Tax and Compliance Issues for 401(k) Plans

The AICPA Employee Benefit Plan Audit Quality Center (EBPAQC) has developed this primer to provide Center members with a general understanding of the tax and compliance requirements for 401(k) plans that are subject to the reporting requirements under the Employee Retirement Income Security Act of 1974 (ERISA). This primer discusses the tax advantages of plan qualification under the Internal Revenue Code (IRC); the IRC requirements for a plan to be qualified; plan design and Internal Revenue Service (IRS) determination, opinion, and advisory letters; non-discrimination tests and other operating tests to maintain qualified status; safe harbor plans; plan document failures and operational errors; IRS correction programs; unrelated business income tax considerations; and additional IRS and AICPA resources.

Introduction

A 401(k) plan is a type of defined contribution retirement plan that allows employees to contribute a portion of their wages on a pre-tax basis (except in the case of a Roth account, discussed below) to an individual account within the plan. In some plans, the employer also makes contributions (e.g., matching the employee's contributions up to a certain specified percentage). A well designed 401(k) plan can play an important role in helping companies attract and retain employees.

There are three types of 401(k) plans: traditional plans, safe harbor plans, and SIMPLE plans. This primer addresses the tax and compliance requirements of traditional and safe harbor 401(k) plans. SIMPLE 401(k) plans are specifically for small business with 100 or fewer employees and, as such, are not addressed in this primer.

Tax Advantages of a Qualified Plan

401(k) plans are popular with employers and employees because they may provide significant tax benefits to both. For the plan sponsor, employer contributions are deductible on the employer's federal income tax return. For the employee, elective contributions and related income earned are sheltered from income tax until distributed to the participant, except in the case of Roth 401(k) feature, where employee contributions are made on an after-tax basis and distributions upon retirement are not taxed.

IRC section 401(a) establishes minimum design and operational requirements for a plan to qualify for favorable tax status (i.e., to be considered a *qualified* plan). These requirements include participation eligibility rules; vesting standards establishing when participants have a nonforfeitable right to their benefits; contribution limits for both the employee and the employer; and restrictions on when and how the plan can make distributions to participants.

In order for a qualified plan to retain these tax advantages, the plan must operate in accordance with the plan document and continue to meet certain *nondiscrimination tests* and other operating tests, which are discussed below. Plan qualification requirements are complex and periodically change, and plan document failures and operational errors can occur. All compliance matters must be addressed and resolved in order for the plan to maintain its tax-qualified status.

A plan's tax disqualification can negatively affect both the employer and participants. The employer may lose its tax deduction for all employer contributions made to the plan that are not yet vested to the plan participants, and the employer may also be subject to penalties for failure to remit income tax withholding on the amounts that employees must recognize as income. For participants, all vested contributions may become immediately taxable. Further, participants may not be able to roll over distributions from a disqualified plan into an Individual Retirement Account (IRA) or other qualified plan in order to defer paying taxes. In addition, the plan's investment earnings may become taxable. The IRS may assess interest and penalties on all of these taxable amounts.

Plan Qualification Requirements

IRC section 401(a) addresses many aspects of plan qualification requirements relating to plan design and operations including, but not limited to, participation, contributions, vesting, distributions and loans. These requirements are intended to ensure plans are fair to all employees, that the assets are secured and used only for the benefit of the plan participants, and that the plan participants have the nonforfeitable right to their benefits within a reasonable amount of time.

Some of the more important plan qualification requirements are summarized as follows:

- *Plan document must be in writing* – The plan must have a written plan document that defines the terms and conditions related to the operation and administration of the plan. The written document establishes the employer's obligations to participants and beneficiaries as well as the participants' and beneficiaries' rights under the plan. The provisions in the plan document must satisfy the requirements of the IRC *and* the plan provisions must be followed (for example, if the plan document does not state that the plan allows automatic enrollment, then automatic enrollment is not allowed under the plan, even though automatic enrollment is permitted by the IRC). When the tax laws and regulations affecting 401(k) plans change, the plan document must be updated. The IRS generally establishes a deadline by which plan amendments that reflect tax law changes must be adopted.

- *Plan assets must be used to benefit only plan participants or beneficiaries* – The plan's assets must be used for the exclusive benefit of the plan participants or their beneficiaries (i.e., paying appropriate and reasonable plan expenses and paying benefits to plan participants).

- *Contributions and benefits must not be discriminatory* – The plan must not discriminate in favor of highly compensated employees (HCE), as defined by the IRC (generally an employee who is a more than 5% owner and/or who is highly compensated based on the compensation threshold as indexed for inflation for that year). For example, for calendar plan year 2012 discrimination testing, a highly compensated employee had compensation of more than $110,000 in calendar 2011. In order to satisfy this non-discrimination requirement, the plan must pass the *actual deferral percentage* (ADP) and *actual contribution percentage* (ACP) tests (described later in this section). Exclusions for these non-discrimination tests apply for *safe harbor plans*, which are described in the *Safe Harbor Plans* section below.

- *Contributions and allocations are limited* – The IRC limits the maximum allowable total contributions by both the employer and employee, subject to cost of living adjustments, per plan participant. For 2012, total contributions for each participant cannot exceed $50,000 (excluding *catch-up contributions* as described below).

- *Elective deferrals are limited* – The IRC limits the maximum dollar amount of employee elective deferrals (employee contributions) per calendar year, subject to cost of living adjustments. For example, the limit is $17,000 in 2012. The IRC also allows an additional catch-up contribution of $5,500 for plan participants age 50 or older. These limits apply to each participant regardless of the number of plans in which the person participates, and regardless of the number of employers. In other words, the limit on elective deferrals is applied on a per participant basis, rather than on a per plan or per employer basis.

- *Considered plan compensation is limited* – The IRC limits the total base compensation, subject to cost of living adjustments, on which allowable employer contributions can be calculated. For example, the limit is $250,000 in 2012.

- *Minimum vesting standards must be met* – The plan participant is immediately 100% vested in all employee contributions. The IRC defines the maximum period of service that a plan participant must meet in order to have nonforfeitable (vested) rights to the employer's contribution to the plan on his or her behalf as not to exceed 6 years under a graded vesting schedule, or 3 years under a cliff vesting schedule.

- *Participation requirements must be met* – In general, an employee must be allowed to participate in the plan once he or she reaches age 21 and completes at least 1 year of service. Plans may allow employees to participate earlier, but may not be any more restrictive than the IRC allows. A plan also cannot exclude an employee because he or she has reached a specified age.

- *Restrictions on 401(k) distributions are required* – The plan may not distribute plan assets to a plan participant until a *distributable event* has occurred. A distributable event is generally defined as a plan participant's severance from employment, reaching age 59½, death, disability, a financial hardship, or the plan sponsor terminating the plan without maintaining a successor plan. Plans also may permit participants loans and hardship withdrawals for specified reasons.

- *"Top-heavy" plan requirements must be met* – The plan may not disproportionately benefit key employees. As such, the plan must meet certain requirements to ensure it is not *top-heavy* (see the *Non-discrimination and Other Operating Tests for Plan Qualification* section below).

For updated compensation and contribution limitations noted above, refer to the IRS's Table for COLA Increases for Dollar Limitations on Benefits and Contributions.

Refer to the following key IRC section references for additional information on 401(k) plan qualification:

- Section 401(a) - General requirements for qualification
- Section 401(k) - Additional requirements for cash or deferred arrangements
- Section 402(g) - Limitations on exclusion for elective deferrals
- Section 410 - Minimum participation standards
- Section 411- Minimum vesting standards
- Section 414 - Definitions and special rules
- Section 415 - Limitations on benefits and contribution under qualified plans
- Section 416 - Special rules for top-heavy plans
- Section 72(p) - Loans treated as distributions

Plan Design and IRS Determination, Opinion, and Advisory Letters

Plan sponsors may individually design their own plan, or they may adopt a *master and prototype plan* or a *volume submitter plan* prepared by a third party (known as a *mass submitter, sponsor* or *practitioner*, depending on the type of plan and number of adopting employers) that is *pre-approved* by the IRS. Upon request, when the plan meets the requirements of the IRC section 401(a), the IRS Employee Plans Determinations program will issue a favorable determination letter for an individually designed plan; an opinion letter for a master and prototype plan; or an advisory letter for a volume submitter plan. There are many benefits to the plan sponsor in obtaining a favorable determination, opinion or advisory letter. A favorable letter may be nullified if there is a misstatement or omission of a material fact or there is a material change in the plan or law.

Individually designed plans allow for the greatest flexibility with respect to plan structure and investment options. Plans sponsors of individually designed plans must ensure the plans comply with laws and regulations affecting 401(k) plans. Sponsors of these plans may, but are not required to, request written assurance from the IRS once every five years that the form of their plan document meets the applicable requirements of IRC section 401(a). A favorable determination letter from the IRS provides assurance that the plan would not be disqualified solely because the plan document has some minor error or omission. A determination letter does not provide any assurance that the plan is operating in accordance with the plan document. A determination letter applies only to the plan document as of the date submitted and applies only to the employer and the participants of that plan. If the plan document is subsequently amended (e.g., for new tax laws and regulations affecting 401(k) plans or a change in plan provisions) the plan sponsor plan may submit a request for a plan determination letter on the amended plan document.

Master and prototype plans consist of a basic plan document, an adoption agreement, and a trust or custodial account (that may or may not be included in the basic plan document). A master plan and a prototype plan are similar with one important exception: in a master plan all employers use the same trust or custodial account, whereas each employer has a separate trust or custodial account in a prototype plan. The basic plan document is the portion of the plan containing the non-elective provisions applicable to all adopting employers. No options can be provided in the basic plan document. An adoption agreement is the portion of the plan containing all the options that can be selected by an adopting employer. Plan options may include investments offered, definition of total compensation, and how the employer match is calculated.

Under a master or prototype plan, an employer properly completing the adoption agreement typically will not have to file for a determination letter (in fact, adopters of pre-approved plans may obtain a determination letter only in certain specified circumstances) and can rely on the IRS opinion letter issued for the pre-approved plan document.

A *volume submitter plan* consists of a plan document and a trust or custodial account similar to a master or prototype plan except the employer's choices may be integrated into one plan document (i.e., a separate adoption agreement is not necessary). In addition, there are restrictions on the types of provisions that can be included in a master or prototype plan, which typically do not apply to a volume submitter plan. The IRS will accept the simplified Form 5307 determination letter applications from volume submitter plan adopters only if they modify the terms of the approved plan, and have not made modifications that cause the plan to be treated as an individually designed plan.

Master and prototype plan and volume submitter plan mass submitters, sponsors and practitioners must submit their plans to the IRS every six years to obtain an IRS opinion or advisory letter approving the form of the plan document. It is important to note that IRS determination letters, opinion letters, and advisory letters express the IRS's opinion only on the *form* of the plan and provide no opinion of qualification related to the *operation* of the plan. To ensure that the plan operates in accordance with IRC section 401(a), applicable annual tests must be met as discussed below and any operational and plan document errors must be corrected on a timely basis.

Non-discrimination and Other Operating Tests for Plan Qualification

To ensure that a plan is operating within the specific guidelines established by the plan document in accordance with the IRC, certain non-discrimination and other compliance tests should be performed annually. Many plan sponsors hire a third-party administrator (TPA) to perform these tests (often the same party contracted to do the plan's recordkeeping).

Minimum Coverage

IRC section 410(b) stipulates that a plan must not benefit a disproportionate share of the employer's highly compensated workforce. To confirm compliance with this requirement, a plan performs what is referred to as the "minimum coverage" test. Generally, a plan must cover at least 70 percent of employees who are not highly compensated (percentage test) or the percentage of non-highly compensated employees covered must be at least 70 percent of the percentage of the highly compensated employees covered (ratio test). For plans that fail either the percentage or the ratio test, there is an alternate coverage test known as the *average benefit percentage test*. The average benefit percentage of the non-highly compensated employees must be at least 70 percent of the average benefit percentage of the highly compensated employees.

For purposes of testing compliance with this requirement, a plan generally is allowed to exclude from the total count of non-highly compensated employees those employees who are covered by a collective bargaining agreement, employees with non-resident alien status earning no U.S. sourced earned income from the employer, and employees who do not meet the age and service requirements specified by the plan document.

Employers will occasionally structure a plan to exclude employees working in a specific division or certain applicable affiliated companies of the plan sponsor, or may cover those employees under a different retirement plan with different contribution levels. When performing the minimum coverage test, these employees must be considered in the calculation. If the company has recently been involved in a restructuring, downsizing, merger, acquisition or divestiture, it would be important that testing be re-performed to ensure adequate coverage still exists.

Nondiscrimination

Traditional 401(k) plans, including Roth 401(k) plans, must meet two specific, annual nondiscrimination tests to ensure that the plan does not unfairly benefit HCEs. As discussed below, safe harbor 401(k) plans are not subject to these annual nondiscrimination tests. IRC sections 401(k) and 401(m) establish specific contribution percentage ratios for deferrals and contributions to which the plan must adhere in order for the plan to maintain its qualified status. These nondiscrimination rules require average deferrals and average contributions for the HCE group to be within a certain range of the average deferrals and contributions for the NHCE group.

- *Actual Deferral Percentage (ADP) test -* The ADP test compares elective deferrals made by HCEs (on a before-tax basis and excluding the extra catch-up contributions discussed above) to those made by NHCEs. The percentages for employees within each group are totaled and averaged to get the average deferral percentage for both groups. The ADP for the HCE group is compared with the ADP of the NHCE group to determine if the plan passes the test according to specific formulas.
- *Actual Contribution Percentage (ACP) test –The ACP* has similar testing limits to the ADP but measures employer matching contributions and employee after-tax contributions.

For purposes of these tests, all participants who are eligible to receive an employer matching contribution (including those who meet all the requirements to receive a matching contribution but elect not to defer), and those who make an elective deferral, are included in the test. These tests can be performed using the HCE's percentage for either the preceding plan year or the current plan year, based on the plan's provisions. In certain situations where a company sponsors multiple plans where matching contributions and employee deferrals are made, the plans are combined for testing purposes. Refer to the IRS Publication 4531, *401(k) Plan Checklist and Fix-It Guide*, for a discussion on these tests and acceptable ratios.

If a plan fails one or both of these non-discrimination tests, corrective action must be taken in a timely manner. A plan failure of the ADP test typically can be corrected in one of two ways: pay any excess contributions back to the HCEs, or pay a qualified non-elective contribution (QNEC) to the plan for all NHCEs. A plan failure of the ACP test typically is corrected by distributing vested matching contributions or by the forfeiture of any excess employer contributions by the HCEs.

Top-Heavy

IRC section 416 establishes special vesting and minimum benefit requirements for *top heavy* plans. A plan is considered to be *top heavy* if the total of the accounts (i.e., accrued benefits or account balances) of key employees under the plan exceeds 60 percent of the total of the accounts of all employees under the plan. A key employee is defined as an employee who is a 5% owner, who owns more than 1% of the business with total annual compensation exceeding $150,000 or who is an officer with annual compensation exceeding a threshold amount ($165,000 for 2012). Refer to the IRS' Table for COLA Increases for Dollar Limitations on Benefits and Contributions for updated compensation limits. If a plan is top-heavy, the employer must contribute up to three percent of annual compensation for all non-key employees to the plan.

Safe Harbor 401(k) Plans

A safe harbor 401(k) plan is similar to a traditional 401(k) plan but, because it meets specific requirements—including certain required employer contributions and immediate 100% vesting by plan participants of all employer contributions—it is not subject to the complex annual ADP or ACP nondiscrimination tests. The required contributions may be employer matching contributions limited to employees who make contributions to the plan, or employer contributions made on behalf of all eligible employees, regardless of whether they make elective deferrals. Safe harbor 401(k) plans that do not provide any additional contributions in a year are also exempted from the top-heavy rules of IRC section 416. Although safe harbor plans are not subject to these tests and/or rules, operational errors or plan document failures that require correction can still occur. Plan sponsors of safe harbor 401(k) plans must also satisfy certain notice requirements related to the employee's rights and obligations under the plan.

Another type of safe harbor 401(k) plan was recently added to the IRC known as a *Qualified Automatic Contribution Arrangement (QACA)*, which provides for automatic enrollment and automatic contribution increases.

Plan Document Failures vs. Operational Errors

When plan compliance issues arise, they typically are either plan document failures or operational errors. It is important to correctly identify the type of issue in order to adequately address and correct it.

A *plan document failure* occurs when the plan document is not designed in accordance with IRS regulations. This can be the result of an unintentional error in writing the plan document, or not timely amending the plan due to a statutory or regulatory change. This type of error generally requires the plan document to be amended. Unless the amendment is favorable to plan participants (i.e., the plan participants' benefits would be reduced under the current plan document if the plan were not amended), the plan document cannot be amended retroactively to correct the issue. As such, the plan sponsor may need to address both the correction of the participants' account balances, if applicable, and the correction of the plan document. Plans may need to consult an ERISA attorney to ensure the plan documents are corrected properly to meet the plan qualification requirements.

A *plan operational error* occurs when a transaction is not in accordance with the plan document or the plan participant's instructions, or when the plan fails the non-discrimination tests and timely corrective action is not taken. Common operational errors include failure to admit participants into the plan when they become eligible, incorrect contribution amounts made to the participants' accounts, and incorrect vesting percentages used when making distributions.

The more frequent plan document and operational errors in 401(k) plans include the following:

- The plan document is not timely updated or amended
- Failure to properly apply the plan's provisions
- The definition of compensation used operationally is different from the plan document (e.g., improper inclusion or exclusion of compensation for plan purposes or improper period considered for newly eligible employees)
- Excluding eligible employees or including ineligible employees (e.g., the definition of employee and employer is not followed, missed entry date, or entry allowed too early)
- Incorrect employer matching contributions
- Participant elections (e.g., error in set-up of participant elections, failure to restart subsequent year contributions after limits are met, and excess elective deferrals)
- Vesting errors (e.g., improper application of years of service)
- Distributions (e.g., improper hardship determinations or partial termination errors)
- Plan loans (e.g., the plan document does not allow for loans but loans are extended, the failure to withhold loan payments, or loans exceed plan or IRC limits)
- Incorrectly performing non-discrimination and other operating tests
- Failure to annually meet required discrimination and compliance tests

IRS Correction Programs

The IRS's Employee Plans Compliance Resolution System (EPCRS) is available for plan sponsors to correct most common plan errors. The EPCRS allows plan sponsors to bring plans into compliance with ERISA and IRS regulations and the participants' account balances to the level they would have been had the error not occurred. The EPCRS offers three programs for correcting plan errors, depending on the significance and timing of the error.

Self-Correction Program (SCP) - In the SCP, a plan sponsor is allowed to self-correct an operational error that occurs due to failure to operate the plan according to the plan terms. There is no requirement to notify or file any documents with the IRS for approval or authorization; however, if the error is significant, a favorable IRS determination letter is required to participate in this program. The SCP is permitted for operational errors only, and the plan sponsor must have sufficient compliance practices and procedures in place. As discussed above, operational errors generally are errors that occur when the plan is not administered in accordance with the terms of the plan document (for example, where deferrals should be withheld from a bonus payment, but are not withheld due to administrative error). An insignificant error can be corrected at any time; however, significant errors must be corrected within two years of occurrence in order to qualify for this program. Certain types of errors, such as demographic errors or re-amortization of defaulted participant loans, cannot be corrected under SCP; instead they must be corrected under VCP, described below.

Voluntary Correction Program (VCP) - The VCP is available to correct most operational errors, as well as other types of plan failures including those related to plan form and eligibility. This program allows the plan sponsor to come voluntarily to the IRS to bring the plan into compliance without IRS sanctions. A favorable IRS determination letter is not required to participate in the VCP program. This correction will involve a filing with the IRS and the payment of a fee. The plan sponsor can negotiate with the IRS the mechanics of the plan correction and applicable penalties.

Audit Closing Agreement Program (Audit CAP) - If plan failures are noted as a result of an IRS audit, then in many cases the plan sponsor's only option is to go through Audit CAP to correct the plan failures. The plan correction and fees are outlined through the closing agreement at the end of the audit, and the plan sponsor must comply with the agreement to retain the plan's qualified status. Audit CAP often involves the payment of a significant monetary sanction to the IRS that is considerably higher than the amount the plan sponsor would have paid under VCP.

All penalties are the responsibility of the plan sponsor, and are not to be paid from plan assets, regardless of the correction option selected.

Unrelated Business Income Tax

Investment earnings of qualified plans generally are exempt from income tax; however, in certain circumstances, unrelated business income may result in a tax liability in an otherwise tax qualified plan. For example, unrelated taxable income, although not common in a 401(k) plan, may occur when a limited partnership interest is included as a plan asset. In this situation, the plan may be required to file a Form 990-T with the IRS to pay taxes on the unrelated business taxable income. Refer to IRS forms and publications site for further instructions and information on this form.

IRS Resources

A Guide to Common Qualified Plan Requirements discusses some of the more important retirement plan requirements to help employers in implementing practices, procedures and internal controls to monitor plan operations.

401(k) Resource Guide provides an overview of 401(k) plans, plan qualification requirements, elective deferral limitations, and other important information applicable to plan sponsors and participants.

401(k) Plan Checklist discusses many of the important 401(k) plan requirements with which a plan must comply. This checklist is not a complete description of all plan requirements.
IRS EP Determination Letter Application Guide walks you through the Employee Plans ("EP") determination letter application and review process.

IRS Retirement Plans FAQs regarding the Determination Letter Process contains frequently asked questions regarding determination, opinion and advisory letter issues.
Publication 794, *Favorable Determination Letter,* explains the significance of a favorable determination letter, points out some features that may affect the plan's qualified status and nullify an IRS determination letter. It can be found at http://www.irs.gov/pub/irs-pdf/p794.pdf.

Accounting and Auditing Resources

AICPA Audit & Accounting Guide, *Employee Benefit Plans,* provides guidance on auditing the plan's tax status (Chapter 12) and excess contribution distributions (Chapter 9).

AICPA *Accounting Trends & Techniques--* *Employee Benefit Plans*, includes illustrative note disclosures and management letter comments regarding the plan's tax status and compliance.

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