THE EMPLOYEE BENEFIT
Forum
current issues in retirement benefit planning

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Correcting Excess Contributions

SITUATION: We will be conducting the annual actual deferral percentage (ADP) nondiscrimination test on our 401(k) plan for the first time and are concerned that the plan may not pass the test.

QUESTION: What should we do if our plan fails the ADP test?

ANSWER: If your plan fails, you can take corrective action to protect the plan's qualified status.

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 the averages for the highly paid and lower paid employees must be within certain limits.

If your plan fails testing, you need to take corrective action. The three ways to make corrections are:

Distribute excess contributions to highly compensated employees within 12 months after the end of the plan year. A 10% excise tax generally will apply to any excess contributions that are not distributed within the first 2½ months of the new plan year. For plans that are "eligible automatic contribution arrangements" and cover all eligible employees, corrective contributions can be made up to six months following the end of the plan year without incurring the excise tax.

Recharacterize the excess contributions as after-tax contributions within 2½ months of the plan's year-end.

Make qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs) within 12 months.

COMMENT: Going forward, you may want to consider adopting a safe harbor plan design to avoid ADP testing altogether.

Ways Plans Pass the ADP Test (% of plans)	
Excess Contributions Returned to Participants After Plan Year Ended	18.2%
Elections of Highly Paid Participants Limited When Contributions Reached the Maximum Allowed by the Test or by Plan Design	13.8%
Excess 401(k) Amounts Deposited into a Nonqualified Arrangement	0.7%

Source: *56th Annual Survey of Profit Sharing and 401(k) Plans*, Plan Sponsor Council of America, 2013 (2012 plan experience)

Plan Limitations for 2014

The IRS's recently released 2014 cost-of-living adjustments for various retirement plan limitations are a mixed bag, with some limitations increasing and others remaining at their 2013 levels. Changes include the following increases:

- Maximum annual additions to a defined contribution plan account from $51,000 to $52,000
- Maximum annual benefit from a defined benefit pension plan from $205,000 to $210,000
- Maximum annual compensation used to determine qualified plan benefits or contributions from $255,000 to $260,000
- Compensation limit for determining whether officers are key employees for top-heavy plan purposes from $165,000 to $170,000
- Social Security taxable wage base from $113,700 to $117,000

The following limitations remain unchanged:

- 401(k), 403(b), and most 457 plan deferrals: $17,500 with a $5,500 limit on catch-up contributions
- SIMPLE deferrals and catch-up contributions: $12,000/$2,500
- Dollar limit used in the definition of highly compensated employee: $115,000

Hardship Distributions for Casualty Losses

Hurricane Sandy. Tornadoes in the Midwest. Blizzards on the Great Plains. 2012 and 2013 saw a slate of natural disasters. And like other plan sponsors, you may be seeing the aftermath — more employees requesting hardship withdrawals from their 401(k) plan accounts to cover repairs to their homes.

Casualty Loss Safe Harbor

Hardship distributions may be made only to satisfy an immediate and heavy financial need. Whether a need is immediate and heavy depends on the facts and circumstances. However, the IRS has provided safe harbors under which certain expenses are deemed immediate and heavy, including one for casualties to a participant's principal residence.

Under the safe harbor, casualty loss hardship distributions are allowed for the cost of repairing damages to a participant's *principal residence* that would qualify for a casualty loss deduction under the federal tax law. However, eligible costs are *not* limited to amounts exceeding 10% of a participant's adjusted gross income, as required for the income-tax deduction. According to the IRS, a casualty is "the damage, destruction, or loss of property resulting from an identifiable event that is *sudden, unexpected, or unusual* . . . ."

Additionally, the employee must have obtained all other currently available plan distributions and loans *and* be prohibited from making elective deferrals to the plan for at least six months following the hardship distribution.

Other Expenses

Affected participants may be able to receive hardship distributions under other IRS safe harbors. Distributions are also allowed for certain medical and post-secondary educational expenses, the costs of purchasing a principal residence for the participant, payments to prevent eviction from or foreclosure on a mortgage on the participant's principal residence, and burial or funeral expenses for immediate family members and dependents.

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Setting Plan Defaults

When you set automatic enrollment and investment defaults for your 401(k) plan, you need to understand and satisfy pension and tax law requirements. But you also should be aware that the default choices you make could significantly impact how financially prepared your employees will be for retirement. Below we answer some questions plan sponsors may have about setting plan defaults.

How does a plan's automatic enrollment default deferral rate affect retirement readiness? Research shows that many plan participants who are automatically enrolled in their employer's plan at the default contribution rate don't question whether a different rate would be better for them — even though about 65% of plans have default contribution rates of 3% or less,* and many retirement advisors recommend significantly higher contribution rates. Consequently, an employee who contributes to an employer's plan at a low default rate for his or her entire career risks having a plan account balance at retirement that's far smaller than the employee will need to meet retirement expenses.

Is any particular group of employees more likely to stick with the default? Yes, according to the National Bureau of Economic Research (NBER), lower income employees are more apt to stay with the default rate than higher income employees.**

What can we do to get employees to move from the default rate to a deferral rate more appropriate for them? Employee communications encouraging participants to calculate how much money they may need in retirement can help. In addition, many plans are turning to automatic and voluntary contribution rate escalation features to encourage higher contribution rates.

With automatic contribution escalation, a plan participant's deferral increases gradually over time with no effort on the part of the employee. Employers must implement the increases according to a specified schedule. They also must notify employees of the amount of the deferral increases and when increases will occur. Employees must be able to opt out. With voluntary contribution escalation, the participant opts into (and can opt out of) the employer's increase schedule.

We understand participants staying with a low default contribution rate, but when they see the effect of contribution escalation on their paychecks, don't they opt out? Interestingly, the NBER found that lower paid employees tend to stay with the default rate even if it's higher than they may need to replace their preretirement income in retirement. Higher paid employees are more likely to change their contribution rate if it isn't appropriate for their needs.

How does our default investment choice affect employees' retirement readiness? First, there's an inertia factor similar to that associated with default contribution rates. Employees automatically invested in the default investment often leave their money in that investment. In addition, NBER data seems to indicate that a plan's default investment choice influences how participants overall allocate their plan savings. In the study, when a plan changed its default investment choice from a more conservative (no stock) fund to a balanced or target date fund with substantial stock exposure (classified as aggressive funds in the study), plan participants allocated more of their accounts to aggressive funds.

* *56th Annual Survey of Profit Sharing and 401(k) Plans*, Plan Sponsor Council of America, 2013 (2012 plan experience)

** *Financial Inertia Among Low-Income Individuals — Plan Carefully When Setting 401(k) Defaults*, National Bureau of Economic Research, 2013

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RECENT DEVELOPMENTS In Benefit Plans

Few Americans Are Financially Literate. When it comes to understanding finances, Americans have a lot to learn. The Life Insurance and Market Research Association (LIMRA) asked 2,000 individuals to explain the differences between a stock and a stock mutual fund, to calculate simple interest, to identify the age when Social Security benefits can be collected, and to answer other basic financial and retirement questions. Only one in eight could correctly answer most of the questions. More than one third (36%) failed the quiz.

Sponsors' Top Goals. It seems plan sponsors are well aware of the lack of financial knowledge among participants. Eighty-four percent of sponsors who participated in the *12th Annual 401(k) Benchmarking Survey*, conducted by the International Foundation of Employee Benefit Plans, Deloitte, and the International Society of Certified Employee Benefit Specialists, cited improved participant education as a focus area for their plans. Only 12% reported that their employees are or will be financially prepared for retirement.

Workers Opt for Lump-sum Payouts. Only about one in four workers (27.3%) covered by a defined benefit pension plan chose an annuity option when given a choice between a lump-sum distribution or a lifetime income stream, according to a study conducted by the Employee Benefit Research Institute. The study focused on workers age 50 to 75 who had a minimum job tenure of five years, a minimum account balance of $5,000, and no restrictions on their payout decision.