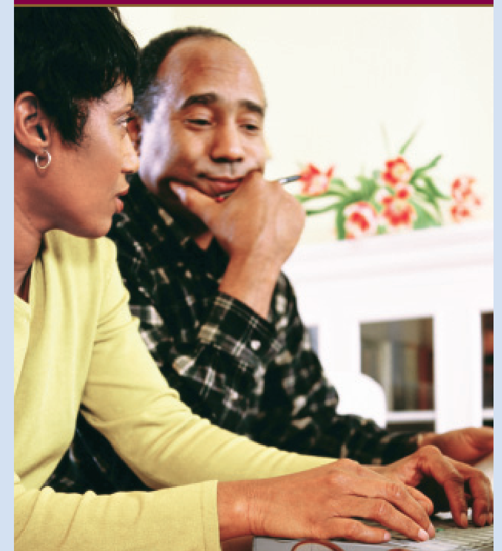

When a Plan Is Disqualified

Failure to follow tax law requirements for your qualified retirement plan can cause the IRS to disqualify the plan — with costly consequences for you and the employees who participate in it. Below we answer questions you and other plan sponsors may have about plan disqualification and the consequences.

What happens to a plan when it is disqualified? Essentially, when the IRS disqualifies a plan, the plan's trust loses its tax-exempt status and becomes a nonexempt (or taxable) trust.

How are plan participants affected by plan disqualification? Generally, participants must include in gross income any amounts the employer contributed to the plan for their benefit in the years the plan is disqualified (to the extent the participant is vested in those contributions). As a result, participants are subject to current federal income tax on those contributions. Highly compensated employees may have to include their entire vested plan balance in income (any amount not previously taxed) if the plan is disqualified for certain reasons.

What consequences would we, as the plan sponsor, face? Your deductions for contributions to the plan could be restricted and delayed. Once a plan is disqualified, different rules apply to the amount an employer can deduct for plan contributions and when deductions are allowed. Unlike contributions to a qualified plan, contributions to a nonexempt employees' trust cannot be deducted until contributions are includable in employees' gross income. Employers that sponsor a defined benefit plan (or other plan that does not maintain separate accounts for each employee) cannot deduct any contributions.

How are the investment earnings held in the plan's trust treated? When a plan is disqualified, the plan trust must pay income tax on the trust earnings. Qualified plan earnings are not taxed to the plan trust.

What effect does disqualification have on distributions from the plan? Distributions from a plan that has been disqualified are not considered eligible rollover distributions. Consequently, employees receiving distributions cannot roll them over to an individual retirement account or another employer's retirement plan. Distributions generally are taxable to the recipients in the year they are received.

How does a plan regain its tax-exempt status? Generally, the error that caused the disqualification has to be corrected before the IRS will requalify the plan. Corrections can be made through the IRS Voluntary Correction Program or, if the plan is under examination by the IRS, through the Audit Closing Agreement Program.

Top Ten Plan Errors

- Failure to amend the plan for tax law changes by the required date
- Failure to follow the plan's definition of compensation for purposes of determining contributions
- Failure to include eligible employees in the plan or to exclude ineligible employees from the plan
- Failure to satisfy plan loan provisions
- Impermissible in-service withdrawals
- Failure to satisfy required minimum distribution rules
- Employer eligibility failure
- Failure to pass annual nondiscrimination testing
- Failure to properly provide the minimum top-heavy benefit or contribution to non-key employees
- Failure to observe the limits on maximum annual contributions a participant can receive (in a defined contribution plan) or the amount of benefits a participant can accrue (in a defined benefit plan)

Source: IRS, 2011

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

RECENT DEVELOPMENTS
In Benefit Plans

Small Plan Compliance Failures. A study by the IRS's LESE (Learn, Educate, Self-Correct, and Enforce) project found that small retirement plans (less than $5 million in assets) are missing the mark in several compliance areas. The project looked at plans that had investments in real estate and either offered participant loans or filed a Form 5500 Schedule D (*DFE/Participating Plan Information*). Among the failures: 25% of the plans had at least one prohibited transaction and 25% had real estate investments that weren't valued at fair market value. Problems with plan loans included failure to follow the plan loan provisions, to document loans and loan payments, and to prohibit loans to the employer or related entities.

Contribution Benchmarks. Preliminary information from the IRS's Section 401(k) Compliance Check Questionnaire gives plan sponsors some benchmarks for assessing their 401(k) plans' contribution features in comparison to other plans. The findings: 54% of 401(k) plans have a one-year-of-service requirement for participation, 64% contain an age-21 eligibility requirement, 41% let participants change elective deferrals at any time, and 96% allow participants age 50 and older to make catch-up contributions. Only 22% of the 401(k) plans surveyed permit designated Roth contributions. As for employer contributions, 68% of plan sponsors make matching contributions, 65% provide employer nonelective contributions (such as a profit sharing contribution), and 58% of plans have a one-year-of-service requirement for receiving matching contributions.

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P.O. Box 1768
Savannah, GA 31402
(800) 542-6785
www.qplans.com

Atlanta Office:
1870 The Exchange SE | Suite 235 | Atlanta, GA 30339
T: (678) 387-3961 | F: (678) 387-3965

Peoria Office:
222 NE Monroe | Suite 903 | Peoria, IL 61602
T: (309) 494-9855 | F: (309) 494-9866

Savannah Office:
2702 Whatley Avenue | Suite A-1 | Savannah, GA 31404
T: (912) 356-1120 | F: (912) 356-0257

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