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Employee Benefits Update

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Is a safe harbor plan the right move?

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Do you worry each year about whether your highly compensated employees (HCEs) will have "excess" salary deferrals returned to them due to the plan failing the actual deferral percentage / actual contribution percentage (ADP/ACP) discrimination tests? Most small plan sponsors take advantage of "safe harbor" rules that nearly always eliminate the need to worry about passing these tests. But there are risks to this approach as well.

What are the test formulas?

Currently, the threshold for HCE status is an annual salary of $120,000, or at least 5% company ownership.

Using the ADP test, you first calculate your HCEs' average deferral rates, including employees eligible to participate in the plan but who choose not to. For example, if you have only two HCEs, and one deferred 5% and another 6%, the average is 5.5%. Also suppose, using the same calculation method, that your nonhighly compensated employees' (NHCEs') average deferral rate is 4.5%.

Although the HCEs' ADP exceeded the NHCEs', you'd pass the test because, when the NHCE average deferral rate is between 2% and 8% (as is typical), the HCEs' ADP can exceed the NHCEs' by up to two percentage points. That is, the NHCEs' average deferral could have been as low as 3.5%, and you'd still pass. (Different formulas kick in when the NHCEs' average deferral rate is below 2% or above 8%.)

The ACP test is similar, but also includes employer matching contributions and after-tax employee deferrals.

What if you don't pass?

If you're consistently failing those tests by a wide margin, a safe harbor plan design could look attractive. The rules provide two safe harbor formula categories

to choose from to avoid ADP/ACP testing, as well as top-heavy testing:

1. Minimum matching contribution formulas. This requires plans to either:

- Match 100% of the first 3% of deferred compensation and 50% on deferrals between 3% and 5% (which means the maximum you'd contribute is 4% of employee compensation), or
- Match 100% on the first 4% deferred.

2. Nonelective contribution rate. The company must contribute 3% of the eligible employee's compensation, regardless of how much or little NHCEs save on their own.

And the cost is…

Let's say you have the alternative of offering a less generous plan, but still pass the actual deferral percentage / actual contribution percentage (ADP/ACP) discrimination tests. How much would a safe harbor plan "cost" you? The answer depends on:

- How elaborate and aggressive a 401(k) promotion plan you'd need to convince enough nonhighly compensated employees to participate and tilt the scales, and
- How close to the minimum safe harbor matching and nondiscretionary contribution formulas you'd need to get to clear the tests.

You'll have to conduct this analysis to make your estimate. You'll also need to weigh the dollars at stake against your goals behind sponsoring a 401(k) plan in the first place. You might conclude that spending a bit more by establishing a safe harbor plan is worth the (potentially extra) investment in helping employees save for their future.

All safe harbor contribution amounts must vest immediately with the employee.

How about a QACA?

A qualified automatic contribution plan (QACA) is also a form of safe harbor plan. With this approach, you must auto-enroll employees into the plan and a qualified default investment option such as a target date fund. A QACA must have a minimum initial deferral rate of 3% and annual deferral rate increases of at least 1%, until the deferral rate reaches at least 6%, but no more than 10%.

If you want to establish a new safe harbor plan, you must do so by October 1 for calendar year plans; existing 401(k) plans have until January 1 to start as a safe harbor plan.

In addition, the plan must match 100% of deferrals on the first 1% deferred, and at least 50% on incremental deferrals up to 6%. (The net result is a maximum required match of 3.5%.) A two-year cliff vesting formula is permissible.

Where to next?

Starting a safe harbor plan takes some planning. If you want to establish a new one, you must do so by October 1 for calendar year plans. Existing 401(k) plans have until January 1 to start as a safe harbor plan.

You must provide participants a notice of intent to be a safe harbor plan for the coming year at least 30 days prior to the new plan year. If you currently have a 401(k) plan, check your plan documents to ensure you can amend them to add a safe harbor plan.

Should you do it?

Going the safe harbor route is the path of least resistance, but it can also be the more expensive one. (See "And the cost is…" above.) Set a time to discuss the pros, cons and applicable documentation with your benefits advisor. He or she can review the ADP/ACP discrimination tests with you, as well as determine whether a safe harbor plan would work for your organization. □

Avoid litigation with attention to common red flags

Any size retirement plan can run into serious trouble when sponsors aren't careful. With some planning, though, your qualified retirement plan doesn't have to be the target of ERISA litigation. A reminder of the most common red flags leading to litigation might be helpful.

Reasonable expenses

Of course, you can't assure consistently strong investment performance. But plan sponsors can — and must — ensure that expenses are reasonable.

When your plan's investment portfolios are performing well, it's easy to pay less attention to the recordkeeping costs and investment management fees. But when performance is subpar, out-of-line expenses stick out like the proverbial sore thumb. Make sure you schedule regular, independent reviews of your plan expenses and fees every three to five years as part of your due diligence.

Opaque fee structures

In the past, complex and opaque fee structures such as revenue-sharing arrangements between asset managers and third-party administrators made it harder to get a handle on cost. But with the U.S. Department of Labor's fee disclosure regulations now in their fourth year, pleading ignorance is no excuse. In fact, it never really was.

Mutual fund shares with built-in revenue sharing features still exist but, with required disclosure statements, it's easier for you (and plan participants) to understand what they are. Although these built-in revenue sharing features aren't inherently bad, they tend to be associated with funds that have higher expense charges.

Try not to incorporate such funds into your plan — absent a good reason that you can explain to participants. In some plan fee litigation, courts have deemed fee-sharing arrangements a payoff to an administrator to recommend those funds, subordinating its assessment of the funds' merits as sound investments.

Bundled services

Another expense-related red flag that could trigger litigation is exclusive use of a bundled plan provider's investment funds. This also can raise questions about the effort that you put into investment performance evaluation.

So if you use only a bundled provider's funds, you could give the appearance of not performing your fiduciary duty to seek out the most appropriate and competitively priced funds. And in fact, the odds are slim that one bundled provider has best-of-class funds in all of your desired investment strategy categories and asset classes. When retaining a bundled provider, question whether the recommendation of primarily proprietary funds could result in a conflict of interest if better performing and lower cost funds are available on their platform.

Share classes

Even when your plan's investment lineup features funds from multiple asset management companies, you could be inadvertently flying a red flag if the funds in your investment menu are in an expensive share class. Individual investors, unless they have very deep pockets,

generally have access to only retail-priced share classes. In contrast, retirement plans, even small ones, typically can use more competitively priced institutional share classes. The failure to use institutionally priced share classes has been at the heart of many class actions against plan sponsors.

Different share classes of the same mutual fund have different ticker symbols; that's one easy way to determine what's in the portfolio. Fund companies that offer shares with sales loads typically offer more variations, with "A," "B" and "C" categories of retail shares, and an institutionally priced "I" share class without embedded sales charges.

Having some high-cost investments in your fund lineup isn't in itself a reason that you'll be deemed to have breached your fiduciary duties. There may indeed be good reasons to include them, notwithstanding the higher costs.

Investment policy statements

The concept of "procedural prudence" is embedded in ERISA and case law. This means plan sponsors must establish — and follow — policies and procedures to safeguard participants' interests and set the criteria used to evaluate vendors, including asset managers.

Create an investment policy statement (IPS) to articulate your vision for plan investments overall, and the investment options you want to make available to participants. The IPS should clearly state:

- What kind of assets you'll include in investment options,
- The degree of investment risk and volatility that's acceptable,
- How you'll assess investment performance, and
- When you'll change managers.

Although having an IPS isn't obligatory, doing so can show that you're exercising procedural prudence — provided you can document your compliance with it. Merely signaling prudence won't get you off the hook; following carefully crafted procedures and policies will go a long way toward preventing missteps that could lead to litigation in the first place. If you already have an IPS, be sure to follow it.

Next steps

Avoiding ERISA litigation is on every plan sponsor's wish list. Reviewing expenses, fee structures and bundled services, and creating and following an IPS, can help you achieve this. Start by making periodic review of these areas the norm, in good times and bad. □

Compliance Alert

Upcoming compliance deadlines:

6/30 Deadline for processing corrective distributions for failed actual deferral percentage / actual contribution percentage (ADP/ACP) tests from plans with eligible automatic contribution arrangement (EACA) without 10% excise tax

7/29 Summary of material modifications is due (210 days after the end of the plan year in which the amendment was adopted)

7/31* Form 5500 is due for calendar year plans or a request for an extension on Form 5558

7/31 Form 5330 to report excise tax on prohibited transactions and excess 401(k) plan contributions is due

7/31 Form 8955-SSA for calendar year plans to report separated participants with a deferred vested benefit, unless an extension is requested

** This date reflects an extension of the normal deadline, which falls over the weekend this year.*

Helping soon-to-be retirees understand RMD rules

Do you have employees who will soon reach retirement age? If so, are they aware of the required minimum distribution (RMD) obligations beginning at age 70½ for both their individual IRAs and their 401(k) plans? It's important that they know what to expect when they reach that age, for financial and tax-planning purposes.

IRAs and 401(k)s

To avoid a whopping penalty, current employees must take RMDs from their IRAs on reaching age 70½. However, the first payment can be delayed until April 1 of the year following the year in which the employee turns 70½. But they don't have to begin taking distributions from their 401(k)s if they're still working.

Although the regulations don't state how many hours employees need to be working to postpone 401(k) RMDs, they must be doing legitimate work and receiving wages reported on a W-2 form. There's an important exception, however: Workers who own at least 5% of the company must begin taking RMDs from the 401(k) beginning at 70½, regardless of their work status.

If an employee has multiple IRAs, it doesn't matter which one he or she takes RMDs from so long as the total amount reflects their aggregate IRA assets. In contrast, RMDs based on 401(k) plan assets must be taken specifically from the 401(k) plan account.

Sooner rather than later

The IRS prefers taxing income sooner rather than later. (Roth IRAs aren't subject to RMD requirements because the money in them has already been taxed.) The IRS determines how RMD amounts change each year as the retiree ages, using a formula and life expectancy tables.

For example, at age 72, the IRS "distribution period" is 26.5, meaning that the IRS assumes that participants will live another 26½ years. Thus, participants must withdraw the percentage of the IRA or 401(k) account that is 1 divided by 26.5 (3.77%).

If a participant lives to age 90, the distribution period would be 11.4, resulting in an 8.77% RMD. Although the percentage amount increases over time, the IRS rules don't force retirees to zero out their accounts. Still, based on the IRS formula, they're not likely to have a lot of funds remaining in those accounts when they die.

Other pertinent facts

Here are some additional RMD facts that you can share with employees approaching retirement:

Beneficiary spouses. Account holders who have a beneficiary spouse at least 10 years younger are subject to a different RMD formula that allows them to take out smaller amounts to preserve retirement assets for the younger spouse.

Tax penalty. The tax penalty for withdrawing less than the RMD amount is 50% of the portion that should have been withdrawn. Participants must pay the penalty first and then bring a refund case for the penalty.

Form of distribution. RMDs can be in cash or be taken in stock shares whose value is the same as the

RMD amount. Although this can be administratively burdensome, participants can defer incurring brokerage commissions on securities they don't want to sell. And, their tax basis in the stock (for future capital gains liability calculation purposes) resets to the value of the securities when they're distributed.

Informed participants

Remember, informed participants are happy participants. It's never too early to educate your soon-to-be retirees about their RMD obligations. Involve your benefits advisor to ensure you're providing the most current information. □

IRS simplifies process for avoiding rollover penalties

The IRS has made it a lot easier for retirement plan participants (and IRA owners) to avoid penalties when they botch a rollover. Although many plan sponsors encourage 401(k) plan participants to request a direct trustee-to-trustee transfer or direct rollover, participants sometimes get impatient and ask to have their account balances distributed directly to them (which is subject to a 20% mandatory tax withholding).

A participant has 60 days from the date he or she receives an IRA or retirement plan distribution to roll it over to another plan or IRA. Otherwise, the participant may have to pay a 10% tax penalty on top of being taxed on the distribution's full amount.

Previously, account holders faced an arduous process to convince the IRS that they'd made an honest mistake. New IRS Revenue Procedure 2016-47 allows participants to "self-certify" valid reasons to the receiving financial institution. The guidance also furnishes a model letter for taxpayers and describes various scenarios in which participants can avoid the penalty, including the following:

- The financial institution receiving the contribution or making the distribution to which the contribution relates committed an error.
- The distribution was made in the form of a check, which the taxpayer misplaced and never cashed.
- The taxpayer deposited the distribution into an account that he or she mistakenly thought was an eligible retirement plan.
- The taxpayer's principal residence was severely damaged.
- A member of the taxpayer's family died, or the taxpayer or a member of the taxpayer's family was seriously ill.
- The taxpayer was incarcerated.
- A foreign country imposed restrictions.
- The post office committed an error.
- The distribution was made because of a levy and the proceeds were returned to the taxpayer.

Finally, the taxpayer can certify that, despite his or her reasonable efforts to obtain the information, the party making the distribution to which the rollover relates delayed providing information that the receiving plan or IRA needed to complete the rollover. □

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Pension audit specialists

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