401(k) Plans

A Cornucopia of 401(k) Goodness

The Treasury Department recently issued a slew of Notices and Revenue Rulings that impact both plan sponsors and participants. Our regular columnist, Adam Pozek, examines these releases.

By Adam C. Pozek

Adam C. Pozek, ERPA, QPA, QPFC, is the vice president of consulting services for Sentinel Benefits & Financial Group in Reading, Massachusetts. He has worked in the employee benefits field since 1990 and has assisted companies that range in size from two to 30,000 employees and that represent a variety of industries.

Following a relative lull in 401(k) guidance in recent months, the Treasury Department made up for lost time by publishing a bumper crop of new releases, including at least five Notices and four Revenue Rulings. Much of this guidance is designed to highlight approaches plan sponsors can use to make it easier for their participants to make elective deferral contributions. It was published in concert with President Obama's September 5th weekly address in which he described his upcoming retirement savings initiatives.

Vacation or Retirement

The concept of contributing the value of unused Paid Time Off ("PTO") to a qualified plan is not a new one. In Revenue Rulings ("Rev. Rul.") 2009-31 and 2009-32, the IRS provides some explanation of how such provisions should be implemented.

Rev. Rul. 2009-31 describes these provisions in the context of active employees, while Rev. Rul. 2009-32 discussed such contributions for terminated participants. The rulings analyze two general options—one in which the value of unused PTO is allocated to participants as nonelective contributions and another in which participants may elect to contribute some or all of the value of unused PTO as elective deferrals.

The rulings clarify the arrangements and will not cause a PTO plan to lose its status as a bona fide sick or vacation plan for purposes of the deferred compensation rules under IRC 409A.

Nonelective Contributions

Not all employees will have the same amount of unused PTO at the end of a given year. As a result, a qualified plan must allow for nonuniform allocations to accommodate this provision. The allocation is treated as an annual addition for purposes of the limitations under I.R.C. § 415 for the limitation year to which the contribution relates.

Example #1

Mystery, Inc. sponsors a PTO plan and a 401(k) Profit Sharing Plan, both of which are calendar year plans. The PTO Plan provides that, at the end of each year, any unused PTO is forfeited. Mystery, Inc. makes a nonelective contribution to the 401(k) Profit Sharing Plan on behalf of each participant equal to the value of that participant's forfeited leave.

Fred is a participant in the PTO and 401(k) plans, and his salary is $2,500 per week. As of December 31, 2009, Fred has two weeks of unused PTO with a value of $5,000. Fred's unused PTO is forfeited under the terms of the PTO plan, and Mystery, Inc. makes a nonelective contribution equal to $5,000 to Fred's account in early 2010 for the 2009 limitation year. The $5,000 contribution is treated as an annual addition for 2009.

Example #2

The facts are the same as those in Example #1, except that Mystery, Inc. treats the nonelective contribution of unused PTO as allocated in the year immediately following the date the unused leave is forfeited, e.g., 2010.

Fred terminates employment on December 15, 2009. Mystery, Inc. can only contribute $2,500 as a nonelective contribution for Fred and must pay the remaining $2,500 to him as compensation no later than February 28, 2010, e.g., two and a half months following date of severance. If Mystery were to contribute the entire $5,000, Fred would not have any compensation in 2010 and the nonelective contribution would exceed the annual additions limit. By splitting the value of the unused PTO between contribution and compensation, Fred's annual additions for 2010 equal 100% of his compensation for 2010.

To the extent any highly compensated employees ("HCEs") receive aggregate nonelective allocations that are greater than those received by any nonhighly compensated employees ("NHCEs"), the plan is subject to the general nondiscrimination test under I.R.C. § 401(a)(4). Further, if the plan must test on a benefits basis, e.g., cross-testing, it must ensure all NHCE allocations also satisfy the minimum gateway requirements. An employer may want to avoid all of this hassle by simply carving HCEs out of the PTO-based contribution allocation.

Elective Deferrals

Alternatively, the plans can be structured so that the value of unused PTO is paid to a participant as additional compensation, and he or she can elect to contribute some or all of that amount to the plan as an elective deferral. Any such deferrals are subject to all limitations and nondiscrimination tests applicable to all other elective deferrals in the plan.

Example #3

The facts are the same as in example #1 except that the Mystery, Inc. PTO Plan provides that the value of unused PTO is paid to each employee as additional compensation in the year following the year of forfeiture.

Daphne is a participant in both plans and has a salary of $3,000 per week. As of December 31, 2009, Daphne has one week of unused PTO that is forfeited. Mystery, Inc. includes an additional $3,000 in Daphne's biweekly paycheck for the January 29, 2010, pay period. Daphne's current deferral election is 5% of pay. Her elective deferrals for the January 29th pay period equal $450 ($9,000 x 5%). This amount is subject to the elective deferral limit under I.R.C. § 401(a)(30), the annual additions limit under I.R.C. § 415, and the ADP test for 2010.

Automatic Enrollment

The Treasury Department published final regulations on Eligible Automatic Contribution Arrangements ("EACAs") and Qualified Automatic Contribution Arrangements ("QACAs") in February 2009. [*See* "Automatic Enrollment Redux: The Final Regulations Have Arrived," *Journal of Pension Benefits,* Volume 16, Number 4.] Because EACAs and QACAs were both created by the Pension Protection Act ("PPA"), plans implementing one of these designs must be amended no later than the last day of the 2009 plan year, or if later, the last day of the plan year in which the feature is added [PPA § 1107 and IRS Rev. Proc. 2007-44].

Sample Plan Amendments

IRS Notice 2009-65 provides two sample amendments to facilitate automatic enrollment. The first sample is for sponsors that wish to add an automatic enrollment feature (not an EACA or a QACA) to their existing 401(k) plan. The second sample can be used to add an EACA that allows for permissible withdrawals.

Unlike model amendments, plan sponsors are free to modify the language in sample amendments as applicable to their plans. The Notice makes clear that adoption of either sample amendment will not cause a plan to lose reliance on an existing favorable opinion, advisory, or determination letter.

In two additional notices (Notices 2009-66 and 2009-67), the IRS provided guidance and sample amendments for adding automatic contribution arrangements to SIMPLE IRA plans.

Deferral Escalators and the Uniformity Requirement

One requirement for EACAs and QACAs is that subject to certain exceptions, the automatic enrollment rate (a/k/a default deferral percentage) must be uniform for all covered employees. In Revenue Ruling 2009-30, the IRS clarifies that this uniformity requirement does not apply to automatic enrollment plans that are neither EACAs nor QACAs. Thus, such plans are permitted to include provisions whereby automatically enrolled employees will have their default deferral percentage automatically escalated pursuant to a formula or schedule that results in different escalation rates for different participants.

The second scenario addressed in Rev. Rul. 2009-30 describes an automatic enrollment plan that is intended to be an EACA and a QACA and is, therefore, subject to the uniformity requirement. The ruling provides that a QACA can provide for escalation of the default deferral percentage at a time other than the beginning of a plan year as long as the escalation is applied consistently for all covered employees with same number of years or portions of years elapsed since their initial automatic enrollment.

The default deferral percentage must be at least 3% of pay during the Initial Period (date of initial automatic enrollment through the end of the subsequent plan year). It must increase by one percentage point each year thereafter until it reaches a minimum of 6% of pay. The escalation can continue up to a maximum of 10%.

Example #4

The Big Kahuna 401(k) Plan includes a Qualified Automatic Contribution Arrangement. The plan provides for an initial default deferral percentage of 3% of pay applicable to all covered employees and escalates by one percentage point each July 1st beginning in the plan year following the first plan year covered by the QACA. The maximum default rate is 8%.

Jules is first covered by the QACA on April 1, 2010, and is automatically enrolled at the default rate of 3% of pay. The Initial Period as it applies to Jules runs from April 1, 2010, through December 1, 2011. His default rate is escalated as follows:

Default Rate	Jules' Escalation Schedule	Minimum Required Escalation Schedule
3%	April 1, 2010	April 1, 2010
4%	July 1, 2011	January 1, 2012
5%	July 1, 2012	January 1, 2013
6%	July 1, 2013	January 1, 2014
7%	July 1, 2014	N/A
8%	July 1, 2015	N/A

The default deferral rate, including the escalations, is applied on a uniform and consistent basis to all covered employees with the same number of years or portions of years covered by the QACA. In addition, Jules' default rate is at all times equal to or greater than the minimum required rate and does not exceed 10%.

Example #5

The facts are the same as in Example #4 except that the first escalation takes place on July 1st following the Initial Period.

Default Rate	Jules' Escalation Schedule	Minimum Required Escalation Schedule
3%	April 1, 2010	April 1, 2010
4%	July 1, 2012	January 1, 2012
5%	July 1, 2013	January 1, 2013
6%	July 1, 2014	January 1, 2014
7%	July 1, 2015	N/A
8%	July 1, 2016	N/A

This schedule does satisfy the uniformity requirement. However, because Jules' default deferral rates meets the minimum required level for only six months out of each year, the plan does not meet the requirements to be a QACA.

Miscellaneous

The IRS also issued other guidance applicable to 401(k) plans, as well as other qualified plans. While a full discussion is beyond the scope of this article, a brief summary is provided below.

The last update to the model Distribution Notice (a/k/a Rollover Notice a/k/a Special Tax Notice a/k/a 402(f) Notice) came in 2002. IRS Notice 2009-68 updates the model notice for regulatory changes over the last seven years. The new model which is in Q&A format is divided into two separate notices—one for distributions of pretax accounts and the other for distributions of designated Roth accounts. Participants with both types of accounts must be provided with both notices. The IRS is expected to publish a Spanish-language version of the notice in the near future.

Prior to the PPA, terminated participants who were below the applicable modified adjusted gross income ("MAGI") threshold could convert their pre-tax accounts to Roth IRAs; however, they had to do it in two steps. First, they were required to elect a direct rollover from the plan into a traditional IRA account. They would then convert the traditional IRA to a Roth IRA. The PPA streamlined the process by allowing a direct rollover from a plan to a Roth IRA. IRS Notice 2009-75 provides additional guidance on this process.

The Worker, Retiree and Employer Recovery Act of 2008 ("WRERA") allows participants to postpone required minimum distribution ("RMD") applicable to the 2009 plan year. This includes RMDs due on both December 31, 2009, and April 30, 2010. IRS 2009-82 provides guidance on the RMD waiver, as well as sample amendments plans can use to document the manner in which they operated. The Notice also includes transition relief for plans that did not process RMDs in accordance with terms of their documents between January 1, 2009, and November 30, 2009.

With the new administration now in place, it is anticipated that we will continue to see additional guidance from both the IRS and the Department of Labor. Let us give thanks for the cornucopia of 401(k) goodness that has been bestowed upon us. ■