retirement
plan news

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Safe Harbor 401(k) or QACA for 2008?

The safe harbor 401(k) plan is one of the most popular plan designs for small employers. But that may change. With the introduction of the qualified automatic contribution arrangement (QACA) for 2008, employers may want to consider both options before deciding which will best meet their goals.

The QACA is a new type of safe harbor 401(k) plan — one with an automatic enrollment feature. Introduced by the Pension Protection Act of 2006 (PPA), the new safe harbor option has certain advantages that may be attractive to many traditional safe harbor 401(k) employers.

"Traditional" Safe Harbor Plan. Under a safe harbor plan, an employer makes a safe harbor contribution and the discrimination tests the plan would otherwise have to pass — the average deferral percentage (ADP) test that applies to employee deferrals and, in some cases, the average contribution percentage (ACP) test that applies to matching and after-tax contributions — are satisfied. This allows highly compensated employees (HCEs) to make the maximum allowable deferral of compensation without the need for the plan to pass the discrimination tests (possibly the biggest advantage of the safe harbor design).

Before choosing a traditional safe harbor 401(k) plan, employers need to fully review the costs involved. For one thing, if a plan sponsor makes a nonelective safe harbor contribution, it must be made for all eligible employees, including those who do not work 1,000 hours during the year or are not employed on the last day of the plan year. In addition, all safe harbor contributions are immediately 100% vested.

Enter the Qualified Automatic Contribution Arrangement. The QACA, like the traditional safe harbor plan, avoids the ADP and ACP testing. But there are several differences between the two safe harbor options. The QACA's automatic enrollment feature is one. The QACA also has advantages in the areas of vesting, safe harbor match, and top-heavy rules.

Vesting. The QACA permits 100% vesting after two years of service. Thus, an employer may use a two-year-cliff vesting schedule for safe harbor contributions. If an employee leaves before completing two years of vesting service, any QACA safe harbor contributions that are not vested are forfeited.

Safe Harbor Matching Contribution. The QACA safe harbor matching contribution is less than the traditional safe harbor plan match. Here are the two formulas.

- The traditional, basic safe harbor matching contribution formula is:

  A 100% match on the first 3% of compensation deferred and a 50% match on deferrals between 3% and 5% for a total maximum match of 4%.

- The QACA safe harbor matching contribution formula is:

  A 100% match on the first 1% of compensation deferred and a 50% match on deferrals between 1% and 6% for a total maximum match of 3.5%.

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Example: If a participant deferred 3% under a traditional safe harbor plan, the employer would provide a match of 3%. With a QACA, the same 3% deferral would receive only a 2% match.

Note: The nonelective safe harbor contribution (NEC) for both types of plans is 3%. Generally, the 3% NEC must be provided to all employees eligible to make elective deferrals to the plan.

Top-heavy Rules. A traditional safe harbor 401(k) plan that permits only elective deferrals and contributions that satisfy the ADP and ACP safe harbor provisions is exempt from the top-heavy rules. This is a year-by-year determination. In a year in which the employer does not meet the top-heavy exemption requirements, the plan is subject to the top-heavy rules. The QACA is subject to the same rules. However, the QACA's smaller safe harbor matching contribution generally decreases the cost of satisfying the top-heavy exemption.

Minimum Deferral Percentages. The QACA must have a minimum automatic contribution percentage. (Employees may choose to reduce or increase their contributions or opt out entirely.) For the first full year of participation, the minimum deferral amount is at least 3% (but no more than 10%) of compensation. As each participant continues with the plan, his or her minimum deferral rate automatically increases to 4% the second year, 5% the third year, and 6% the fourth year. The maximum deferral percentage cannot exceed 10%. The traditional safe harbor 401(k) plan does not have a required minimum deferral feature.

Some in the industry are considering starting automatic enrollment in a QACA at the 6% minimum deferral rate, the highest rate required. Then there would be no need to escalate participants' deferral rates until they reach 6%.

90-day Revocation. This PPA provision allows employees 90 days to request the return of their automatic deferrals (and earnings). It was included to cover situations where employees fail to return enrollment forms and then complain when contributions are automatically taken from their pay.

Guidance Expected for QACAs and QDIAs. Although the PPA created the QACA, IRS guidance is needed to provide operational details. PPA also created a safe harbor for a qualified default investment alternative (QDIA). Since automatically enrolled participants may fail to choose their own investments, QDIAs provide plan sponsors that follow the safe harbor rules for default investments with fiduciary relief. Final QDIA regulations are needed from the Department of Labor (DOL). The QDIA rules will become effective 60 days after the final regulation is published in the Federal Register.

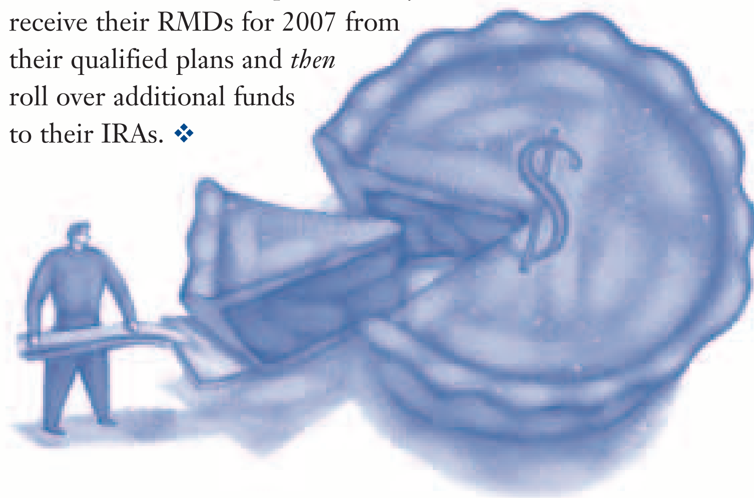
Notices. Traditional safe harbor plans must provide participants and beneficiaries with an annual notice, generally between 30 and 90 days before the beginning of the next plan year. As a safe harbor plan, a QACA will no doubt also require this notice. In addition, there is a QACA automatic enrollment notice that must be given to new employees when they are hired and before they enter the plan. This notice must also be provided to all eligible employees on an annual basis (30 days before the beginning of each plan year).

If the final QDIA rules maintain the proposed rules, QACAs will also need to send a QDIA notice to participants and beneficiaries 30 days in advance of the first investment in a QDIA and annually thereafter (at least 30 days before the start of each plan year). We will continue to cover this and other important guidance when it is issued. ❖

Charitable Donation IRAs

Section 1201 of the Pension Protection Act of 2006 (PPA) permits an IRA owner who is age 70½ or older to make a direct, tax-free donation of up to $100,000 per year from his or her IRA to a qualified charitable organization. The donated amount counts toward satisfying the required minimum distribution (RMD) for the year. The opportunity to make such a donation ends December 31, 2007.

This law *does not apply* to distributions from qualified plans, such as profit sharing and 401(k) plans. Furthermore, if a participant in a qualified plan wishes to roll over funds to an IRA and then make a charitable donation from that IRA, the IRS's RMD rules require that the RMD for the year be taken from the qualified plan first. Only distribution amounts that exceed the RMD may be rolled into an IRA. Thus, donations for 2007 are possible only if interested donors first receive their RMDs for 2007 from their qualified plans and *then* roll over additional funds to their IRAs. ❖



Missed RMD Payments

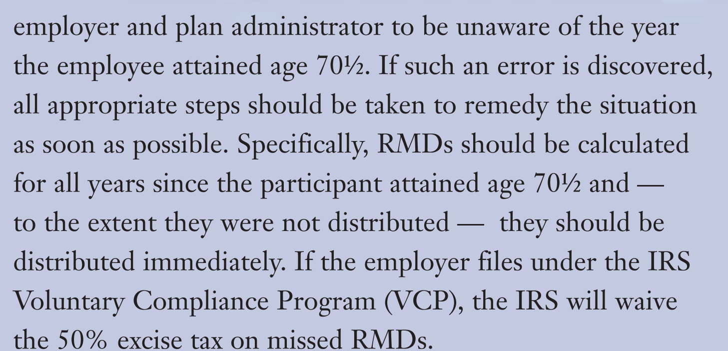
Qualified plans, such as profit sharing, 401(k), and money purchase, must meet the requirements of Internal Revenue Code Section 401(a). For example, the plan must be established and maintained for the exclusive benefit of the employees and their beneficiaries, contributions or benefits under the plan must not discriminate in favor of highly compensated employees, and the plan must satisfy minimum coverage requirements and vesting standards. Failure to comply with the more than 30 requirements in Section 401(a) can cause disqualification.

Section 401(a)(9) RMD Rules. Section 401(a)(9) requires every qualified plan to provide required minimum distributions (RMDs) as soon as a participant reaches his or her required beginning date (RBD), generally age 70½, and at the participant's death. So, if an individual works at seven jobs during his career and leaves money in each 401(k) plan until reaching age 70½, each plan is required to distribute an RMD amount to the individual.

Different Rules for IRAs. The rules governing required minimum distributions from individual retirement accounts (IRAs) are different from the ones that apply to qualified plans in one important way: IRA RMDs may be aggregated. If an individual has traditional IRAs with 10 different financial institutions, when RMDs are due (at age 70½ and thereafter), she can calculate the RMD amount for each IRA, add the 10 RMD amounts together, and take the aggregate RMD amount from just one IRA (or more, if she wishes). The IRA RMDs may not be combined with the qualified plan RMDs. Individuals often think the IRA rules apply to qualified plans. They do not.

Missed RMDs from Qualified Plans. If an RMD is not distributed from an employer's qualified plan, then the plan fails to satisfy one of the Section 401(a) qualification requirements and could be subject to disqualification, especially if there is an IRS audit that uncovers a disregard of the RMD requirements of Section 401(a)(9).

However, mistakes can happen. For example, an employee's date of birth may be incorrect, inadvertently causing the



employer and plan administrator to be unaware of the year the employee attained age 70½. If such an error is discovered, all appropriate steps should be taken to remedy the situation as soon as possible. Specifically, RMDs should be calculated for all years since the participant attained age 70½ and — to the extent they were not distributed — they should be distributed immediately. If the employer files under the IRS Voluntary Compliance Program (VCP), the IRS will waive the 50% excise tax on missed RMDs.

Missing RMDs must be a frequent audit issue because the IRS added a correction procedure for missed RMDs to its Employee Plans Compliance Resolution System (EPCRS) in Revenue Procedure 2006-27.

Fee Schedule for RMD Failures. Normally, the IRS filing fee is based on the number of participants in the plan. But a new fee schedule applies to plan failures involving RMD rules. The fee for a missed RMD filing is much lower than the regular IRS schedule. If 50 or fewer participants are affected by the failure, the penalty is $500, regardless of the actual number of plan participants. In addition to simplifying and encouraging the correction process, this enhancement sets a clear benchmark in an area of plan administration that is *likely* to experience problems at one time or another.

It is important to make sure that each individual in a qualified plan who has reached his or her RBD begins taking RMDs. Even if the plan document does not otherwise provide for installment payments, RMDs may be distributed in annual installments because the RMD requirements must be met for the plan to be qualified. Thus, a plan document may permit RMD amounts to be taken each year, even if the only distribution method in the plan document is the lump-sum method. ❖

recent developments

IRS Priority Guidance Plan for 2007-8. Each year, the IRS makes public the list of priority projects that it intends to complete during the coming year. Following is a list of some of the retirement plan items that are in the new priority guidance plan:

- Employee Plans Compliance Resolution System (EPCRS) update
- Model 402(f) eligible rollover distribution notice
- Guidance on automatic enrollment plans
- Guidance on hybrid defined benefit plans (such as cash balance plans)
- Guidance on the diversification requirements for employer stock
- Guidance on Form 5500 reporting as a result of the Pension Protection Act (PPA)
- Guidance on a host of defined benefit issues from PPA

403(b) Final Regulations. After waiting for more than two and a half years, retirement plan practitioners have finally received updated, finalized, comprehensive regulations for Internal Revenue Code Section 403(b) arrangements. In general, the new regulations revise the operation and administration of 403(b) arrangements so that they are, in many respects, much more like 401(k) plans. The regulations replace those issued on December 24, 1964, and are generally effective for taxable years that begin after December 31, 2008.

Deadline for Cycle B and DB Plans Approaching. The restatement deadline for submitting Cycle B individually designed plans of sponsors with employer identification numbers ending in 2 or 7 is January 31, 2008. In addition, those who offer preapproved defined benefit plans will be submitting for new opinion letters by the same date.

Avoiding Roth RMDs. When a plan participant directs that his or her designated Roth account be directly rolled into a Roth IRA before the calendar year in which the participant reaches 70½ years of age, the individual does not have to take a required minimum distribution (RMD), since Roth IRAs are not subject to RMDs. ❖

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.

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