ASPPA

Making Retirement Plans Work

Part of the American Retirement Association

Deferral Election Trouble Spots

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Audits

- IRS audits
  - Tax compliance
- Independent CPA audits – almost an extension of DOL
- DOL “investigation” (including PBGC)
  - Focus on ERISA protections for participants

What is a Cash or Deferred Election?

- A CODA is any direct or “indirect” election by an employee to have an employer either:
  - Provide cash or other taxable benefit that is not currently available, or
  - Contribute an amount to a plan that defers compensation

Current Availability

- A deferral can only be made with respect to amounts that are not currently available
- Currently available if:
  - Paid
  - Employee has discretion to currently get paid or have a taxable benefit
- Not currently available if there is a restriction on right to receive or if payment cannot be made until a future date

Cash Tips

- Once the employee has the cash in hand, deferrals cannot be made out of those amounts
  - Unless tips are pooled
- A deferral election can still be based on these amounts as long as the contribution does not come from these amounts
  - E.g., I can elect to defer 3% of total compensation – means I must contribute more than 3% of regular pay

Timing of Contributions

- A contribution can only be made *after* the election is made
- A contribution can only be made *after* the services generating the contribution were performed
  - Exception for bona fide administrative reasons (e.g., bookkeeper going on vacation)
  - Accelerating deductions cannot be the principal purpose

Elections Not to Participate

- A CODA does not include an election to have contributions of a set amount, including $0, provided the election is:
  - Irrevocable
  - Made prior to eligibility
  - Applies to all current and future plans of that employer
- Plan must permit the election
  - Prototype plans may not include this option
- No exemption from IRC §410(b) coverage testing for elections not to participate

Partnerships and Self-Employed

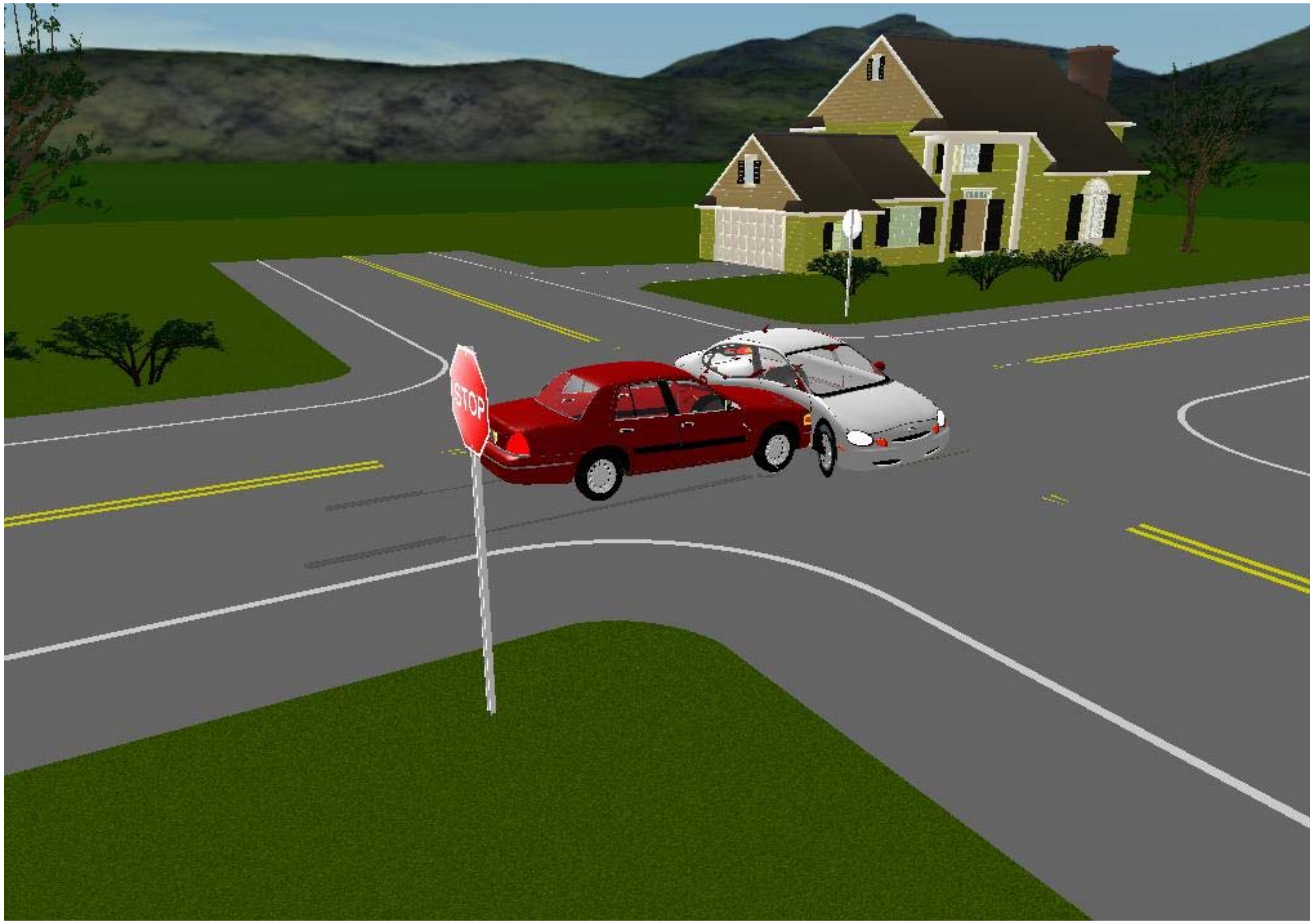
- A CODA includes any arrangement that allows the partners to vary the contributions made on their behalf
  - Have plan contributions determined at partnership level
- Earned income is "currently available" as of the last day of the taxable year of the individual
- Deferral elections must be made by that date
- If a draw is based on a reasonable estimate of earned income, then a deferral can be made if an election is made prior to payment of the draw

Deferral Deposit Deadline

- If plan is subject to ERISA, partner deferrals are subject to the same deposit deadlines as employee deferrals
- Deferrals taken from draws:
  – ASAP (or 7 business days) after draw
- Deferrals taken after earned income determined
  – ASAP (or 7 business days) after earned income determined or would have been distributed

COMPENSATION

Intersection of Deferrals and Compensation



Compensation

- What is deferrable compensation?
- What flexibility does a plan have in defining deferrable compensation?
- How does the plan actually define deferrable compensation?
- What has a participant elected to defer?

Deferrable Compensation

- May only defer out of compensation within the meaning of IRC §415(c)(3)
- One of the 3 base definitions
  - W-2 wages
  - Wages for Withholding
  - 415 regulatory definition (current income)

Post-Severance Compensation

- 415 Compensation must include certain compensation that is paid after severance if paid by the later of:
    - 2 ½ months after severance
    - The end of the limitation year including the date of severance
- Exception for disability payments if only recognized for NHCEs or if recognized for all participants but for a set period of time

Post-Severance Compensation

- Must include regular pay
  - Compensation for services outside the employee's regular working hours (such as overtime, shift differential, commissions, bonuses and other similar compensation)
- May include:
  - Leave cash-outs = payments for accrued bona fide sick, vacation, or other leave, but only if the employee would have been able to use the leave if employment had continued
  - Nonqualified unfunded deferred compensation

Post-Severance Compensation

- The following are never compensation if paid after severance (even if within 2½ months)
  - Severance pay
  - Golden parachute payments
- Cannot defer out of these amounts
  - Trap because in many cases you may not be aware a person has severed employment

Deferrals From Post-Severance Compensation

- Mary severs employment in December 2014
- Receives final paycheck in January 2015 for regular pay
- Mary makes a deferral out of the last paycheck
- General rule:
  - She has 415 compensation in 2015
  - It's a 2015 deferral for ADP test and IRC §402(g)
- Exception: If last few weeks rule is used, the compensation and deferral can be treated as 2014 amounts
  - Rarely used because must be used for all employees

Differential Wage Payments

- HEART provides that an individual in active duty is still an employee
- Differential wages are regular compensation after 2008
  - Prior to 2008 these amounts were covered by the post-severance compensation rules of the 415 regulations


401K
SAVINGS
PLAN

Flexibility for Plans

- General rule: Plans have flexibility in determining deferrable compensation
  - Treas. Reg. §1.401(a)(4)-4(e)(3) provides that the rate of elective deferrals permitted must be nondiscriminatory
  - A rate is based on compensation regardless of whether it satisfies IRC §414(s)

Right to Make "Each Rate"

- Plan cannot permit deferrals out of total compensation for HCEs but base pay for NHCEs
- Plan can provide that deferrals may only be made from base pay for all employees
  - Even if NHCEs have a larger percentage of compensation attributable to non-base pay

ADP Safe Harbor Plans

- ADP Safe Harbor plan can limit deferrable compensation to a “reasonable” definition of compensation (no compensation ratio test)
  - QACA Regulations provide that compensation for purposes of determining default contributions means safe harbor compensation as defined in Treas. Reg. §1.401(k)-3(b)(2)
    - 414(s) except cannot exclude comp over $ limit

Reasonable Under 414(s)

- Safe harbor minus items of “irregular” or “additional” compensation:
  - Bonus
  - Overtime
  - Shift differential
  - Call-in premium
- Can exclude compensation over a threshold (*e.g.*, exclude compensation over $100K) except for SH contributions and QACA deferrals
- Can exclude any fringe benefit items
- Impermissible exclusions:
  - Compensation = 75% of Compensation
  - 2015 Compensation = December compensation

Matching Problems

- Right to “each rate” of matching contributions, based on plan’s compensation definition
  - Compensation must satisfy IRC §414(s)
  - Different rates exist if based on different compensation definitions
- If you have different rates of match, you have to apply benefits, rights and features test
  - In addition to ACP test if not an ACP test SH

Must Follow the Plan Terms

- How does plan define compensation for deferral purposes

Plan Terms

- Regardless of the definition of Compensation selected in the Adoption Agreement, the Administrator may adopt a uniform policy for purposes of determining the amount of a Participant's Elective Deferrals of excluding "non-cash Compensation."
  - Non-cash = items not paid on cash or for which there is no opportunity to defer, such as cash tips
- Additionally, the Employer may, on a uniform and nondiscriminatory basis, permit different salary deferral elections for different items of Compensation (e.g., a separate salary deferral election for bonuses), and may exclude for purposes of calculating Elective Deferrals one or more items of irregular pay (e.g., car allowance).

Optional Inclusions

- Permitted to add back deferrals to:
  - 125 cafeteria plans
  - 401(k) plans
  - 403(b) plans
  - SIMPLE
  - SARSEP
  - 457
  - Qualified transportation fringe benefit plan

Gross vs Net Compensation

- Always use gross compensation for deferral purposes
  - Pete elects to defer 4% of plan compensation – if net is used then how do you determine his deferral?
- Beware of using net compensation for matching purposes
  - Plan has 100% match on deferrals up to 4% of compensation
  - Pete wants to defer the maximum amount that is matched
  - If plan uses net compensation, how does Peter figure out how much to defer?
    - If he defers 4% of gross then he has over contributed since match is only on 4% of net

Taxable Fringe Benefits

- A safe harbor adjustment (under IRC §414(s)) can be made for:
  - reimbursements or other expense allowances
  - fringe benefits (cash or non-cash) – IRS Publication 15-B
  - moving expenses
  - deferred compensation
  - welfare benefits
- Helpful because of matching contributions

Does Plan Impose Limits on Deferrals?

- Must follow any plan imposed limits on deferrals
- If plan permits catch-ups then must allow catch-ups above plan limit
  - Exception: may provide that total deferrals can't exceed 75% of compensation
  - Can plan provide limit of $0 for HCEs so that all deferrals are catch-up contributions?
- Must apply compensation limit ($265,000 in 2015) in applying plan imposed deferral limit

Compensation Limit of IRC §401(a)(17)

- Compensation limit of IRC §401(a)(17) does not affect deferrals
- Suppose Sue earns $50,000/month ($600,000)
  - Can she defer after June 2015 (2015 comp limit is $260,00 and her comp as of June 2015 exceeds $260,000)?
  - Yes – this was clarified in preamble to the regulations
- Issues raised by IRS in prior years centered on interpretation of deferral election forms

Be Careful on Matching Contributions

- Compensation limit does apply to matching contributions and is applied on an annual basis (does not need to be pro-rated throughout the year)
- Example: Plan has monthly match of 100% on deferrals up to 4% of compensation
  – Mary defers 4% of $50,000 monthly compensation
  – Match for 2015 cannot exceed 4% X $260,000 = $10,400
  – If plan does not apply pro-rated limit when depositing the match, this limit could be exceed
    - Mary's deferrals and match are $2,000/month if limit not pro-rated
    - In June she will have received maximum permissible matching contribution

Interaction with Matching Contributions

- A plan excludes bonuses for deferral purposes (only needs to be reasonable) but does not exclude bonuses in applying a limit on matching contributions
- Match is 100% of deferrals up to 3% of compensation and is on a payroll basis
- Jim makes $10,000/month ($5K semi-annual pay) and has elected to defer 4% of compensation per pay check
- Match is normally $150 per pay period
- Jim receives a bonus of $10,000 in March 2014 payroll
- Match is now $400 - even though he can't defer, it's part of compensation for the matching contribution

Bonus is Paid as Separate Payroll

- Same facts: Jim makes $5K semi-annual pay; 4% deferral election per pay check; match only on 3% (of gross)
- Match is normally $150 per pay period
- Jim receives a bonus of $10,000 in a separate payroll
- Deferral is $0 and match is now $0
- What if match is determined on an annual basis instead of payroll?
  - Annual match does not mean match can't be deposited earlier
  - True-up would be required if Jim had deferrals during the year that were not matched due to 4% of comp limit

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Back to Tips

- Participants who are NHCEs receive cash tips
- Plan provides a match of 100% on deferrals up to 4% of “compensation

Example – Part 1

- Plan includes tips in definition of compensation for deferral and matching purposes
- Jennifer elects to defer 4% of "compensation"
- Plan would need to withhold more than 4% of deferrable compensation
  - – Impossible to apply

Example – Part 1

- Jennifer elects to defer 4% of base compensation
- Plan can operationally implement
- How does Jennifer elect to defer maximum amount that will be matched?
  - Match is based on total compensation
  - No way for her to accurately determine deferral

Example – Part 2

- Plan excludes tips for deferral purposes
- If match still based on total compensation then issue with Jennifer being able to get maximum match
- If match also excludes tips then an IRC §414(s) problem
  - HCEs have a higher rate of match (100% on 4% of all comp); NHCEs have rate of match of 100% of 4% of net compensation)

SALARY DEFERRAL AGREEMENT

Participant Information

Name ____________________

Address ____________________

Last 4 digits of Social Security Number: ________

Check one: ☐ New Agreement ☐ Change

The Election

- I elect to defer _____% of my compensation (proportionately from each pay period)
- How will auditors interpret compensation?

Irregular Compensation

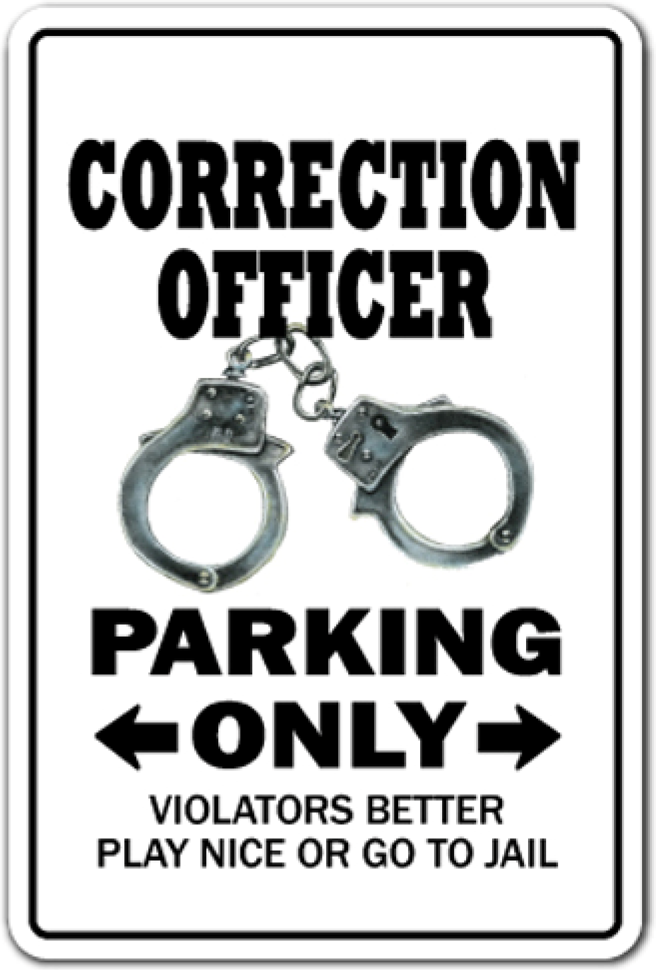
- Suppose plan does not exclude bonuses for deferral purposes
- A participant has elected to defer 3% of compensation
- What procedures are being used with respect to deferral elections on the bonus?
  - No deferral taken out unless special election is made
  - 3% is taken out unless special election is made
  - 3% is taken out because no special election is permitted

6-Month Suspension

- Plans using 401(k) safe hardship distributions or permitting military deemed severance provisions must suspend deferrals for 6 months
- How does a plan implement this provision?

Example

- Lauren has a deferral election of 4% of compensation
- Lauren receives a hardship (safe harbor rules) on April 28, 2015
- What happens on October 28, 2015?
  - No deferrals taken
  - 4% taken out


CORRECTION
OFFICER
PARKING
ONLY
VIOLATORS BETTER
PLAY NICE OR GO TO JAIL

Improper Exclusion: Correction

- ER contributes QNEC equal to:
  - Missed Deferral Opportunity
  - Missed After-Tax Opportunity
  - Required safe harbor contribution
  - QNEC is pretax (even if plan has Roth provision)
- ER makes corrective nonelective contribution for missed match (unless SH match)
  - It used to be a QMAC

Missed Deferral Opportunity

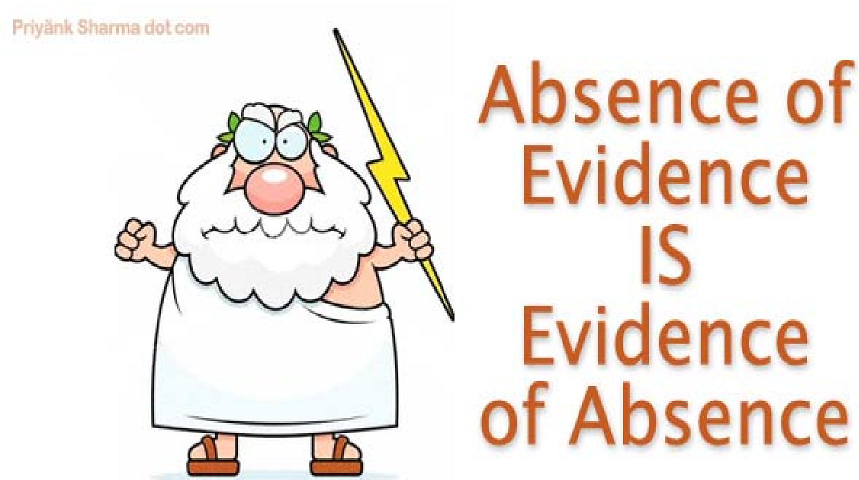
- Missed Deferral Opportunity = 50% of Missed Deferrals
- Missed Deferrals for traditional 401(k) plan:
    - ADP of the group to which the EE belongs (HCE or NHCE) times compensation for portion of the year for which the EE was excluded
        - Use current year numbers
  - Missed Deferrals for Safe harbor Plans:
    - Nonelective SH: 3% of compensation
    - Matching SH: Greater of 3% of compensation or maximum deferral % with at least 100% match

Missed Match

- Missed match = Match participant would have received if the participant had contributed 100% of Missed Deferrals
  - Apply plan's matching formula to missed deferrals (not missed deferral opportunity)

Proof

- Many auditors (IRS and CPAs) asking for proof of elections for those making $0 deferral
- How do you prove employees were not omitted by accident?



What if Employer Withholds Too Much?

- Excess allocation
  - Plan distributes to participant
    - Code E on 1099R
    - Taxed in year of distribution
  - Forfeit associated match
  - Not included in ADP test

What if Employer Withholds Too Little?

- Failure to follow terms of deferral election
- Missed deferrals are amount determined under deferral election
- Apply the same rules as Improper Exclusion

Brief Exclusion

- If employee has 9 months left in plan year to defer then:
  - No contribution for missed deferrals
  - Must still make missed matching contribution with earnings
- This rule still applies even with new correction methods of Rev. Proc. 2015-28

Rev. Proc. 2015-28: EPCRS Update

- Eases corrections for automatic enrollment or automatic escalation errors and for other deferral errors
- New rules reduce or eliminate the missed deferral QNEC (but not the match or earnings)

Rev. Proc. 2015-28

- Establishes 3 new rules
- 2 new terms:
  – Employee Elective Deferral Failure
  – Automatic Contribution Feature

Employee Elective Deferral Failure

- A failure to implement elective deferrals correctly in a § 401(k) plan or 403(b) Plan, including
  - Affirmative election
  - Automatic contribution feature
- A failure to afford an employee the opportunity to make an affirmative election because the employee was improperly excluded from the plan

Automatic Contribution Feature

- Automatic enrollment
- Automatic escalation (whether affirmatively elected or not)

Plans with Automatic Contribution Features

- Failure to:
  - Implement automatic contribution feature
  - Implement affirmative election of employee otherwise subject to automatic contribution feature
- Conditions:
  - Rectified within 9½ months after end of plan year of failure
  - Correct deferrals begin no later than first payday on or after 9½ months after plan year end or, if earlier, first payday for month after employee notifies employer
  - Employer gives notice to employee within 45 days after correct deferrals begin
- Relief: No QNEC for missed deferrals (but must contribute missed match plus earnings within 2 years after end of plan year of failure)

Automatic Contribution Arrangements

- This rule will sunset at the end of 2020 unless the IRS decides to extend (they are looking for increases in auto-enrollment plans)
- Earnings calculation: permits use of QDIA rate if the affected participant has not elected an investment option
  - If losses, cumulative losses cannot reduce the amount of any required corrective contribution (i.e., can have 0% cumulative earnings, but not negative)

All Plans: 3-Month Correction

- Failure: Employee Elective Deferral Failure
- Condition:
  - Rectified within 3 months after failure first occurs for participant
  - Correct deferrals begin no later than first payday on or after 3 months following when failure first occurs or, if earlier, first payday for month after employee notifies employer
  - Employer gives notice to employee within 45 days after correct deferrals begin
- Relief: No QNEC for missed deferrals (but must contribute missed match plus earnings within 2 years after end of plan year of failure)

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All Plans: 2-Year Correction

- Failure: Employee Elective Deferral Failure
- Condition:
  - Rectified within 2 years after end of plan year in which failure occurs
  - Correct deferrals begin no later than first payday on or after 2 years following plan year end or, if earlier, first payday for month after employee notifies employer
  - Employer gives notice to employee within 45 days after correct deferrals begin
- Relief: 25% QNEC for missed deferrals (but must contribute missed match plus earnings within 2 years after end of plan year of failure)

Notice Contents

- General information relating to the failure, (e.g., % of comp and date deferrals should have started)
- A statement that appropriate amounts have begun to be deducted and contributed (or will be) to the plan
- A statement that corrective contributions relating to missed matching contributions have been or will be made
- An explanation that the participant may increase deferral % to make up, subject to §402(g)
- Contact information

Mitigation

- **Duty to review pay records.** I understand I have a duty to review my pay records (pay stub, direct deposit receipt, etc.) to confirm the Employer has properly implemented my salary deferral election. Furthermore, I have a duty to inform the Administrator if I discover any discrepancy between my pay records and this salary deferral agreement. I understand the Administrator will treat my failure to report any withholding errors for any payroll to which my salary deferral agreement applies, by the cut-off date for the next following payroll, as my affirmative election to defer the amount actually withheld (including zero). However, I thereafter may modify my deferral election prospectively, consistent with the Plan terms.


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THEY CONTROL OUR PAYROLL DATABASE. THEY'RE MAKING DEMANDS.
LEAVE THE ACORNS AND NO ONE WILL GET THEIR DEDUCTIONS INCREASED.
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QUESTIONS