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Plan Sponsor Basics

Webinar 2 of 6

401(k) Plan Issues

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Agenda

- Automatic enrollment
- Expanded Roth conversions
- Fiduciary relief for investment mapping
- QDIAs
- Carryover elections
- Allocation of forfeitures
- Plan amendments

General Elective Deferral Plan Enrollment

- Eligible employees generally participate by either:
  - Completing a salary reduction agreement in order to participate, or
  - Becoming "automatically enrolled"
- Plan design dictates how participation occurs

Types of Automatic Enrollment

- Three types of automatic enrollment arrangements
  - “Traditional” Automatic Contribution Arrangement (ACA)
  - Eligible Automatic Contribution Arrangement (EACA)
  - Qualified Automatic Contribution Arrangement (QACA)

ACA

- ERISA § 514(e)(2) safe harbor:
  - Any group or subset of employees may be covered
  - No minimum or maximum deferral percentage required (2%-3% common) but deferral percentage must be uniform
  - Must be invested in a QDIA unless an affirmative investment choice is made
    - *QDIA regulations clarify that ERISA preemption applies to ACA even if not defaulted into a QDIA*

ACA (cont.)

- May be adopted any time during the plan year
- ADP/ACP testing required (unless combined with a safe harbor plan)
- May be designated Roth contributions
- No safe harbor definition of compensation required (unless combined with a safe harbor plan)
- Auto-escalator provision optional
- Initial and annual notice required

EACA

- An ACA that satisfies additional requirements:
  - Specific notice requirements
  - May generally be implemented only as of the first day of a plan year unless limited to newly hired employees
- May provide for 90-day withdrawal
  - Penalty-free withdrawal right for automatic contributions/related earnings; forfeiture of associated matching contributions
- May extend period to refund ADP/ACP excess
  - Extension only available if EACA extends to <u>all</u> participants

EACA – 90-Day Permissible Withdrawal

- Election by participant to withdraw any default elective contributions made under the EACA
- Must be specified in plan document
- Election period must be at least 30 days
- Must be made no later than 90 days after the date of the first default elective contribution
- Does not require spousal consent
- Requires forfeiture of associated matching contributions
- May be reduced by fees that generally apply to any other distributions of cash under plan
- Disregarded for ADP and 402(g) testing

EACA

- Any group or subset of employees may be covered (e.g., employees hired on or after the effective date of the EACA)
- Plan must state whether an employee who makes an affirmative election remains covered under the EACA; if so, the employee must continue to receive the required annual notice before each plan year
- Six-month extension (normally 2½ months) to refund ADP/ACP corrections if EACA covers <u>all</u> eligible employees
- No minimum or maximum deferral percentage required
- Auto-escalator provision optional; any escalator provision must be uniform
  - Uniformity for auto-escalator requires increase to apply in the same manner to all eligible employees; same rate of increase must apply to all eligible employees
- Must be adopted before beginning of plan year

EACA (cont.)

- ADP/ACP testing required (unless combined with safe harbor plan)
- No safe harbor definition of compensation required (unless combined with safe harbor plan)
- Initial and annual notice required for each eligible employee covered by the EACA

QACA – General

- An ACA that automatically enrolls eligible employees into an alternative safe harbor plan design with deferral elections based on a “qualified percentage”
  - Qualifies for waiver of the ADP/ACP testing
  - May qualify for exception to top-heavy rules

QACA – Eligibility

- Must cover all eligible employees hired on or after effective date of the QACA
  - Previously hired employees who made an affirmative deferral election (including 0%) do not need to be automatically enrolled
    - *Affirmatively solicit elections (including 0%) prior to implementing QACA to limit coverage of existing employees*
  - Previously hired employees who did not make an affirmative election must be auto-enrolled under the QACA unless they were previously auto-enrolled at a contribution rate that is at or above the initial QACA percentage (the auto-escalate will, however, apply to this group)

QACA – Qualified Percentage

- The "qualified percentage" of compensation for the default deferral election must be at least:
  - 3% for 1st plan year
  - 4% for 2nd plan year
  - 5% for 3rd plan year
  - 6% for each year thereafter
- Cannot exceed 10%
- Must use a "safe harbor" definition of compensation

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QACA – Automatic Escalator

- QACA must provide for auto-escalation
- Automatic deferral percent increases annually by 1%
  - Cannot exceed 10% of compensation
- Initial contribution period begins when the employee has first made contributions and ends with the last day of the following plan year
- The schedule for implementing automatic increases must be uniform
  - Exception to the uniformity requirement by allowing qualified percentages to vary based on the number of years or portions of years since the "initial period" began; thus, employers may implement automatic increases in the middle of a plan year so long as the adjustments occur no later than the first day of the plan year called for under the minimum schedule

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QACA – Automatic Escalator (cont.)

- Auto-escalation continues as though the employee were actively participating during a hardship withdrawal suspension period, LOA, etc.
- Plan may disregard an employee's prior participation in a QACA (giving the employee a new start) if no default contributions are made on the employee's behalf for at least an entire plan year (not just 12 months)

QACA – Employer Contributions

- Must provide for safe-harbor employer contributions
  - Safe-harbor matching contributions; or
  - Safe-harbor nonelective contributions
- Safe-harbor definition of compensation required for employer contributions
- Safe-harbor employer contributions subject to two-year cliff vesting

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QACA – Safe-Harbor Matching Contributions

- Provides for one of the following safe-harbor matching contributions:
  - – Fixed basic safe-harbor matching contribution equal to at least:
    - *100% match on first 1% of safe-harbor compensation deferred, plus*
    - *50% match on next 5% of safe-harbor compensation deferred*
  - – Fixed enhanced matching contribution at least equal to the matching contributions under the basic formula

QACA – Mid-Year Reduction/Suspension of Safe-Harbor Matching Contributions

- Same rules as for traditional safe-harbor plans
  - Notice of change must be provided at least 30 days before the effective date of the amendment to reduce or eliminate the match;
  - Employees must have a reasonable opportunity to change their deferral elections before effective date of amendment;
  - Safe-harbor matching contributions must be funded through the date of the amendment;
  - ADP and ACP testing will apply for the entire year

Summary

	ACA	EACA	QACA
Advance/annual notice	X	X	X
May be adopted mid-year	X		
Permit 90-day withdrawal period		X	
Deemed to meet ADP/ACP			X
Need to cover all employees		X (to get extended period for return of excess contribution)	X
Mid-year amendments permitted	X		

Expanded Roth Conversions

- American Taxpayer Relief Act of 2012 expanded Roth conversion opportunities

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Expanded Roth Conversions (cont.)

- Plan sponsors (401(k), 403(b), and 457(b) plans) <u>may</u> offer in-plan transfers from a non-Roth account to a Roth accounts before the non-Roth account can be distributed to the participant
  - Optional design feature – plan amendment required
  - Plan sponsor may wish to offer less than full conversion options

Expanded Roth Conversions (cont.)

- In-Plan Roth conversions
  - Participant can now convert sooner
  - Participant is taxed at time of conversion – may limit who can convert
    - *Mandatory and voluntary withholding should not apply*
    - *10% penalty on early distributions should not apply*

Expanded Roth Conversions (cont.)

- Distributions from converted account will be tax-free if participant is at least 59½ at time of distribution and account has been in place for at least five years
  - *10% recapture tax*
  - *Plan will probably have to track separate five-year periods*

Expanded Roth Conversions Issues

- Which accounts can be converted?
  - Can participant convert nonvested amounts?
    - *If nonvested amounts are later forfeited, will participant be able to file for a refund?*
  - Conversion of after-tax account would allow a participant to circumvent Roth contribution limit (currently at $17,500)
  - How would conversion of current-year contributions be treated for nondiscrimination testing?

Expanded Roth Conversions Issues (cont.)

- Is spousal consent required?
- Will preconversion distribution restrictions continue to apply to converted amounts?
  - Converted money purchase contributions and QJSA/QPSA requirements
  - In-service restrictions on deferrals and safe-harbor employer contributions

Expanded Roth Conversions Issues (cont.)

- Can safe-harbor plan be amended to offer in-plan conversions mid-year?
- Will nonparticipants (e.g., alternate payees, beneficiaries) be permitted to elect in-plan conversions?
- May individuals revoke conversion elections?
  - Based on IRS position on in-plan rollovers, no revocations will be permitted
- What notice must be given to individuals making conversion elections?
- Are Roth conversions protected benefits?

Expanded Roth Conversions
Plan Sponsor Flexibility

- Plan sponsor flexibility
  - Imposes conversion ordering rules if participant has distributable and nondistributable amounts
  - Restricts sources available for conversion
  - Limits number of conversions
  - Removes some or all of preconversion distribution restrictions

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Fiduciary Relief for Investment Mapping

- Qualified change in investment options
  - Change in investment lineup under single plan
  - Transfer of accounts to another plan of same or different employer
- Participant notice 30-60 days before change, comparing old and new investment options, and explaining investment mapping
- Stated characteristics of old and new options, including risk/return characteristics, are “reasonably similar”

Fiduciary Relief for Investment Mapping (cont.)

- No affirmative participant investment directions that are contrary to mapping
- Old investment allocation was, or was deemed to be, result of participant direction
- Consider use of QDIA
  - Only default funds (i) invested in QDIA in old lineup, (ii) funds for which there is otherwise no instruction, and (iii) funds for which there is no corresponding new investment
  - Default all transferred funds

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QDIAs

What qualifies?

I. A. Life-cycle fund or TDF;

B. Balanced fund; or

C. Managed account

And

II. A. RIC; or

B. Managed by 3(38) investment manager, trustee, plan sponsor, or plan sponsor committee

QDIAs (cont.)

And

III. No employer securities

But

IV. May be provided through variable annuity or similar contract, common or collective trust fund, or pooled investment fund

QDIAs (cont.)

- Participant opportunity to direct investment but failed to do so
- 404(c) disclosures provided
- Opportunity to transfer investments at least quarterly
- Opportunity to transfer investments without penalty or restriction for first 90 days
- 404(c) broad range of investment alternatives

QDIAs (cont.)

- Participant notices
  - At least 30 days before plan eligibility or first QDIA default
  - At least 30 days before each subsequent plan year
  - Description of QDIA default rules and rules for deferral elections
  - Explanation of right to direct investments
  - Description of QDIA, including risk/return profile, and fees/expenses
  - Description of right to direct QDIA funds to other investments, including restrictions, transfer fees
  - Explanation of where to get more information
  - Notices may be combined/coordinated with participant-level fee disclosures

Carryover Elections

- Investments and/or contributions
- Useful for account transfers to another plan of same or different employer
- Generally not available for transfer of participation without account transfer
  - In that case, need to follow QDIA and/or auto-enrollment rules

Allocation of Forfeitures

- Nonvested amounts can be forfeited upon:
  - Distribution of vested account
  - Five consecutive breaks
- What does the plan document provide with respect to the time and use of forfeitures?

Allocation of Forfeitures (cont.)

- Forfeited amounts can be used:
  - In a DB or DC plan
    - *To pay the plan's reasonable administrative expenses*
    - *To reduce employer contributions*
  - In a DC plan
    - *Reallocated to remaining participants on a nondiscriminatory basis*
    - *To restore previously forfeited amounts*
  - Special rules for plan termination

Allocation of Forfeitures (cont.)

- Forfeitures should be determined annually
- Forfeitures should generally be used or allocated in the year incurred
- If used to pay plan expenses or reduce employer contributions, forfeitures should be used no later than the immediately following plan year
- Best practice – use or allocate forfeitures as of a set date each year

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Allocation of Forfeitures (cont.)

- Failure to timely use or allocate forfeitures may be corrected under EPCRS using VCP or, if the failure is de minimis or fixed within two years of the close of the plan year in which failure occurred, by self-correction
  - Retroactively allocate to participants who would have received allocations (including participants who terminated employment)
  - May be appropriate to reduce current-year employer contributions

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Plan Amendments

- Conform to legislative and regulatory changes
  - Specific deadlines set by legislation or regulation
- Design changes
  - By year-end, with certain exceptions
    - *Adding deferrals*
    - *Reducing rate of contribution*
    - *Terminating plan*
    - *Adding safe-harbor provisions*

Plan Amendments

- Safe-harbor plans
  - Safe-harbor provisions must be added before the beginning of the plan year
  - Generally can't be amended during the year, with exceptions for:
    - *Adding (1) a hardship distribution option, (2) a Roth feature, or (3) a safe-harbor 3% nonelective contribution if appropriate annual and supplemental notice requirements are met*
    - *Reducing or suspending safe-harbor contributions mid-year if certain requirements are satisfied*

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