

# *Owner's Manual for Your 401(k) Plan - 2009*

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## Owner's Manual for Your 401(k) Plan - 2009

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### Topics Covered

- Enrollments and Employee Contributions
- Nondiscrimination Requirements and Testing
- Employer Contributions
- Withholding and Reporting Requirements
- Fiduciary Responsibilities

### **INTRODUCTION**

401(k) plans are one of the most popular benefits an employer can offer. They are preferred by employees, can be cost-effective to install and maintain, and the employer is not usually required to make a contribution. But, more often than not, concise, technical guidelines for operating a 401(k) plan are not passed along in the marketing process.

Congress first established 401(k) plans in 1978. As you would expect, any program created by Congress reflects the varied philosophies of its membership, and 401(k) plans are no exception. Despite their many advantages, 401(k) plans require strict attention to detail.

The Pension Group, Inc. is your partner in helping you to administer the plan. We provide compliance support, distribution processing, participant loan documentation, annual trust accounting, preparation of annual compliance and administration reports as well as a number of other miscellaneous services. Our precision in determining your plan's compliance with federal nondiscrimination rules (page 2) depends upon the accuracy of the employee census and payroll data you – the employer - provide.

### **ENROLLMENTS AND EMPLOYEE CONTRIBUTIONS**

#### **Eligibility**

Employees are eligible to participate and make 401(k) contributions (also known as “elective deferrals”) beginning on the first entry date *following* completion of the plan's age and service requirements. Employees who decline to make a contribution *are still counted as participants* for all plan purposes, and are generally entitled to share in any employer non-matching contributions.

Depending upon your plan document provisions, most employees who are rehired will be eligible to participate immediately upon rehire, if they were previously eligible to participate, and make a contribution.

## **Enrollments and Changes**

New employee contributions should start on the *first payroll period beginning on or after the entry date*. The effective date for changes to existing contributions is the *first payroll period beginning on or after the change date*. Participants may stop deferrals entirely as of any payroll period. Change dates are established by company policy. Often change dates coincide with entry dates but you may have as many or as few change dates as you feel is necessary and practical as long as there is at least one change date per year. Changes cannot be made retroactively.

Depending upon your company policy, employees who stop their 401(k) contributions may have to wait until the next plan entry or enrollment date before they can restart their contributions.

All deferral elections must be in writing, even if that election is 0%.

## **Contribution Limits**

Salary Deferral Limit: For 2009, the maximum amount an employee can contribute to *all* 401(k) plans in the calendar year is \$16,500. Future increases will be indexed for inflation. Also, this limit is not pro-rated for short plan years. If an employee participates in a 403(b) tax sheltered annuity plan, a combined single limit of \$16,500 applies to both plans. In 2009, employees age 50 or older will be able to make a “catch-up” contribution up to \$5,500. Future increases will be indexed for inflation.

Individual Limit: The maximum overall contribution an employee can receive in one plan year is the lesser of 100% of compensation, or \$49,000. This includes employee 401(k) contribution, employer matching and other employer plan contributions but does not include catch-up contributions.

Plan Limit: The employer has a deductible contribution limit which is 25% of the aggregate compensation of all employees eligible to participate.

*Note: Employee 401(k) contributions do not count toward the plan limit.*

Compensation Limit: The maximum employee compensation which can be used for most plan purposes is \$245,000 (indexed). This limit is pro-rated for short plan years. The maximum compensation limit is not applicable to employee 401(k) contributions. That is the withholding of employee 401(k) contributions does not need to stop when the compensation exceeds the compensation limit.

## **Withholding Employee Contributions**

The individual responsible for collecting enrollment forms and changes in contribution amounts must transmit this information to the person or firm who is responsible for payroll so that the correct amounts can be withheld. The payroll period in which the contribution or change takes effect should also be identified. 401(k) contributions are exempt from federal and most states' income tax withholding, but subject to most other payroll taxes.

## **Transmitting Contributions**

Department of Labor (DOL) regulations require an employer to invest employee contributions **as soon as it is administratively feasible** for the employer to do so, but not later than 15 business

days after the end of the month in which the contributions were deducted from employees' paychecks.

On February 29, 2008 the DOL issued proposed regulations providing guidelines on when the deposits of employee monies (401(k) salary deferrals and loan repayments) should be deposited. For small plans with less than 100 participants the DOL has proposed a 7 business day safe harbor during which the deposits will be considered made timely. The 7 business days begin with the pay date the monies are withheld from the pay checks. Though no such guideline was given for large plans with more than 100 participants was given, the preamble stated that DOL felt that the deposits should be made in less than 7 business days. *To avoid problems with the DOL, consistently remit the contributions within 3 to 5 business days after each payday; coincident with the deposit of payroll taxes.*

In order to satisfy the DOL's expectations the monies must be deposited in the plan's trust though not necessarily allocated to the participants' accounts.

### **Participant Loans**

Loan payments are made by payroll deduction. As stated above, to avoid problems with the Department of Labor, such payments must be transmitted to the investment provider for deposit into the participant's account(s) at the same time as employee contributions. The interest paid on these loans is not tax-deductible.

Note: All plan participants, including sole proprietors, partners, members of LLCs or LLPs, C-corporation and S-corporation owners may take a participant loan from a retirement plan, if the plan allows for participant loans.

### **NON-DISCRIMINATION REQUIREMENTS AND TESTING**

The process of checking compliance with federal non-discrimination requirements begins with the employer providing The Pension Group, Inc. with *accurate census and payroll data from employer records.*

The first step is identifying employees who (a) have an ownership interest, (b) are an officer of the employer, or (c) are related to an owner of the employer. The next step is providing dates of birth, hire, rehire, hours of service and termination of employment (if applicable) for all employees employed during the year.

The last step is to list the gross compensation, 401(k) contributions, and employer matching contributions, if any, for each employee for the plan-year. Much of this information can be found on Forms W-2 for calendar year plans.

### **Limits for Owners & Highly Paid Employees**

To encourage employers to promote the benefits of a 401(k) plan to their employees, allowable contributions by owners and Highly Compensated Employees (HCEs) are tied to contributions made by eligible rank and file employees (these are called non-highly compensated employees or "NHCEs").

Note: An HCE is defined as a more than 5% owner (includes family attribution of ownership), or an employee earning more that \$105,000 (indexed) in the previous plan year.

To determine the average deferral percentage (called “ADP”) for NHCEs, the contribution each employee makes is divided by their compensation either (a) for the full year, if they were eligible at the beginning of the year or (b) from their entry date, depending on plan provisions.

“0%” is entered for each employee who was eligible to but did not make a contribution. Following is an example of how an average deferral percentage is calculated for NHCEs:

Employee A.....	5%
Employee B.....	2%
Employee C.....	0%
Employee D.....	15%
Employee E.....	5%
Employee F.....	<u>3%</u>
	30%

NHCE ADP: 30% divided by 6 = 5%

Allowable contributions for HCEs, based on contributions by NHCEs, are illustrated in the following table:

<u>Average NHCE ADP</u>	<u>Average HCE ADP</u>
1%.....	2%
2%.....	4%
3%.....	5%
4%.....	6%
5%.....	7%
6%.....	8%
7%.....	9%
8%.....	10%
9%.....	11.25%
10%.....	12.50%

When more than one HCE is eligible to participate the ADP limitations may be less of a factor as shown in the example below:

HCE A.....	12%
HCE B.....	0%
HCE C.....	<u>8%</u>
	20%

HCE ADP: 20% divided by 3 = 6.67%

The plan in this example passes the ADP test because 6.67% is less than the 7.00% limit (5.00% NHCE plus 2%).

### **Prior Year vs. Current Year Testing**

Many 401(k) plans use prior year NHCE ADP results to determine allowable deferrals for HCEs in the current year. With this method you will know the maximum allowable HCE deferral percentage for the current plan year as soon as the prior year’s NHCE ADP is determined.

However, for a plan’s *first* year, the employer can elect to use either (a) a safe harbor ADP for HCEs of 5%, or (b) the current year ADP if that allows a higher contribution by HCEs. New

plans are usually designed to use the first year safe harbor that permits the HCEs to contribute an average of 5%.

### **Returning Excess Contributions**

If an employee 401(k) deferral exceeds \$16,500 for the 2009 calendar year, the excess contribution plus earnings must be returned by April 15 of the following year. If this is not done on a timely basis, the penalty is severe... *the excess contribution is taxable to the employee in both the year deferred and the year returned. If this excess went into a single plan and remains uncorrected – the IRS could challenge the plan’s tax-exempt status.*

If the plan fails the ADP test, excess contributions plus earnings may be returned to HCEs within 2½ months after the end of the plan year without the employer being subject to an excise tax. The refunds are taxable to the participants in the calendar year during which the refunds are paid. Contributions are returned first to the HCE who deferred the largest dollar amount, not the largest percentage.

If excess contributions plus earnings are not returned within 2½ months after the end of the plan year, they must be returned within 12 months after the end of the plan year. The employer must also pay a 10% federal excise tax on the amount of excess deferrals returned.

Plans with automatic enrollment that meet the requirements of the Eligible Automatic Contribution Arrangement (EACA) have 6 months after the end of the plan year to pay the refunds before the employer is liable for the excise tax.

## **EMPLOYER CONTRIBUTIONS**

### **Matching Contributions**

Matching contributions by the employer can be discretionary. Many employers make a small matching contribution every year as an incentive for employees to make a 401(k) contribution. As an incentive, matching contributions are most effective when communicated to employees at the beginning of the plan year.

Matching contributions are normally expressed as a percentage of each employee’s 401(k) contribution. However, they may also be expressed as either (a) a percentage of compensation, or (b) a flat dollar amount that is unrelated to the employee’s 401(k) contribution.

Matching contributions are usually subject to one of two vesting schedules (a three year “cliff” or 20% per year starting at the second year of service schedule). Other vesting schedules are permitted as long as they are at least as favorable as one of these two standard schedules. Fully vested matching contributions may be used to increase the ADP for HCEs (“Safe Harbor 401(k) Plan”).

When matching contributions are made at the end of the year, employees are usually required to complete at least 1,000 hours of service and be an active employee on the last day of the year.

If matching contributions are made along with employee contributions on a monthly or semi-monthly basis, the 1,000 hours and last day requirements are not recommended.

## **Discretionary Contributions**

Discretionary non-matching contributions (also called profit sharing contributions) are usually allocated as a percentage of the compensation of eligible participants and are not contingent upon employee 401(k) contributions.

Discretionary contributions can be weighted towards employees whose compensation exceeds the social security taxable wage base. This technique, called integration or permitted disparity, helps to offset the loss of employer social security contributions on the excess compensation. Other weighting methods, using more sophisticated testing to meet IRS requirements, are also used by a growing number of retirement plans.

Discretionary contributions are almost always subject to a vesting schedule. Also, it is customary to require employees to complete at least 1,000 hours of service and be an active employee on the last day of the plan year to share in any discretionary contributions.

## **Qualified Non-Elective Employer Contributions (“QNECs”)**

QNECs are fully vested employer contributions that are used to remedy problems that can arise in a 401(k) plan. For example, QNECs can be used to fix ADP or ACP failure. QNECs will count towards a top-heavy contribution requirement, thus serving a dual purpose.

## **Top Heavy Plans**

A plan is top heavy when the account balances of owners or officers of the employer (called Key Employees) exceed 60% of the plan’s assets. For 2009, Key Employees are defined if, during the prior year, as:

- An officer of the employer earning more than \$150,000 in annual compensation from the employer
- A more than 5% owner of the employer (includes family attribution of ownership)
- A 1% owner of the employer who earns at least \$150,000 in annual compensation from the employer

It is advisable for a 401(k) plan to avoid becoming top heavy because under current law, contributions by Key employees in a top heavy plan *will trigger a mandatory top heavy employer contribution of up to 3% of the compensation of all eligible non-key employees*. Matching contributions count toward satisfying top heavy minimum contributions.

## **WITHHOLDING AND REPORTING REQUIREMENTS**

### **Distributions to Participants**

Participants are customarily allowed to request a distribution of the account value attributable to their contributions within a short period following termination of employment. Distribution of any vested employer contributions is normally made at the same time.

The employer may place restrictions on distributions if the restrictions are stated in the plan document. For example, distributions may be delayed until after the end of the plan year in which an employee terminates service.

Participants have a variety of options available when they become eligible to receive a distribution of their plan benefits. They may leave their balance in the plan, transfer it to an IRA, transfer it to their next employer's plan or take it in cash, subject to immediate taxation.

### **Withholding Requirements**

If participants take their distribution in cash, federal law requires income tax withholding equal to 20% of the taxable portion of the distribution. State income tax withholding may also be required. Distributions are fully taxable in the year of distribution, if not rolled over to another qualified plan or IRA. Participants under age 59½ will pay an additional 10% federal excise tax and a possible state excise tax on distributions that are not rolled over.

Some investment providers will pay distributions at the source, handle withholding on behalf of the employer, and file all required federal and state reporting forms. The Pension Group, Inc. will be able to provide you with information about the withholding, deposit, and reporting requirements for distributions paid to participants if your vendor does not offer these services.

### **Reporting to Participants**

Participants must receive statements on their accounts at least annually. When participants are allowed to direct the investment of their accounts, statements must be provided at least quarterly.

Participants must also be given an annual summary of the information provided to the EBSA (Department of Labor) on Form 5500. This is called the "Summary Annual Report" and is prepared by The Pension Group, Inc.

### **Annual Filing Requirements**

Federal law requires each plan to file Form 5500 Return/Report annually with the EBSA. This return, along with required schedules is prepared by The Pension Group, Inc. for the employer's signature and filing with the EBSA.

The filing deadline is 7 months after the end of the plan year; however, a 2½-month extension is available.

Plans with more than 100 participants on the first day of the plan year must file a Form 5500 plus required *additional* schedules which are accompanied by an independent qualified accountant's opinion. The employer must engage an independent qualified accountant to audit the plan and issue this opinion.

Plans with less than 100 participants may also need an independent qualified audit unless one of the following exceptions is met:

- (1) At least 95% of the plan's assets are "qualifying plan assets"; or
- (2) The plan fiduciaries are bonded for 100% of the value of non-qualifying plan assets.

Most 401(k) plans that have funds held exclusively by banks, insurance companies, mutual fund companies or brokerage firms will meet exception (1) above. If the plan holds other assets such as privately issued stocks, limited partnerships, third-party notes, real estate or collectibles, the employer should immediately discuss this with an administration case manager of The Pension Group, Inc.

*Caution: Failure to file Form 5500 on a timely basis is subject to a penalty of up to \$1,100 a day assessed by the Department of Labor. Other penalties may also be assessed by the DOL and/or IRS for late or incomplete filings.*

## **FIDUCIARY REQUIREMENTS**

Both the employer and the plan trustees are fiduciaries of a 401(k) plan.

Federal law requires a plan to be operated for the *exclusive* benefit of the plan's participants and their beneficiaries. What this means is that a plan's assets may never be used for the personal benefit of either the employer or the plan's trustees, although trustees can apply for loans from plans in which they participate. Plan assets cannot be combined with the employer's assets under any circumstances.

The plan trustees control the assets of the plan, and are responsible to review the plan's investment program periodically to verify that it is meeting the trustees' expectations (called the "investment policy").

Trustee responsibility and liability for investment decisions may be reduced in plans which (i) allow participants to direct the investment of their funds, (ii) provide participants with the ability to manage their risk of investment losses by including investment choices with varying risk levels, and (iii) allow the transfer of funds between investments on at least a quarterly basis. Participants must receive adequate information on the funds available on a regular basis. An experienced licensed financial advisor can assist the plan trustees in positioning the plan to meet fiduciary compliance.

Lastly, if the employer/plan sponsor chooses to make a change in its plan's investment provider and/or temporarily suspend the ability of participants/beneficiaries to change investment selections, take loans or distributions under the plan, the Department of Labor has issued regulations under the "Sarbanes-Oxley Act of 2002". A timely issued "blackout notice" must be issued to all participants/beneficiaries otherwise the employer/Plan Sponsor may face stiff financial penalties assessed by the Department of Labor.

## **THE PENSION PROTECTION ACT OF 2006**

The Pension Protection Act of 2006 (PPA '06) became law in August of 2006 and covers a broad range of rules affecting qualified retirement plans in general, employers that sponsor those plans, and plan participants. Not all provisions are effective at the same time. Some became effective in 2006 and some become effective in later years. Moreover, the IRS and the DOL will continue to issue regulations clarifying what employers/plan sponsors need to do to comply with PPA'06. Since many of the changes are complex and vary by type of plan, it is best for an employer to seek professional assistance to help best take advantage and comply with the new rules.

*Please see our outline "Safe Harbor Plans - 2009" for more information about 401(k) plans using IRS safe harbor contributions to satisfy ADP/ACP contribution testing and eliminate contribution refunds to HCEs.*

*This general information piece is distributed with the understanding that The Pension Group, Inc. is not rendering any legal advice. Plan Sponsors should consult with their legal representatives about the application of any law pertaining to retirement plans.*