MBC Retirement Services, Inc.
Your Retirement. Our Expertise.

COMMON CHALLENGES IN RETIREMENT PLAN ADMINISTRATION
UPDATED FOR 2020 LIMITS

Qualified plan administration is a challenging and complicated business. Often, plan sponsors find themselves overwhelmed by the amount of paperwork and diligence required to set up and maintain a qualified retirement plan. Errors and omissions often require costly and time-consuming corrections. Fortunately, many errors easily can be avoided by the well informed. To assist our clients in avoiding common pitfalls in retirement plan administration, MBC Retirement Services, Inc. has put together this summary of our most frequently encountered challenges.

ACTUAL DEFERRAL PERCENTAGE DIFFERS FROM ELECTED DEFERRAL PERCENTAGE

Participants elect a deferral percentage to be deducted from their paychecks at the time they enroll in the plan. Additionally, they may change this elected percentage at certain intervals as prescribed by the plan document. As plan sponsor, it is the employer’s responsibility to set up internal controls to ensure participants’ elected deferral percentages are being deducted from their checks as of the effective date of the election. Participants’ elected deferral percentages, as well as the effective date of the election, should be communicated to the employer’s payroll department or service whenever these elections are made. Corrections for missed deferrals may require deposit of the missed contribution, plus applicable earnings, at the employer’s expense.

EMPLOYEES BEGIN PLAN PARTICIPATION BEFORE DATE OF ENTRY

To become a plan “participant,” employees must not only meet eligibility requirements, but also reach a plan entry date. If, for example, your plan document requires 6 months of service and allows quarterly entry dates, an employee must not only work for six consecutive months, but also be employed as of the next quarterly entry date to begin participation in the plan. For a calendar year plan with the above requirements, this means an employee hired on January 10 would not begin plan participation until October 1. If the employee terminated employment after July 10 (6 months of service) but prior to October 1, he or she would be considered *not* to have ever been a participant of the plan.

Sometimes employers make the mistake of allowing employees to begin deferrals after they have completed the eligibility requirements but before they have reached the next entry date. To correct this, deferrals prior to the entry date must be distributed from the plan and refunded to the employee as part of his or her regular income. If the ineligible deferrals incurred an investment loss, the employer must reimburse this amount to the trust.

LOAN PAYMENTS DO NOT CORRESPOND TO THE AMORTIZATION SCHEDULE

When a participant initiates a loan from his or her retirement account, the employer must ensure after-tax loan payments are deducted as indicated by the loan amortization schedule. Loan payments must begin on the first payment date and must be for the exact payment amount as amortized. ***Late or missed payments may result in loan default, which can result in taxable income to the participant as well as additional time and expense charges for plan administration.*** If payments are started late or missed, they should be made up as soon as possible.

INTERNAL REVENUE CODE SECTION 415 VIOLATIONS (EXCESS ANNUAL ADDITIONS)

For plan years ending in 2020, code section 415 stipulates that no plan participant may receive annual additions in excess of 100 percent of his or her gross income, or $57,000, whichever is less. This does *not* mean participants may *defer* $50,000, as deferrals are still subject to the limit set forth in code section 402(g). Annual additions include deferrals, match, employer contributions (e.g., profit sharing, money purchase, QNEC, etc.) and reallocated forfeitures. If the employer maintains two plans, annual additions applicable to both plans must be considered when determining whether or not this limit has been exceeded. If total annual additions exceed the 415 limit, deferrals plus applicable earnings must be refunded to the participant as part of his or her taxable income for the year of distribution. This usually requires additional time and expense charges to the employer for plan administration.

INTERNAL REVENUE CODE SECTION 402(G) VIOLATIONS (EXCESS DEFERRALS)

Code section 402(g) stipulates that participants may not defer more than a specified dollar amount during the *calendar* year. For 2020, this amount is $19,500. (The catch-up contribution limit, for employees age 50 or older by December 31, 2020, is $6,500.) The deferral limitation applies to *all* plans to which an employee defers, regardless of employer. That is, if an employee defers $19,500 prior to leaving his or her previous employer in June 2020 and is immediately eligible for a new employer's plan in July, he or she regardless may not make additional deferrals until January 2021 (unless he or she is eligible for catch-up contributions).

Fiscal year plans are often tripped up by this limitation. Regardless of your plan year, the 402(g) limitation applies to the *calendar* year. If this limit is exceeded, participants must receive a refund of the excess deferral as well as applicable earnings. The excess deferral is taxable in the year the contribution was made to the plan, but interest allocable to the excess deferral is taxable in the year the amount is distributed to the participant. Note, however, that if the refund is not made prior to April 15 of the following year, the excess deferral is taxable in *both* the year the excess deferral was made *and* the year it is distributed.

Calculation of excess deferral, applicable earnings, and tax treatment, as well as completion of the required Forms 1099-R and/or statements to be included with the participant's Form 1040 will result in additional time and expense charges billed to the employer.

TOP HEAVY MINIMUM CONTRIBUTIONS ARE NOT MET

The term "top heavy" is often confused with ADP/ACP test failure, but is *not* related to that issue. A plan may be top heavy without failing those tests or may fail those tests without being top heavy. **A qualified retirement plan is considered "top heavy" when key employees own more than 60 percent of the total plan assets.** In this situation, a year-end profit sharing contribution must be made for all non-key employees for a plan year in which key employees' benefit.

The minimum contribution required is 3 percent, unless the highest benefit received by a key employee is less than this amount. If no key employee benefits during the plan year (i.e., no deferrals, employer contributions, or reallocated forfeitures), no top-heavy minimum contribution will be required for that year. For years in which a top-heavy minimum contribution is required, all participants employed on the last day of the year must share in the contribution based on their *full year* gross compensation, regardless of hours worked or plan entry date.

If entry requirements for profit sharing contributions are more stringent than those for 401(k), all participants eligible for 401(k) *still must* receive the top-heavy minimum contribution. If the profit sharing contribution allocation is greater than the top-heavy minimum, participants not yet eligible for profit sharing will receive *only* the top-heavy minimum, based on their full year gross compensation.

If an eligible participant does not receive a required top-heavy minimum contribution, the employer must make a corrective contribution plus earnings under the Self-Correction Program (SCP). This correction must be accrued during the plan year following the missed contribution, or the employer may not correct under SCP and might be subject to additional fees and/or penalties.

INTERNAL REVENUE CODE SECTION 404(A) (DEDUCTIBLE LIMIT) VIOLATIONS AS A RESULT OF PRE-FUNDING

For 2020, the deduction amount for a defined contribution plan cannot exceed 25 percent of eligible compensation. The deduction limit no longer applies to elective deferrals, but only to employer contributions. For defined contribution pension plans (e.g., money purchase or target benefit), the deduction is the amount necessary to meet the minimum funding standards. If total contributions exceed the deductible limit, the employer must pay a 10 percent excise tax on the excess amount as well as include the excess amount in the next year's deductible calculation.

Unwary employers often exceed the deductible limit by pre-funding the year-end contribution. For a plan with a last day requirement, this is often the result of making estimated contributions for participants who terminate before year end and are ineligible to receive the year-end contribution. To avoid this pitfall, if you feel you *must* pre-fund, we recommend pre-funding not more that two-thirds the estimated contribution for the year, and funding the contribution to a separate account, if possible.

INCORRECT DATE OF HIRE FOR RE-HIRES

Generally, for rehired employees with no break in service, the date of hire for plan purposes is their original hire date. A break in service occurs when an employee works fewer than 501 hours in a plan year. Therefore, a full-time plan participant who terminates in June (thus working over 501 hours) but is rehired in November will be treated as if he or she never left for plan purposes. This participant would be immediately re-eligible for plan participation. Participants who do incur a break in service sometimes must complete another year of eligibility service to re-enter the plan; however, they re-enter upon completion of that year rather than waiting until the next entry date. Because the break in service rules are complicated and may vary based on your plan document, you should call us whenever you are unsure of how to treat a rehired employee for eligibility purposes.

COMPENSATION LIMIT DISREGARDED WHEN CALCULATING EMPLOYER CONTRIBUTIONS

For plan years beginning in 2020, the compensation limit is $285,000. This means compensation in excess of this limit is disregarded for plan purposes. That is, even if the employee earns more than $285,000 in 2020, all plan calculations are based on compensation of only $285,000. For example, a participant with deferrals of $19,500 and compensation of $387,500 will be treated as having an actual deferral percentage of 6.84 percent, rather than 5.03 percent. This limit can affect match and profit sharing calculations as well as the employer's deductible limit. When calculating match and/or profit sharing allocations, *be sure to disregard compensation above $285,000*.

HARDSHIP DISTRIBUTION ISSUES

Plans that offer safe-harbor hardship distributions are subject to an important requirement that is often overlooked. When a participant receives the distribution, he or she must suspend deferrals for six months. This means a participant taking a hardship distribution may *not* contribute to the plan for six full months from the time the distribution is taken.

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Employer Contribution Allocations may not be Changed after the Benefit Accrues

Most plan documents specify an allocation amount or method. Although it is possible to change the allocation requirements by amending the plan document, the amendment must be done *before* plan participants become eligible to receive the contribution. For example, if a document specifies a year-end match for all participants who have worked 1000 hours, regardless of whether or not they are still employed on the last day of the year, an amendment to change or revoke that match must generally be done prior to mid-plan year. (Employees usually earn 1000 hours of service within six months.) For plans with a last day requirement, the amendment must be made prior to the end of the plan year. Employers who wish to change their allocation method (e.g., from pro-rata to age-weighted) should also be sure to amend the plan *before* participants become eligible to receive the contribution.

Plan Document Definition of Compensation is Disregarded

When a qualified plan is designed, the plan sponsor must decide which definition of compensation to use for plan purposes. Most employers elect to use W-2 compensation, which is the simplest choice administratively. Additionally, W-2 compensation is considered a safe-harbor definition of compensation and will not subject the plan to additional testing. Employers using W-2 compensation often face the same challenge: *a plan using W-2 income may* ***not*** *arbitrarily exclude bonuses from deferrals*. If an employer pays bonuses, 401(k) contributions *must* be withheld at the employee's current elected deferral percent unless the employee elects otherwise with respect to the bonus. Employers using the W-2 definition of compensation should take steps to ensure their payroll department or provider understands that deferrals *must* be taken from bonuses, even if bonuses are paid as a separate or manual check, unless the employer has received a written election not to defer on bonuses from the participant.

Plans may be designed or amended to use a different definition of compensation. For example, bonuses, commissions, and overtime pay may be excluded from compensation used for plan purposes. However, a non-safe harbor definition of compensation will subject the plan to more complex administration, additional testing, and higher administration fees.

Plan Assets may not be Used for Any Other Purpose

Plan assets must be segregated from the employer's general assets at all times. Participant deferrals and loan payments must be deposited *as soon as administratively possible*. Additionally, plan assets may not be used directly to pay debts to the employer. This means an employer may not offset a participant's distribution for a debt owed to them. If the participant takes a cash distribution, he or she may use part of that distribution to repay an employer debt, *but only after the distribution is received in full from the trust*. Using plan assets for any other purpose may result in a prohibited transaction, with the associated penalties, and should be avoided at all costs.

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