employee benefits update

year end 2014

What you need to know about ADP/ACP discrimination testing

Are you offering a Roth 401(k) plan option yet?

401(k) plan automatic enrollment: A winning formula

Help participants avoid an inappropriate IRA rollover

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What you need to know about ADP/ACP discrimination testing

Each year plan sponsors must test 401(k) plans to ensure that the contributions made by and for rank-and-file employees, also known as non–highly compensated employees (NHCEs), are reasonably proportional to contributions made for highly compensated employees (HCEs), generally a company's owners and managers. As the NHCEs save more for retirement, the rules allow HCEs to defer more. All employers should understand the tests — known as the actual deferral percentage (ADP) test and the actual contribution percentage (ACP) test.

Testing formulas

Generally, plans can't disproportionately benefit HCEs. For 2014, plan participants are considered HCEs if:

- Their compensation in 2013 or 2014 was more than $115,000 (this limit may increase for 2015), or
- They owned more than 5% of the business at any time during the year or the preceding year, regardless of their compensation.

Once you know who your HCEs are, you can calculate deferral and contribution percentages for each test:

ADP test. Under the ADP test, you calculate both HCE and NHCE pre–tax deferral rates. The deferral percentage is the average of the deferral percentages of those in the group, where the deferral percentage for each employee is the ratio of the amount of their annual deferrals to their eligible pay for that year. You must include eligible employees who don't participate in the plan with a deferral percentage of zero. Eligible nonparticipating employees tend to be NHCEs, pulling that group's deferral percentage down. To pass the test, the HCEs' average ADP can't be higher than the greater of 1) 125% of the NHCEs' average ADP, or 2) the lesser of two percentage points above or two times the NHCEs' average ADP.

Before switching to a safe harbor plan design, analyze your plan to see why eligible NHCEs aren't deferring.

If your plan allows for catch-up contributions for participants age 50 and older, generally these aren't included in the ADP test. Consult your benefits specialist for more information.

ACP test. The ACP test is similar to the ADP test. It compares the average ratios of the employer-matching contributions to the compensation received by both HCEs and NHCEs for the year. For example, if the average match percentage for NHCEs is 3% of pay, the average match percentage for HCEs must be limited to 5% of pay.

Another important discrimination test is whether a plan is deemed "top heavy" or "super top heavy." That determination is based on the proportion of plan assets held by "key employees" (defined differently from HCEs) relative to the total plan assets (at least 60% for top-heavy plans and 90% for super-top-heavy plans). If your plan is deemed top heavy, you may have to make a minimum contribution to NHCE accounts to meet top-heavy requirements.

Safe harbor design alternative

If your plan failed discrimination tests or you want to avoid the testing altogether, you can instead adopt a safe harbor provision in your plan. However, the safe harbor plan contribution formula can increase plan costs.

You can create a safe harbor plan two ways:

1. Matching deferrals dollar-for-dollar up to 3% of compensation, plus 50 cents on the dollar on the next 2% of compensation, or
2. Making a nonelective annual contribution of 3% of compensation to all eligible participants' accounts regardless of whether they make employee pretax contributions.

Under either formula, employer contributions are immediately fully vested. This contrasts with the six-year graded schedule (20% after one year, 40% after two years, and so on) or three-year cliff vesting options for non–safe harbor plans.

Before switching to a safe harbor plan design, however, analyze your plan to see why eligible NHCEs aren't deferring. And if your plan narrowly failed the discrimination testing, switching to a safe harbor plan may not be worth the added cost.

Don't be a testing failure

If your defined contribution plan flunked the nondiscrimination test in the last testing cycle, you're not alone. According to a recent survey by Judy Diamond Associates, about 12% of plans did so, too. Your plan doesn't have to be one of these statistics. Talk to your benefits specialist to learn more about ADP/ACP discrimination testing.

Communication and following your plan document

Simply tinkering with matching formulas won't help with actual deferral percentage (ADP) / actual contribution percentage (ACP) discrimination testing issues unless you also communicate the importance of plan participation with employees. With increased communication, you might be able to turn a discrimination testing failure around without changing your matching formula.

Recently, the IRS sampled more than 5,000 forms submitted by plans making corrective distributions after failing discrimination testing, and found problems with about 10% of those returns. The problems identified offer a useful checklist of compliance requirements that might require extra attention for plans failing the discrimination tests. The first problem was a failure to make a "full and proper correction" on time — or even at all. Errors calculating the required distribution amount were common.

Additional problems spotted by the IRS included allowing employees to participate earlier than provided in the plan and not timely including employees after they had met the plan's eligibility requirements. Following the terms of the plan document and communicating clearly with employees about the benefits of participating in the plan can be the difference between passing or failing the test.

Upcoming compliance deadlines:

12/31 Deadline for making required minimum distributions for 2014

12/31 Deadline for making corrective distribution for failed 2013 actual deferral percentage (ADP) and actual contribution percentage (ACP) tests with 10% excise tax penalty, as well as for making a qualified nonelective contribution (QNEC)

1/31* 2014 Forms 1099 due to participants

Blackout notice: 30 to 60 days before the last day participant may make a change

** Because Jan. 31, 2015, falls on a Saturday, the deadline for delivering Forms 1099 will occur on the next business day: Feb. 2, 2015.*

Are you offering a Roth 401(k) plan option yet?

In a Roth 401(k) plan, participants make after-tax contributions to a qualified plan and receive tax-free distributions, provided the funds are in the plan for at least five years from the date of the initial Roth 401(k) plan contribution. Thus, while participants pay a tax on the income that was the source of the contribution, the earnings on the contributions are tax-free. Is the option of a Roth 401(k) plan right for your qualified plan?

Enter the Roth option

Roth IRAs have been around since 1997, and Roth 401(k) plans became a reality under the Pension Protection Act of 2006. The ability to convert existing pretax balances within a 401(k) to Roth status was expanded by the American Taxpayer Relief Act of 2012.

Generally, it's easier for participants to start making after-tax contributions to a Roth account within their 401(k) plan than to convert a significant existing pretax amount to the plan's Roth component. Why? Because, as with an IRA conversion, a Roth 401(k) conversion triggers a tax liability that participants must pay on the conversion. If they need to raise the cash from retirement funds and they're younger than age 59½, they'd get to keep only 90% of the amount after the 10% premature withdrawal penalty, less whatever amount regular income taxes would take.

Even so, many plan sponsors let participants sort that decision out for themselves. According to a survey by consulting firm Aon Hewitt, in-plan Roth conversion features are gaining momentum. In 2013, 27% of surveyed sponsors allowed in-plan conversions, and another 66% were likely to add that feature.

It's one thing to offer a Roth 401(k) plan option, but are participants using it? At the beginning of this year, an average of 11% of employees in the Aon Hewitt survey who had the Roth 401(k) plan option used it. Generally, the longer the Roth 401(k) plan choice exists, the more participants use it. For example, 18% of participants in plans that had a Roth option for at least seven years took advantage of that opportunity.

Age makes a difference

The participant's age also factors into the use of a Roth 401(k) plan option. For example, more than 17% of twenty-somethings contributed to a Roth last year vs. less than 9% of participants in their 50s. Given that younger participants have a longer time period to benefit from the buildup of tax-free earnings on their contributions, this makes sense.

They're also less likely to face the prospect of a big tax hit by converting an existing pretax 401(k) plan balance to a Roth account because existing balances are generally lower. For older participants, there may not be enough time to make that money that's lost to taxes on the conversion, and they may be better off leaving those assets alone.

Roth 401(k) plan in action

How can participants decide whether to take advantage of a Roth feature? Let's assume that a participant's tax rate (25% in this example) will never change. If he or she contributes $5,000 annually to a Roth 401(k) plan earning 7%, after 30 years the accumulation will be about $505,000. The entire sum will be tax-free. If instead the contributions accumulate in a regular pretax 401(k) account, only about $380,000 will be left after taxes.

However, a participant who contributes $5,000 each year in the Roth 401(k) plan will have to pay $1,250 (25%) in taxes each year on that $5,000. If instead the participant contributes only $3,750 to the Roth annually (what would be left over after taking out the 25% tax bite), the accumulation will be the same ($380,000) as would remain after taxes on the $505,000.

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Chances are, of course, the participant's contributions will rise over time. Also, the simplified example doesn't include any employer contributions to the plan. Finally, there's no way of knowing the tax rates the participant will face during retirement. If they're higher, the Roth 401(k) plan after-tax contributions put the participant ahead of the game. In the unlikely event that the participant's tax rate will be lower in retirement (an assumption that used to be made but now seems less likely), the tactic may backfire. Given that uncertainty, participants may choose to split their deferrals between the Roth and the pretax option in the 401(k) plan.

Making the Roth 401(k) option a reality

Giving 401(k) plan participants the opportunity to open a Roth account within a plan — either by starting from scratch or converting some or all of an existing account balance into the Roth structure — may soon become the norm, predicts Aon Hewitt. Half of the plan sponsors in its database (primarily larger companies) already do so. Giving your employees the opportunity to participate in a Roth 401(k) plan may help them hedge their bets about the income tax environment they'll face in retirement.

401(k) plan automatic enrollment: A winning formula

Although the number is slowly shrinking, many 401(k) plan sponsors remain reluctant to institute auto-enrollment and auto-deferral-increase features. However, the fact is inescapable: Plans with these features generally have higher participation rates and account balances.

A look at the numbers

According to Vanguard, about one-third (34%) of the plans that it provides recordkeeping services for automatically enroll new, eligible employees — up 10% from five years ago. Generally, auto-enrollment increases participation rates. Based on Vanguard's data, the average participation rate for auto-enrolled plans is 82% vs. 65% for voluntary plans. Participation rate variances are particularly dramatic when examined by employee demographics. For example, the average participation rate of employees earning less than $30,000 at auto-enroll companies is 78%, but just 34% in voluntary enrolled plans.

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Employers' willingness to auto-enroll employees correlates with their size: Only 25% of employers with less than 1,000 employees auto-enroll, whereas at least 55% of employers with 1,000 or more employees use this feature. Why the disparity? One possibility is that smaller employers worry about increased plan expenses if they auto-enroll employees and provide some level of matching contribution.

Similarly, the participation rate for young (below age 25) workers is 68% at auto-enroll companies

and a meager 29% elsewhere, according to Vanguard. Boosting participation rates among young employees allows them to maximize the benefit of compounding savings accumulation rates. The compounding advantage is even more dramatic for plans that also automatically increase default contribution rates by 1% each year.

Play to win

From an employer perspective, higher participation rates through both auto-enrollment and auto-deferral-increase features are beneficial for several reasons. First, employees who are on track to funding their retirement are more likely to retire, rather than stay in jobs to pay for their basic living expenses. A dynamic workforce tends to be more productive than one that's stagnant. Employees who take advantage of a 401(k) plan, particularly employer-matching contributions, appreciate the value of the benefit and tend to feel more highly compensated.

In addition, the greater the participation rate and dollars in the plan, the more leverage employers have to negotiate with service providers. To establish an auto-enrollment 401(k) plan, first decide whether to set up the plan yourself or to consult a professional to help establish and maintain the plan.

You'll need to adopt a written plan document and arrange a trust for the plan's assets. Make sure you have a recordkeeping system that can manage auto-enrollment and auto-deferral-increase provisions. Finally, you'll need to provide plan information to employees eligible to participate. Employees must receive an initial notice before auto-enrollment in the plan and receive a similar notice each subsequent year.

It's a win-win

Auto-enrollment, coupled with auto-deferral increases, isn't good for only participants — it's also good for employers. Higher participation in 401(k)s by rank-and-file employees allows for higher limits for key employee contributions. Keeping key employees around with the incentive of higher contribution limits may decrease turnover. Auto-enrollment can be a win for everyone.

Help participants avoid an inappropriate IRA rollover

The Government Accountability Office recently found that much of the information touting the benefits of IRA rollovers isn't always objective. This prompted the Financial Industry Regulatory Authority (FINRA) to alert investment advisors and brokerage firms that it's investigating inappropriate IRA rollover solicitations to 401(k) plan participants nearing retirement. In turn, plan sponsors should be aware of employees who may be persuaded to roll over assets into expensive or poorly designed and managed IRAs.

FINRA identified factors to consider before rolling 401(k) plan assets into a particular IRA. Plan sponsors should ask participants how a proposed IRA compares to the 401(k) plan in the following ways:

- What's the range of investment options available?
- How are investment-related and plan or account fees charged?
- What level of customer service is available?
- What are the tax consequences, including penalties, for premature rollovers?

Additionally, FINRA recently released an "investor alert" featuring tips for making sound decisions on IRA rollovers. Plan sponsors should remind participants to:

- Evaluate all transfer options (leaving account where it is, rolling it over or cashing it out),
- Minimize taxes by rolling Roth to Roth and traditional to traditional,
- Think twice before making an indirect rollover — 401(k) plan to participant to IRA,
- Be wary of "free" or "no fee" claims,
- Research conflicts of interest,
- Compare investment options and other services,
- Understand fees and expenses of all options,
- Discuss the options with a financial or tax professional,
- Determine if age affects the tax treatment of withdrawals between the 401(k) plan and IRA, and
- Analyze tax implications of any appreciated company stock.

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