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401(k) Basics Webcast

Lisa H. Barton
Elizabeth Kennedy

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www.morganlewis.com

What Is a 401(k) Plan?

- A qualified cash or deferred arrangement within a tax-qualified profit sharing or stock bonus defined contribution plan, or a rural cooperative plan
  - Cannot be part of a money purchase defined contribution plan, except for “pre-ERISA”
  - Can be part of a defined benefit plan of small employers beginning in 2010

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What Is a "Qualified Cash or Deferred Arrangement"?

- An arrangement involving an election by an employee between receiving compensation in cash or having it deferred into a qualified plan
- A "CODA" that satisfies the requirements of Section 401(k) of the Internal Revenue Code
  - Amounts deferred under the arrangement are not included in the employee's federal taxable income

Introduction

- Can any employer establish a 401(k) arrangement for its employees?
  - Yes, except for a state or local government, a political subdivision of a state or local government, or an agency or instrumentality of a state or local government or political subdivision

Introduction (cont’d)

- Like any qualified plan, a plan containing a 401(k) arrangement must satisfy certain legal requirements (Section 401(a) of the IRC), including:
  - Benefits employees of the employer
  - Cannot impose age or service requirements for eligibility beyond what is allowed by law (generally age 21/1 year of service)
  - Cannot discriminate in favor of highly compensated employees (HCEs)

Introduction (cont'd)

- Legal Requirements cont'd.
  - Required to satisfy certain vesting requirements
  - Must distribute benefits upon a participant's attainment of the "Required Beginning Date" (generally the later of April 1 following the year of attainment of age 70½ or termination of employment)
  - Must meet certain vesting and benefit requirements if the plan is "top-heavy"
  - Its benefits must adhere to certain limits

Introduction (cont'd)

- Legal Requirements cont'd.
  - Required to contain a "direct rollover" option if benefits are paid in a lump sum
  - Assets generally required to be held in trust

Eligibility

- A qualified plan (other than a 401(k) plan) may require that an employee work up to 2 years before becoming eligible if it provides for immediate vesting (though most plans only require 1 year of service)
- The 401(k) arrangement is not permitted to require more than 1 year of service

Eligibility (cont'd)

- A 401(k) plan must pass one of the following tests to show nondiscrimination in coverage:
  - The General 70% Test – the plan covers 70% of all non-highly-compensated employees (NHCEs)
  - The "Ratio" Percentage Test – the plan covers a percentage of NHCEs that equals at least 70% of the percentage of HCEs covered under the plan
  - "Coverage" for a 401(k) plan means "are eligible to participate" (even if they elect not to do so)

Eligibility (cont'd)

- Coverage Tests cont'd
  - The Average Benefits Test – the plan benefits a group of employees who qualify under a nondiscriminatory classification, and the "average benefits percentage" of the NHCEs is at least 70% of the "average benefits percentage" of HCEs covered under the plan

Enrollment (cont'd)

- 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

Automatic Enrollment

- Automatic Enrollment
  - Employee is enrolled at a default deferral rate unless employee opts not to participate or to participate at a different percentage
  - Auto enrollment arrangements typically combined with a “Qualified Default Investment Alternative” into which participants are defaulted if no affirmative investment election is made

Automatic Enrollment (cont'd)

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

Automatic Enrollment (cont'd)

- Traditional Automatic Contribution Arrangements (ACAs)
  - Any group or subset of employees may be covered
  - No minimum deferral percentage required (2%-3% common)
  - No 90-day withdrawal provision
  - Auto-escalator provisions optional
  - May be adopted any time during the plan year
  - ADP/ACP testing required

Automatic Enrollment (cont’d)

- ACAs cont’d
  - No safe harbor definition of compensation required
  - Initial and annual notice required – no specific time frame

Automatic Enrollment (cont'd)

- Eligible Automatic Contribution Arrangements (EACAs)
  - 90-day withdrawal right required
  - Must cover all eligible employees or a specified subset (as stated in plan document)
  - Six months to refund ADP/ACP corrections if plan covers all eligible employees
  - Auto-escalator provisions optional
  - Must adopt on the first day of any plan year
  - Initial and annual notice requirements

Automatic Enrollment (cont’d)

- EACAs cont’d
  - No minimum deferral percentage
  - No safe harbor definition of compensation required
  - ADP/ACP testing required

Automatic Enrollment (cont'd)

- Qualified Automatic Contribution Arrangement (QACA)
  - Safe harbor – no ADP/ACP testing required
  - Auto-escalator required
  - Employer contributions required
  - Must cover all eligible employees
  - Safe harbor definition of compensation required
  - No 90-day withdrawal requirement (unless also an EACA)

Automatic Enrollment (cont’d)

- QACAs cont’d
  - Must adopt on the first day of any plan year
  - Initial and annual notice requirements

Automatic Escalator

- Automatic escalator provisions automatically increase a participant's deferral percentage by one percent each year until a maximum deferral percentage is reached
  - Takes advantage of employee inertia
  - Available to any 401(k) plan
  - No specific requirements unless a QACA
  - Increases can be at beginning of year for all or can coincide with individual pay increase dates (e.g., anniversary dates)

Contributions

- 401(k) plans may provide for the following types of contributions:
  - Pre-tax deferrals/Roth contributions
  - After-tax employee contributions
  - Employer contributions (fixed or discretionary), including matching contributions
  - Catch-up contributions
  - Rollover contributions
  - Qualified nonelective contributions
  - Qualified matching contributions

Contributions (cont'd)

- Designated Roth Contribution
  - An elective deferral that the employee designates as a designated Roth contribution
  - Includable in gross income when contributed, but contributions and earnings may be withdrawn tax-free if certain requirements are met
- Catch-Up Contribution
  - An elective deferral in excess of the permissible deferral amounts available to participants who are age 50 or older
- Qualified Nonelective Contribution (QNEC)
  - An employer contribution (not a matching contribution) that is 100% vested and subject to withdrawal restrictions when made; usually made to correct failed ADP test
- Qualified Matching Contribution (QMAC)
  - A matching contribution that is 100% vested and subject to withdrawal restrictions when made

Contributions (cont'd)

- A Word About Matching Contributions:
  - Usually designed as a flat percentage of elective deferrals
  - May include a "true-up" (if match is made on a plan year instead of payroll period basis)
  - In a 401(k) arrangement, the only contribution that can be contingent upon an employee making a deferral is a matching contribution (the "contingent benefit rule")

Contributions (cont'd)

- Required Annual Limits
  - Compensation used when making contributions cannot exceed $245,000 (Code Section 401(a)(17) limit)
  - All contributions together may not exceed the lesser of $49,000 (for 2010) or 100% of the participant's compensation for the year (Code Section 415 limit)
  - Elective deferral contributions (pre-tax and Roth) may not exceed $16,500 (Code Section 402(g) limit)

The 401(k) Nondiscrimination Test (the "ADP Test")

- ADP = actual deferral percentage
- Actual Deferral Percentage = the average of the deferral percentages of the eligible employees in the 401(k) arrangement
- Matching and after-tax contributions are subject to very similar ACP test (ACP = actual contribution percentage)

The 401(k) Nondiscrimination Test (the "ADP Test") (cont'd)

- The ADP for HCEs:
  - cannot exceed 125% of the ADP for NHCEs, <u>or</u>
  - cannot exceed the ADP for NHCEs by more than 2 percentage points, and can be no more than twice the ADP for NHCEs

The 401(k) Nondiscrimination Test (the "ADP Test") (cont'd)

- Continued (ADP for HCEs)
  - The greater of the results of the two tests is used
- What if the ADP test is failed?
  - Corrective action must be taken within the 12-month period following the plan year
    - *Make QNECs to NHCEs to boost the ADP of the NHCE group*
    - *Include QMACs (if provided in the plan) in the ADP test*

The 401(k) Nondiscrimination Test (the "ADP Test") (cont'd)

- Continued (If ADP Test Is Failed)
  - *Re-characterize HCE deferrals as catch-up contributions (if the employee qualifies)*
  - *Distribute excess to HCEs (note that this must be done by 2-1/2 months after the plan year for the employer to avoid a 10% excise tax)*
  - *Re-characterize HCE deferrals as after-tax contributions (if the plan allows for after-tax contributions)*
  - *Combination permitted*

The 401(k) Nondiscrimination Test (the "ADP Test") (cont'd)

- Continued (If ADP Test Is Failed)
    - *Limit or prospectively reduce deferral rates of HCEs (if plan permits)*
- Safe Harbors
    - QACA
    - Code Section 401(k)(12) Safe Harbor

The 401(k) Nondiscrimination Test (the "ADP Test") (cont'd)

- QACA
  - A CODA that:
    - *Automatically enrolls employees*
      - treats each eligible employee as having elected to have deferrals made in an amount equal to a qualified percentage of compensation
    - *"qualified percentage of compensation" – an amount that is applied uniformly, is no more than 10%, and is at least:*
      - 3% for 1st plan year
      - 4% for 2nd plan year
      - 5% for 3rd plan year
      - 6% for each year thereafter

The 401(k) Nondiscrimination Test (the "ADP Test") (cont'd)

- QACA cont'd
  - *Provides either of the following:*
    - A matching contribution equal to
      - 100% of elective deferrals not exceeding 1% of compensation, plus
      - 50% of elective deferrals in excess of 1% but not in excess of 6% of compensation, or
    - An nonelective contribution in the amount of at least 3% of the employee's compensation

The 401(k) Nondiscrimination Test (the "ADP Test") (cont'd)

- QACA cont'd
  - *Both contribution types are subject to 2-year cliff vesting*
  - *Both contribution types are subject to the same withdrawal restrictions as elective deferrals*

The 401(k) Nondiscrimination Test (the "ADP Test") (cont'd)

- Section 401(k)(12) Safe Harbor
  - The plan provides either of the following:
    - *A matching contribution equal to:*
      - 100% match on first 3% of compensation deferred, plus
      - 50% match on the next 2% of compensation deferred
    - *A nonelective contribution in the amount of at least 3% of the employee's compensation*

The 401(k) Nondiscrimination Test (the "ADP Test") (cont'd)

- Section 401(k)(12) Safe Harbor cont'd
  - Both contribution types are subject to immediate 100% vesting
  - Both contribution types are subject to the same withdrawal restrictions as elective deferrals
  - May provide automatic enrollment, does not have to – if it does, it does not have to satisfy QACA requirements

Vesting

- Always Fully Vested
  - Pre-tax (including Catch-up and Roth), After-tax, QNECs, QMACs and Rollover Contributions
- Traditional Vesting (Non-Safe Harbor Plans)
  - Employer matching contributions (and any nonelective contributions) must have a vesting schedule that is at least as generous as the following:
    - *3-year cliff vesting*
    - *6-year graded (2/20%, 3/40%, 4/60%, 5/80%, 6/100%)*

Vesting (cont'd)

- Safe Harbor Vesting (other than QACAs)
  - Safe harbor 401(k) plans are required to fully vest safe harbor contributions
- QACA Vesting
  - Two-year cliff vesting

Distributions

Permissible Distributable Events

- Severance from employment
- Death
- Disability
- Attainment of age 59½
- Severance from employment due to certain military service (HEART Act or qualified reservist distribution)
- Hardship
- 90-day auto enrollment EACA withdrawal

Distributions (cont'd)

- Distributions upon severance from employment
  - Common forms
    - Lump sum distributions – in cash and occasionally in-kind (e.g., employer securities)
    - Annuities
    - Installment payments
    - Rollovers

Distributions (cont'd)

- Many 401(k) plans offer only lump sum distributions
- Annuities and installments are not required and may typically be eliminated from 401(k) plans (unless the plan contains assets from a prior money purchase pension plan)
  - Merged plans retain the distribution options that existed in each plan prior to the merger unless the optional forms are eliminated

Distributions (cont'd)

- Cashout Distributions
  - Plans may "cash out" participant account balances without consent if the participant's account balance is $5,000 or less (including rollovers), provided the account balance is rolled over to an IRA
  - Plans may "cash out" participant account balances without consent if the participant's account balance is $1,000 or less (excluding rollovers) with payment made in cash directly to the participant

Distributions (cont'd)

- Rollovers
  - A distribution from a plan that is not:
    - *On account of hardship*
    - *Part of a required minimum distribution (e.g., a participant is over age 70½)*
    - *Paid in the form of an annuity or paid over a period of 10 or more years*
  - Rollover distributions must be transferred to an eligible retirement plan (including another employer's 401(k) plan, IRA, etc.) within 60 days of distribution

Distributions (cont'd)

- In-Service Distributions
  - Distributions that may be taken prior to a separation from service
    - *Hardship*
    - *Age 59½*
    - *After-tax, rollover*
    - *Distributions subject to 2-year/5-year rule (employer contributions only)*
  - In-service withdrawals limit distributions of elective deferrals (including pre-tax and Roth deferrals)

Distributions (cont'd)

- Hardship Distributions
  - Distributions must (i) be made on account of an immediate and heavy financial hardship, and (ii) must not exceed the amount needed to satisfy the financial need

Distributions (cont'd)

- Determination of "immediate and heavy financial need"
  - Must satisfy "safe harbor" criteria or be made pursuant to "objective criteria"
  - Hardship "safe harbor" defined in the regulations as:
    - *medical care that would be deductible under IRC §213(d) for the employee, the employee's spouse or the employee's dependents*
    - *costs directly related to the purchase of a principal residence (not including mortgage payments) for the employee*
    - *payments for tuition, related educational fees, and room and board expenses, for the next 12 months of post-secondary education*

Distributions (cont'd)

- Hardship safe harbor reasons cont'd
  - *payments <u>necessary to prevent eviction</u> from the employee's <u>principal residence</u>, or to prevent foreclosure on the mortgage on that residence*
  - *payments for <u>burial or funeral expenses</u> for the employee's deceased parent, spouse, children, or dependents*
  - *expenses for the <u>repair of damage to the employee's principal residence</u> that would qualify for the casualty deduction under IRC §165 (determined without regard to whether the loss exceeds 10% of adjusted gross income)*

Distributions (cont'd)

- Determination of whether the hardship is necessary to satisfy the financial need
  - Must satisfy "safe harbor" or "facts and circumstances" test
    - *Safe harbor*
      - Distribution does not exceed the amount of the financial need
      - Loans and other available distributions are taken first
      - Suspension of deferrals for six months
    - *Facts and circumstances test requires considering all relevant facts and circumstances to determine whether the employee has other resources reasonably available to relieve or satisfy the need*

In-Service Distributions

- Plan design may permit:
  - *Withdrawals of all contributions upon attainment of age 59½, or*
  - *Withdrawals of after-tax contributions or amounts rolled over from a prior plan at any time*

Loans

- Loans must be available on a reasonably equivalent basis
- Loans may not be made available to HCEs in an amount greater than available to other participants
- Loans must be made in accordance with plan provisions
- Loans must bear a reasonable rate of interest and be adequately secured

Loans (cont'd)

- Loans must be evidenced by a legally enforceable agreement in writing
- Amount of loan may not exceed statutory limits ($50,000 or 50% of vested account balance)
- Term of loan (5-year maximum, except for home loan, which is 15 years)
- Level amortization

Loans (cont'd)

- Administrative Issues
  - Timely default (must default per plan document, but no later than the quarter following the quarter in which first payment missed)
  - Leave of absence (may suspend payments for up to one year during an unpaid leave of absence)

Questions?

Contact Information

- Lisa Barton
  - 412.560.3375; lbarton@morganlewis.com
- Elizabeth Kennedy
  - 212.309.6192; ekennedy@morganlewis.com

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