RETIREMENT PLANS MADE EASY

A Special Report on the Current 401(k) Landscape and What Can Be Done to Protect Employer and Help Eligible Participants

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INTRODUCTION: RETIREMENT PLAN BACKGROUND – HOW DID WE GET HERE?

There was a time in the United States when workers did not change jobs very often. In fact, it was not uncommon for an individual to work for 40 years for one company, retire, and get the proverbial gold watch and a pension. The retiree received the pension in monthly payments for the rest of his or her life and the life of the surviving spouse and it was a critical component of the individual's retirement nest egg.

A pension is what is known as a defined benefit plan. During the individual's working career, the company sets aside money for the benefit of their employees, based on number of years worked and compensation level. At retirement, the retiree receives a certain or "defined" amount of benefits.

Unless you work for the government, pension plans are now largely a thing of the past. Not only are they very expensive to operate and administer, there were chronic problems with underfunded plans that caught the government's attention. In the early 1960s, Studebaker, the car manufacturer, went out of business and there were not enough assets in their pension plan to pay all the employees. This led to investigations of all pension plans and subsequent legislation. In 1974 President Gerald Ford signed the Employee Retirement Income Security Act (ERISA) into law, regulating the operation of pensions.

The expense and regulation of pensions led employers to look for alternatives, and in the 1980s defined contribution plans came into being. Defined contribution plans shifted the burden of saving from the employer to the employee since, under these type of plans, employees can choose to set aside a portion of their own income. In some cases the employer partially matches, and it is then generally up the employee to choose his or her own investments. By setting aside a fixed portion of their income, employees make a defined contribution, and what they will have in retirement depends upon the investment choices made and on market performance.

Unfortunately, the actual practice of implementing defined contribution plans has not worked out as designed. We will get into the specific problems later in the report, but in general, plan participants have made poor investment decisions within the plans, and not surprisingly these decisions have let to poor outcomes. The U.S. Department of Labor (DOL) took notice of these outcomes and believed a large portion of them were attributable to plan participants not having adequate information about their choices within a plan, and if they did have that information, they did not have it in a meaningful format. This was especially true, in their view, in regard to expenses and fees related to the investment choices.

All of this prompted the DOL to instigate Rule 408(b)(2) in July of 2012. This intent of the rule is to improve fee transparency within plans and it has many implications for business owners who offer retirement plans to their employees. Explaining this new rule will be a principal focus of this report.

WHY IS THIS IMPORTANT? THE 3 LEGS OF THE RETIREMENT STOOL

In order to properly prepare for retirement, most individuals need to establish multiple income streams and pools of assets to draw upon in order to sustain them. This is all the more important given that people in this country are living ever longer life spans. What follows is a brief description of what we call the three legs, or supports, of the retirement stool and it is excerpted from Southern Capital's 2015 book *Retirement Rescue: A Primer on How to Help Keep Your Retirement Afloat.* (Amazon)

1. Social Security. Workers pay 7.65% of their income during their working years, which is matched by their employers, to the government for payroll taxes (6.2% for Social Security and 1.45% for Medicare). At retirement, workers receive a lifetime income stream based on how much they paid into the system, subject to limitations at the upper end of the earnings scale. Our government assures us that Social Security is funded into the 2030s, but they have borrowed against the trust over the years.

   If you talk to virtually anyone aged 35 and under, it is hard to find those who believe they will receive anything from Social Security. An important point to remember is that Social Security was never intended to cover your retirement income needs fully, but to act as a safety net for those in need. At the time of its founding in the 1930s, the average life expectancy in this country was around 67, so people worked until 65, retired and only drew Social Security for a few years. Also, there were many more workers than retirees then contributing into the system. Today, there are almost as many retirees as workers and people are living much longer. The point is that one should not rely solely on Social Security for retirement.

2. Employer-sponsored Pension Plan. Pensions were covered in the introduction to this report. For most people, there is no second leg of the stool!

3. Personal Savings. Instead, pension plans have been replaced by 401(k) plans. In most of these plans, the worker (participant) must make his or her own investment choices, usually from a relatively limited list, with little or no guidance from the employer. Employers may match participant contributions up to a certain percentage. If you are a participant in a plan like that, our advice is to be sure you are contributing at least enough to take advantage of the maximum employer match. Otherwise, you are leaving money on the table. The ultimate goal, if it is affordable, is to contribute the maximum allowable and get the full tax deduction. When the participant retires or changes jobs this money can be rolled over into an IRA. IRAs, along with anything that can be saved outside of the plan, are the third leg of the stool.

   Outside of retirement plans, workers in the United States are not generally savers. We are a nation of consumers. Because of this, we have one of the lowest savings rates in the industrialized world. Yet personal savings is the leg of the retirement stool over which

the investor has the most control in preparing for retirement. This control factor is one reason why personal savings is such an important leg of the stool for the purposes of this report because each individual controls virtually all the inputs that determine the success of the chosen investment approach.

Yet because of the overall lack of personal savings outside of plans, combined with the long-term questions surrounding Social Security and the lack of existing pension plans, all the pressure lands on the defined contribution plan as the sturdy support for individuals in retirement. Without an adequately sized plan, many of our employees might have to work well beyond when they would otherwise like to retire, or worse, outlive their means in retirement and become dependent on their families or society. This report will address some courageous practices that can be taken to help plan participants build up their balances.

PART I: THE CURRENT 401(K) LANDSCAPE: MANY PROBLEMS

As stated, the outcome of the switch from pension plans to 401(k) plans has not had the intended outcome. According to the Investment Company Institute, there are currently over 500,000 plans nationwide covering 52 million active participants with about $4.4 trillion in assets as of 2014. The average account balance is only about $53,000, which is nowhere close to the amount needed to retire. (www.ici.org)

According to a recent *Wall Street Journal* article, retirement experts think that a plan balance of $500,000 is ideal, based on a retirement age of 67. But based on one study by the National Institute for Retirement Security, 40% of working households have no retirement savings. And Nari Rhee of the Institute for Research on Labor and Employment states in the same article that "the typical American household has almost nothing saved for retirement." (October 16, 2015)

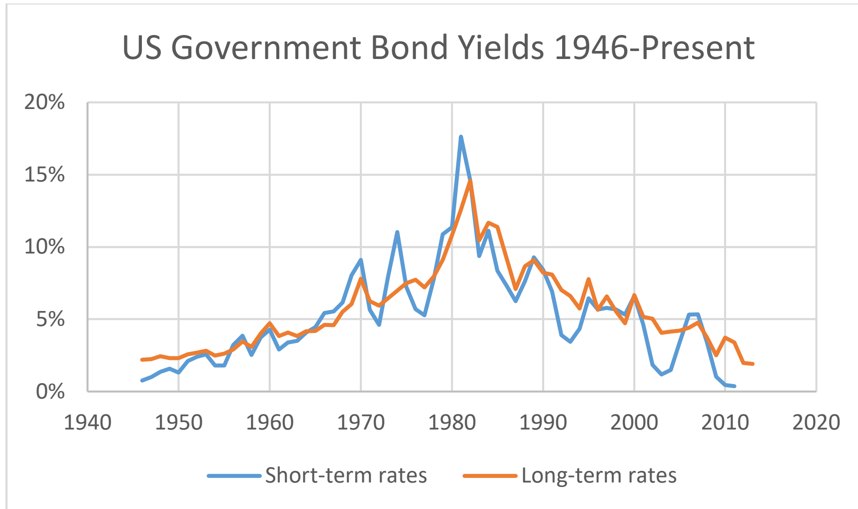
One key reason that so many Americans have little retirement savings is that about 30% of all those eligible to participate in a 401(k) plan do not do so. Of those who do participate, about 20% have outstanding loans against their balance. Taking out a loan lowers the account balance, and therefore does not allow the account to grow nearly as fast as if there was no loan. Another problem is that plan participants are overwhelmed by the choices within a plan. For every ten mutual funds that are added to the menu of plan choices, participation decreases by 2%.

Those who do participate in plans are frequently positioned inappropriately for their risk tolerance. For example, only about 7% of all plan participants describe themselves as having an aggressive portfolio objective, yet when looking at the disposition of plan assets, about 33% of participants are aggressively positioned. Clearly, selecting and managing one's portfolio is a difficult job and if it is not diligently managed, the results do not line up with participant desires.

So to summarize the current 401(k) landscape woes: participant plan balances are inadequately low; a large number of eligible workers do not participate in their plan; too many plan participants have loans against their balances; participants are overwhelmed by choices within plans; and they are inappropriately positioned for their objectives. One would think that with all these problems, companies would be crying out for better solutions for their plans. In practice though, companies are focused on what they do to earn money, and if the employees are not complaining about the plan, everything must be fine. *Maybe this is why over 70% of all retirement plans have not been competitively bid in the past three years or longer.*

A possible reason that more employers are not concerned about their plans is that many one size fits all approaches are sold in the retirement plan marketplace. Many have heard of what are known as Target Date Funds, and these are a staple of many plans. A Target Date Fund invests in a default mix between equities (stocks) and bonds, and automatically adjusts the mix as the investor gets older. For example, an investor who is 50 years old might be assigned a mix that is 70% equities and 30% bonds, shifting to a 60-40 mix when he or she turns 60.

The problem with one size fits all approaches in general is that one approach never fits everyone. The problem with Target Date Funds in particular is that their asset mix does not take into account where we are in the interest rate cycle. Here it is important to point out that as of the timing of this report, we are experiencing historic interest rate lows as the following graph illustrates:



Source data from 1946-2000 Ibbotson; from 2000 onward Advisory World.

In December of 2018, the Federal Reserve, the central bank of the United States, raised interest rates for the first time in many years. This could signal the beginning of a series of rate increases, and if it does, the bond market will likely suffer. Bond values decrease in a rising interest rate climate, and increase in a falling one. Since interest rates had nowhere lower to go, it was inevitable that the Federal Reserve would raise them at some point. Those investors holding substantial 401(k) holdings in Target Date Funds will be exposed to interest rate risk. This is especially true for older participants whose balances hold higher percentages of bonds.

THERE IS STILL HOPE: THE POWER OF COMPOUNDING

Despite inadequately low balances for most 401(k) plan participants, for many it is not too late. The power of compounding has been described by Albert Einstein as the Eighth Wonder of the World. If this power can be harnessed on behalf of those investing in 401(k) plans, it will be a tremendous aid in preparing for retirement.

Of course the earlier one starts, the better. The following table depicts what someone would have to save on a monthly basis at various ages, assuming a 9% annual average compounded rate of return in order to reach a retirement balance of $500,000:

Age	Monthly Saving
25	$190
35	$410
45	$960
55	$2,889

For those on the upper end of the age range, it might not be possible to save the full amount, but it is still worth the effort to save as much as possible. An important point to remember from the table is that it assumes the investor starts saving at the given age with no retirement plan balance. The more you already have at a given age, the less you have to save to get to the desired balance. [Note: It should be added that compounding can also work against you if you owe money, like credit card debt. If you have high interest debt like that, our advice is to pay it off as soon as possible.]

Many investors lose sight of the fact that the power of compounding needs to work for them well beyond traditional retirement age. People are living longer and longer now, and if you retire and get too conservative with your money too soon, it might not last you for your lifetime. The next table from Morningstar shows how long $500,000 will last into retirement at various assumed rates of withdrawal, beginning at age 65:

Rate of Withdrawal	Approximate Age
8%	77
7%	79
6%	82
5%	86
4%	95

The table does not assume any growth on the principal. Ideally, if it was invested and earning better than 6% net of all investment fees, the principal would actually grow at the lower end of the withdrawal range and the recipient would in effect be giving himself a raise every year to combat the anticipated rising cost of living.

THE CRUCIAL DIFFERENCE BETWEEN A BROKER & AN ADVISOR: *FIDUCIARY*

Here let us introduce perhaps the most important word in this report: *fiduciary.* A fiduciary is defined as "a person who has the legal responsibility for managing someone else's money and to place that person's interests ahead of his or her own." This definition applies to over five million men and women in this country and includes such professions as attorneys, CPAs and some investment advisors.

What does this definition have to do with retirement plans? <u>Every business owner who is a retirement plan trustee or anyone who serves on an investment committee for a retirement plan is also a fiduciary</u>. This solemn responsibility carries legal liability, and while a fiduciary duty cannot be delegated, it can be shared.

An important disclaimer is that we the authors are not attorneys and nothing contained in this report should be construed as legal advice. However, there has been case law built up against plan fiduciaries, starting with the LaRue decision of 2008 that went all the way to the Supreme Court. In that case, the employer was deemed to have acted too slowly in implementing some requested changes in an employee's retirement plan investments. That delay caused a monetary loss for the employee, and the employer was successfully sued. Other case law since then includes but is not limited to:

- A federal courts sided with the employees of Edison International who claimed that the company's 401(k) plan fees were excessive.
- Ameriprise Financial, itself a financial services firm, faced a lawsuit accusing it of favoring its own funds in its 401(k) plan over those of competing companies with better track records.
- John Hancock has been sued over breach of fiduciary duties.
- ING has been sued over hiding kickbacks received from funds it offers through 401(k) plans.

How does this case law relate to whether a retirement plan should employ the services of a broker or an advisor? It all boils down to the role each can play: one can be a fiduciary on a plan, and one cannot. The crucial difference is how each one is compensated.

Brokers and insurance agents are typically compensated by commission per transaction. They are paid a percentage up front for selling a stock, bond, mutual fund, CD or annuity. Within a retirement plan, they can charge a fee instead, but are still typically compensated by a revenue stream from the products offered within the plan. Of course, the broker hopes that the investment performs well so there will be an opportunity to sell more products, but in the commission scenario, the broker is paid up front. The standard a broker must meet is called "suitablility," meaning any security sold must be suitable for the client to own, based on his or her goals and means. After that standard has been met, brokers are not required to disclose their compensation and they act in a fiduciary capacity for their broker/dealer or agency.

A Registered Investment Advisor is typically compensated based on a percentage of assets under management: a structure that makes the number of transactions generated by the advisor irrelevant to the advisor's compensation. An advisor is held to a "fiduciary standard," meaning advisors are legally bound to place the interests of the client above their own. Consequently, a fee-only advisor is in position to act as a fiduciary on a retirement plan, and relieve some of that burden from the plan trustee(s).

In the capacity as a fiduciary, the advisor can evaluate and benchmark the investment performance and fees of the offerings within a plan. The advisor can offer advice to plan participants, and in some cases even have discretionary authority to invest on behalf of participants who do not want to make investment decisions for themselves. In short, by putting the interests of the plan trustee ahead of their own, advisors free up the business owner to focus on his or her business.

Even if the business owner is not prepared to take on a fiduciary advisor in a full time capacity, the advisor can still consult with the owner to review the plan's investment offerings and provide valuable resources. These include a fiduciary self-assessment, a document retention checklist, an investment committee responsibilities checklist, and guidance for how to go about selecting an advisor for a plan. These services can be performed on an ongoing or as needed basis and we can provide sample copies of these documents upon request.

Eric and Monica had an interesting experience in 2015 that illustrates the lack of awareness many business owners have about their fiduciary responsibilities. We went to visit a law firm in the Mobile, Alabama area that offered a retirement plan through an insurance company. The plan had not been reviewed in many years. When we questioned the office manager how the trustees benchmarked the plan's investment offerings, she said the insurance agent periodically added or deleted funds from the menu of plan offerings. We repeated the question in a different way: how did the trustees evaluate those offerings versus investments outside the plan in terms of cost and effectiveness, as they are required to do as fiduciaries? The answer was that they do not, and the trustees were not interested in discussing that aspect of the plan. Hopefully their plan will not be audited by the DOL.

THE NEW RULE 408(b)(2): ARE YOU PROTECTED?

The new rule requires workers in 401(k) retirement plans to be given or have access to the information they need to make informed investment decisions, including information about fees and expenses. The delivery of this information must be in a format that allows employees to make meaningful comparisons among the investment options within their plans. Further, the disclosure must use standard methodologies when calculating and disclosing expense and return information in order to create "apples to apples" comparisons among the plan's investment options. The overall goal is a new level of fee transparency.

The disclosure consists of three parts: services, fiduciary status, and compensation.

1. Services. The first requirement is that the service provider furnish a description of its services to the plan. The regulation requires the disclosure be made to the responsible plan fiduciary, who is the person or persons with the authority to hire and fire the service provider on behalf of the plan. For small plans, that is typically the plan sponsor who is the president, key officer, owner, or partner. For mid-size and large plans, it is usually a plan committee.

2. Fiduciary Status. The second requirement is whether the service provider is acting in capacity as an ERISA fiduciary/Registered Investment Advisor. If the service provider "responsibly expects" to be a fiduciary on the plan, it must affirmatively say so. (For example, if an advisor is making recommendations on selections and monitoring of the plan investments, he or she most likely is serving as a fiduciary under the regulation and must state so in writing.) If a provider is silent on this issue, the assumption is that the provider is not a fiduciary. *Hint: if you believe the advisor is a fiduciary, or if you expect the advisor to act in that capacity, request written confirmation of fiduciary status!*

3. Compensation. The third requirement is broadly defined to include anything of monetary value such as gifts, awards, trips, etc. It also includes any payments to affiliates or subcontractors of the provider. These can be transactional costs, like commissions, or if the fees are charged directly against the investments. In any case, the DOL states that in addition to determining the reasonableness of all fees, the plan fiduciaries must evaluate if those payments create any conflicts of interest.

What has been described so far is what the plan provider must provide to the sponsor. The corollary rule to the new regulation is Rule 404(a). This states that the plan sponsor must disclose the information to the plan participants. This is an annual requirement, and the information can be made available electronically.

To us, the big takeaways form the new rules are that the 401(k) business is moving from one of non-fiduciary generalists to fiduciary specialists, and that the rules are changing in order to help plan participants be ready for retirement. Are you protected?

COURAGEOUS PRACTICES

So how do we help plan participants get ready for retirement? There are some simple things that can be done when an employee is hired that depart from traditional 401(k) enrollment practices. Instead of calling them best practices, we refer to them as courageous!

- Automatically enroll employees in the plan. Traditional practice dictates that employees must opt into a retirement plan, but instead it can be set up where they sign something in order not to participate. The default position can be set to everyone participating.

- Immediate eligibility. Traditionally, employees must wait a period of time, typically a year, before they are eligible to participate in a plan, but it can be set up for them to be immediately eligible. The advantage to this is that the participant will not be working for a year, and then have to adjust to a reduced paycheck when plan contributions get deducted. Instead, he or she will be used to the deductions from the beginning. It is certain that some hires will not work out, but it is in the interest of the employee to start saving as early as possible.

- Minimum deferral. While there is typically no minimum compensation level that participants must defer into a plan, courageous practices suggest that the bar be set at least as high as the 3-6% level.

- Employer match. Many employers offer no match to what their employees contribute to the plan, but the suggestion is a minimum of 50% up to the first 6% that a participant defers. In other words if an employee defers 6%, the employer will match 3% for a total of 9%. This represents a 50% return on investment for the participant before the first dollar has even been invested and is a great incentive to increase the deferral amount.

- Auto-deferral increases. Typically an employee must sign a form in order to increase his or her deferral percentage, but what if it increased by 1% automatically every year up to 10%? The employee would have to sign something to prevent the automatic deferral increase, and doing so will not noticeably affect take home pay if the employee is getting cost of living pay increases or raises/promotions along the way.

- Prohibit loans, even for hardships. This might sound callous, but an employee's 401(k) balance should not be looked at as an ATM machine. Many loans are probably not taken for true emergencies, and there are other ways to borrow money without hurting the compounding of your retirement nest egg. The larger point is that the 401(k) balances must be protected at all costs during the participant's earning years.

- Employer pays plan expenses. In most plans, the investment expenses are taken directly from the accounts and borne by all participants. Any fees taken out affect returns, and employers can elect to pay plan expenses directly to the provider outside the plan.

PART II: RETIREMENT PLAN BASICS

Now let's transition to covering various different types of plans. Qualified Retirement Plans or QRPs are retirement plans that qualify for tax benefits under the Internal Revenue Code (IRC). Employers who sponsor QRPs get a tax deduction for contributions, within applicable limits. Eligible Employees who receive contributions do not report those as income until distributed. Retirement plan earnings grow tax-deferred.

There are many different types of Retirement Plans. Retirement Plans may be set up by an individual taxpayer, or by their employer. Individual Retirement Accounts or IRAs are set up by the taxpayer. IRA contributions can be made on a pre-tax basis or on an after-tax basis to a Roth IRA.

Pre-tax contributions help individuals lower their annual taxable income at the time of contribution. Distributions are taxed as ordinary income. On the other hand, after-tax contributions to a Roth IRA are not deductible when contributed. Distributions, including any earnings, are tax-free.

ERISA REQUIREMENTS

The Employee Retirement Income Security Act of 1974, or ERISA, imposed reporting and disclosure requirements in order for a retirement plan to qualify for tax purposes. There must be a written Plan Document which must meet Minimum Standards for Participation, Vesting, Benefit Accrual, and Funding.

ERISA also established Fiduciary Standards for Plan Administrators and asset managers; established the Pension Benefit Guaranty Association or PBGC for defined benefit plans; updated the Internal Revenue Code for tax qualification; and authorized Employee Stock Ownership Plans or ESOPs, and IRAs.

The Plan Document must be available at the main place of business for review by any participant or beneficiary. Summary Plan Descriptions must be given to each eligible employee.

ERISA requires a Fidelity Bond, also called an ERISA bond. Fiduciaries and any individual who handles plan funds are to be bonded so funds in the retirement plan are protected against loss due to theft or dishonesty. The amount of the bond for the current plan year must not be less than ten percent of the plan funds handled during the preceding plan year. The minimum bond amount required is $1,000 and the maximum is generally $500,000. Plans with employer securities must generally be covered up to $1,000,000.

ERISA requires qualified retirement plans to file a Form 5500 Series Annual Report. Form 5500 must be filed electronically with the Department of Labor, who shares the filing with the IRS. Form 5500-SF can be filed by most small employers with under 100 participants. Penalties for late filings can be substantial.

Generally, when a plan's eligible employee population reaches 100, the plan sponsor is considered a "Large Plan" filer and more detailed financial information is required, including a plan audit. The plan audit will need to be performed by an independent auditor and additional outside fees may apply.

Small plans may also be required to have an audit if certain conditions are not met. To be exempt from an audit, small plans must have only "qualifying assets" or have an ERISA bond which covers the full value of the non-qualifying asset.

A Summary Annual Report must be given to participants with information contained in the 5500. Small plans exempt from audits may have additional disclosures in the Summary Annual Report.

SEPs and SIMPLE IRAs

Simplified Employer Pensions or SEPs are Employer Sponsored plans that only the employer contributes to. SEPs are easy to set up using IRS Form 5305-SEP or an investment firm's Plan Document. There are no document fees and no annual IRS or DOL filings. There is usually an annual fee charged to each participant account.

Savings Incentive Match Plan for Employees of Small Employers or SIMPLE IRAs are another type of Employer Sponsored plan. This plan allows employees to contribute by having an amount regularly deducted from their pay. The Employer may contribute a match of 100% on first 3% of employee contributions, or may contribute 2% of compensation for all eligible employees.

The Employer who sponsors a SIMPLE IRA must cover all employees who make more than $5000 in any 2 prior years. Employees, including owners and shareholders who are paid wages, can defer up to $12,500 in 2016, and can defer an additional $3000 catchup contribution if they are age 50 or older.

As with the SEP, SIMPLE IRAs are easy to set up using IRS Form 5305-SIMPLE or an investment firm's Plan Document. There are no document fees and no annual IRS or DOL filings. There is usually an annual fee charged to each participant account.

Employees are 100% vested at all times. Once contributions are deposited into the SIMPLE IRAs, employees can take money out at any time. However, the distributions are subject to ordinary income taxes and a 25% penalty in first 2 years. After the first 2 years, distributions are subject to ordinary income taxes and a 10% penalty unless the employee is at least age 59 ½.

Employers who sponsor SIMPLE IRAs cannot maintain another plan, and cannot make any other contributions such as profit sharing contributions.

Written Documents are required for all qualified retirement plans. As mentioned above, a plan document can be an IRS Form, a Prototype Plan, a Volume Submitter (VS) Plan, or an Individually Designed Plan (IDP). Prototype and VS Plans have been pre-approved by the IRS. IDPs are attorney drafted and must be submitted to the IRS for approval.

IRAs and SEPs can be established for 2015 up until due date of tax return. For an individual, sole proprietor, partnership, or Sub-chapter S Corporation, plans could be established by April 18, 2016 unless an extension to file is requested.

SIMPLE IRAs, Safe Harbor 401(k) Plans and Qualified Automatic Contribution Arrangements must be established by October 1st. These types of plans must be in effect for at least 3 months of the calendar year. Other types of plans must have signed documents in place by the last day of the fiscal year in order to get deduction for that year.

SIMPLE 401k PLANS

SIMPLE 401K Plans are similar to SIMPLE IRAs in that they allow employees to contribute by having an amount regularly deducted from their pay. The Employer may contribute a match of 100% on first 3% of employee contributions, or may contribute 2% of compensation for all eligible employees. Employees, including owners and shareholders who are paid wages, can defer up to $12,500 in 2016, and can defer an additional $3000 catchup contribution if they are age 50 or older. Employees are 100% vested at all times.

SIMPLE 401K Plans are different from SIMPLE IRAs in several ways. SIMPLE 401k Plans are subject to ERISA. The Plan Document must be a Prototype, VS or IDP Document. The plan must cover employees who have 1 year of service, are at least age 21, and work at least 1000 hours per year. The Employer can possibly maintain another plan, which covers employees not covered by SIMPLE 401k. Form 5500 is required to be filed each year.

Distributions from the plan are also different from SIMPLE IRAs. Employees can only withdraw money subject to terms of plan. When allowed, distributions are subject to ordinary income taxes and a 10% penalty unless the employee is at least age 59 ½.

Another difference is how the plan’s contributions are invested. With a SIMPLE IRA, each participant has complete control over the investments in their account. In a SIMPLE 401k, the plan trustee establishes the investment choices, and the participants may or may not be able to direct investments into those choices.

PROFIT SHARING PLANS

When the Employer sponsors a Profit Sharing Plan, the company makes a discretionary contribution which may be based on profits. The contribution can range anywhere from 0 to 25% of the compensation of eligible employees. Maximum compensation which can be considered for each person is $265,000 in 2016. The definition of compensation is flexible and can exclude such things as bonuses, commissions, or overtime.

Profit Sharing Plans are subject to ERISA. The Plan Document must be a Prototype, VS or IDP Document. The plan must cover employees who have 1 year of service, are at least age 21, and work at least 1000 hours per year. Form 5500 is required to be filed each year.

The allocation of contributions is flexible. Contributions can be allocated on a pro-rata based on the compensation of each eligible employee. Contributions can be weighted for high earning individuals who are paying the maximum into Social Security. Contributions can also be weighted based on age or years of service, or a combination of all of these.

Profit Sharing Plans are generally subject to vesting schedules. Maximum schedules allowed are 6 year graded or 3 year cliff schedules. Other schedules can be designed as long as the maximum schedules are not exceeded.

Profit Sharing Plans are subject to Top Heavy rules. A Top Heavy Plan means that 60% or more of benefits are for Key Employees. Key employees are 5% or more owners, 1% owners with comp in excess of $170,000, or officers with comp in excess of $170,000. Top heavy vesting can be 6 year graded or 3 year cliff, or another schedule which doesn’t exceed the top heavy vesting allowances. If there is an allocation, a 3% allocation must be made to non-key employees first, then any remaining contribution can be allocated according to the plan provisions.

Employees can only withdraw money subject to terms of plan. When allowed, distributions are subject to ordinary income taxes and a 10% penalty unless the employee is at least age 59 ½. The Plan may allow In-service distributions under certain circumstances, such as for an employee who reaches Normal Retirement Age but chooses to continue to work.

Plan investments are typically chosen by the Plan Trustees and are not directed by the employees.

401(k) PLANS

Profit Sharing Plans can be designed to include 401(k) provisions. The term 401(k) is from the Internal Revenue Code section which allows employees to defer pay into the plan.

401(k) Plans are subject to ERISA. The Plan Document must be a Prototype, VS or IDP Document. The plan must cover employees who have 1 year of service, are at least age 21, and work at least 1000 hours per year. Form 5500 is required to be filed each year.

Employees, including owners and shareholders who are paid wages, can contribute up to $18,000 in 2016. Employees who are age least age 50 can contribute an additional $6,000 catch up contribution. Employees may have the option of designating these amounts as Roth contributions.

Maximum annual addition per employee is $53,000 in 2016. Maximum annual additions include 401(k), match, Profit Sharing and forfeitures allocated, but do not include catch up contributions. This means that an employee who is age 50 or older could have a total of $59,000 contributed on their behalf.

401(k) Plans usually allow Profit Sharing contributions. The company can make a discretionary contribution which may be based on profits. The contribution can range anywhere from 0 to 25% of the compensation of eligible employees. Maximum compensation which can be considered for each person is $265,000 in 2016. The definition of compensation is flexible and can exclude such things as bonuses, commissions, or overtime.

The allocation of profit sharing contributions is flexible. Contributions can be allocated pro-rata based on the compensation of each eligible employee. Contributions can be weighted for high earning individuals who are paying the maximum into Social Security. Contributions can also be weighted based on age or years of service, or a combination of all of these. The most popular allocation formula is known as the Cross-Tested or New Comparability formula.

Matching contributions and Profit Sharing are subject to vesting schedules. Maximum schedules allowed are 6 year graded or 3 year cliff. Other schedules can be used as long as the maximum schedules are not exceeded.

The Department of Labor requires participant contributions and plan loan payments to be submitted to the plan by the earlier of:

(a) the earliest date on which the contributions can reasonably be segregated from the employer’s general assets; or
(b) the 15th day of the month following the month in which the contribution or loan payment is withheld by the employer from the employee’s wages or the amounts would have been payable in cash.
(c) There is a “safe harbor” for small plans (under 100 participants) of 7 business days.

401(k) Plans are subject to Top Heavy rules. A Top Heavy Plan means that 60% or more of benefits are for Key Employees. Key employees are 5% or more owners, 1% owners with comp in excess of $170,000, or officers with comp in excess of $170,000. Top heavy vesting can be 6 year graded or 3 year cliff, or another schedule which doesn't exceed the top heavy vesting allowances. If there is a profit sharing allocation, a 3% allocation must be made to non-key employees first, then any remaining contribution can be allocated according to the plan provisions.

Employees can only withdraw money subject to terms of plan. When allowed, distributions are subject to ordinary income taxes and a 10% penalty unless the employee is at least age 59 ½. The Plan may allow In-service distributions under certain circumstances, such as for an employee who reaches Normal Retirement Age but chooses to continue to work. Hardship distributions could be allowed subject to IRS rules on what constitutes a hardship. 401(k) Plans can also allow loans to participants.

Plan investments are typically chosen by the Plan Trustees. The Trustees may then allow participants to direct their investments within the plan.

401(k) Plans are usually subject to ADP/ACP testing each year. ADP tests the employee deferral contributions, and ACP tests matching contributions. Highly Compensated Employees or HCEs are defined as 5% or more owners or employees earning $120,000 or more in 2016. ADP/ACP tests compare the average contributions for all HCEs against all Non-Highly Compensated Employees or NHCEs. The NHCE group must include all eligible employees, even if those employees chose not to contribute. If the rate contributed by the HCEs is substantially more than the NHCEs, the testing fails. ADP/ACP test and necessary corrections must be done within 2 ½ months of the plan year end.

Correcting ADP/ACP tests that fail may require the HCEs to get a refund of some of their contributions. Any refunds are taxable to the HCEs. Another method of correcting failed ADP/ACP tests is to contribute an additional amount to the NHCEs.

401(k) Plans can be designed so that ADP/ACP tests are not required. These are called Safe Harbor 401(k) Plans. Safe Harbor 401(k) Plans are very popular since the HCE group can contribute up to the maximum allowed for each year without having to worry about what the NHCEs are contributing.

SAFE HARBOR 401(K) PLANS

Safe Harbor 401(k) Plans require the Employer to make a matching contribution or a non-elective contribution. If the Plan is designed with the Safe Harbor Matching Contribution, the Employer is required to contribute 100% on first 3% deferred plus 50% on next 2% deferred for each contributing employee. Instead of the mandatory match, the employer can elect to make a Safe Harbor Non-elective Contribution of 3% of compensation for all eligible employees.

The Employer is required to notify all eligible employees about the Safe Harbor contribution prior to the start of each year. The Notice must be given between 30 and 90 days of eligibility. Because of this notice and requirement that 401k plan must be a Safe Harbor for the full plan year. Existing 401(k) plans can only be converted to Safe Harbor plans when there is time to give the 30 day notice. In other words, a calendar year plan would have to give notice by December 1 to use Safe Harbor provisions for the following calendar year.

If the Employer has a Profit Sharing Plan with no 401(k) provisions, Safe Harbor 401(k) Provisions can be added to the plan up until the 10th month of the plan. Compensation earned after establishment of 401(k) or Safe Harbor 401(k) can be considered for elective deferrals.

Employees, including owners and shareholders who are paid wages, can contribute up to $18,000 in 2016. Employees who are age least age 50 can contribute an additional $6,000 catch up contribution. Employees may have the option of designating these amounts as Roth contributions.

Maximum annual addition per employee is $53,000 in 2016. Maximum annual additions include 401(k), match, Profit Sharing and forfeitures allocated, but do not include catch up contributions. This means that an employee who is age 50 or older could have a total of $59,000 contributed on their behalf.

Safe Harbor 401(k) Plans usually allow Profit Sharing contributions. The company can make a discretionary contribution which may be based on profits. The contribution can range anywhere from 0 to 25% of the compensation of eligible employees. Maximum compensation which can be considered for each person is $265,000 in 2016. The definition of compensation is flexible and can exclude such things as bonuses, commissions, or overtime.

The allocation of profit sharing contributions is flexible. Contributions can be allocated pro-rata based on the compensation of each eligible employee. Contributions can be weighted for high earning individuals who are paying the maximum into Social Security. Contributions can also be weighted based on age or years of service, or a combination of all of these. The most popular allocation formula is known as the Cross-Tested or New Comparability formula.

Matching contributions and Profit Sharing contributions are subject to vesting schedules. Maximum schedules allowed are 6 year graded or 3 year cliff. Other schedules can be used as long as the maximum schedules are not exceeded. Any Safe Harbor contributions are 100% vested at all times.

The Department of Labor requires participant contributions and plan loan payments to be submitted to the plan by the earlier of:

(a) the earliest date on which the contributions can reasonably be segregated from the employer's general assets; or
(b) the 15th day of the month following the month in which the contribution or loan payment is withheld by the employer from the employee's wages or the amounts would have been payable in cash.
(c) There is a "safe harbor" for small plans (under 100 participants) of 7 business days.

Safe Harbor 401(k) Plans are subject to Top Heavy rules in any year a profit sharing contribution is made. A Top Heavy Plan means that 60% or more of benefits are for Key Employees. Key employees are 5% or more owners, 1% owners with comp in excess of $170,000, or officers with comp in excess of $170,000. Top heavy vesting can be 6 year graded or 3 year cliff, or another schedule which doesn't exceed the top heavy vesting allowances. If there is a profit sharing allocation, a 3% allocation must be made to non-key employees first, then any remaining contribution can be allocated according to the plan provisions.

Employees can only withdraw money subject to terms of plan. When allowed, distributions are subject to ordinary income taxes and a 10% penalty unless the employee is at least age 59 ½. The Plan may allow In-service distributions under certain circumstances, such as for an employee who reaches Normal Retirement Age but chooses to continue to work. Hardship distributions could be allowed subject to IRS rules on what constitutes a hardship. 401(k) Plans can also allow loans to participants.

Plan investments are typically chosen by the Plan Trustees. The Trustees may then allow participants to direct their investments within the plan.

The following chart illustrates contributions for a Safe Harbor 401(k) Plan with Profit Sharing using the Cross-tested allocation method

	Age	Comp	401(k)	CT Profit Sharing	Safe Harbor Match	Catch-up	Total Contribution
Dr. Jane Smith	58	$265,000	$18,000	$24,400	$10,600	$6,000	$59,000
Susie Baker	53	$45,000	$18,000	$3,150	$1,800	$0	$22,950
Donna Grant	54	$40,000	$0	$2,800	$0	$0	$2,800
Otis Nelson	45	$40,000	$0	$2,800	$0	$0	$2,800
Brenda Roberts	35	$35,000	$0	$1,750	$0	$0	$1,750
Brett Roberts	30	$35,000	$0	$1,750	$0	$0	$1,750
George Smith	56	$45,000	$4,500	$4,500	$1,800	$0	$9,450
Angie Taylor	41	$25,000	$1,000	$1,000	$875	$0	$3,125
GRAND TOTAL		**$380,000**	**$41,500**	**$42,150**	**$15,075**	**$6,000**	**$104,725**

AUTOMATIC ENROLLMENT PLANS

Effective January 1, 2008, the Pension Protection Act allows for employees to be automatically enrolled in 401(k) Plans. Automatic Contribution Arrangements or ACAs allow the Employer to automatically enroll employees who meet the eligibility requirements of the Plan. Employers who have ACA provisions in their 401(k) Plans have higher employee participation. Employees have to opt out of the Plan if they choose not to contribute.

Eligible Automatic Contribution Arrangements or EACAs offer a few added advantages. 401(k) Plans with ACA provisions are subject to ADP/ACP testing each year, as are EACAs. The Employer has 6 months to complete ADP/ACP testing and correction with EACAs, rather than the normal 2 ½ months with traditional 401(k) Plans.

Another advantage of EACAs is for employees who were automatically enrolled and wish to opt out. The Employee can opt out within 90 days of the first payroll deduction and have all contributions returned without any adverse tax consequences.

Plan investments are typically chosen by the Plan Trustees. The Trustees may then allow participants to direct their investments within the plan. An EACA may have a Qualified Default Investment Alternative or QDIA. If participant direction of investments is allowed, and a participant doesn't select any investments, the Employer places their contributions in the QDIA.

Qualified Automatic Contribution Arrangements or QACAs are similar to Safe Harbor

401(k) Plans. QACAs automatically enroll eligible employees at a set rate, which may be increased over the next several years. QACAs require the Employer to make a matching contribution of 100% on first 1% deferred plus 50% on next 5% deferred for each contributing employee.

The Employer is required to notify all eligible employees about the QACA provisions prior to the start of each year. The Notice must be given between 30 and 90 days of eligibility. Because of this notice and requirement that 401k plan must be a QACA for the full plan year. Existing 401(k) plans can only be converted to QACA plans when there is time to give the 30 day notice. In other words, a calendar year plan would have to give notice by December 1 to use QACA provisions for the following calendar year.

If the Employer has a Profit Sharing Plan with no 401(k) provisions, QACA 401(k) Provisions can be added to the plan up until the 10th month of the plan. Compensation earned after establishment of 401(k) or QACA 401(k) can be considered for elective deferrals.

Employees, including owners and shareholders who are paid wages, can contribute up to $18,000 in 2016. Employees who are age least age 50 can contribute an additional $6,000 catch up contribution. Employees may have the option of designating these amounts as Roth contributions.

Maximum annual addition per employee is $53,000 in 2016. Maximum annual additions include 401(k), match, Profit Sharing and forfeitures allocated, but do not include catch up contributions.

This means that an employee who is age 50 or older could have a total of $59,000 contributed on their behalf.

ACA, EACA and QACA 401(k) Plans usually allow Profit Sharing contributions. The company can make a discretionary contribution which may be based on profits. The contribution can range anywhere from 0 to 25% of the compensation of eligible employees. Maximum compensation which can be considered for each person is $265,000 in 2016. The definition of compensation is flexible and can exclude such things as bonuses, commissions, or overtime.

The allocation of profit sharing contributions is flexible. Contributions can be allocated on a pro-rata based on the compensation of each eligible employee. Contributions can be weighted for high earning individuals who are paying the maximum into Social Security. Contributions can also be weighted based on age or years of service, or a combination of all of these.

Matching contributions and Profit Sharing contributions are subject to vesting schedules. Maximum schedules allowed are 6 year graded or 3 year cliff schedules. Other schedules can be used as long as the maximum schedules are not exceeded. Any QACA contributions are subject to a 2 year cliff vesting schedule.

The Department of Labor requires participant contributions and plan loan payments to be submitted to the plan by the earlier of:

(a) the earliest date on which the contributions can reasonably be segregated from the employer's general assets; or
(b) the 15th day of the month following the month in which the contribution or loan payment is withheld by the employer from the employee's wages or the amounts would have been payable in cash.
(c) There is a "safe harbor" for small plans (under 100 participants) of 7 business days.

QACA 401(k) Plans are subject to Top Heavy rules in any year a profit sharing contribution is made. Top heavy vesting can be 6 year graded or 3 year cliff, or another schedule which doesn't exceed the top heavy vesting allowances. If there is a profit sharing allocation, a 3% allocation must be made to non-key employees first, then any remaining contribution can be allocated according to the plan provisions.

Employees can only withdraw money subject to terms of plan. When allowed, distributions are subject to ordinary income taxes and a 10% penalty unless the employee is at least age 59 ½. The Plan may allow In-service distributions under certain circumstances, such as for an employee who reaches Normal Retirement Age but chooses to continue to work. Hardship distributions could be allowed subject to IRS rules on what constitutes a hardship. ACA, EACA and QACA 401(k) Plans can also allow loans to participants.

Plan investments are typically chosen by the Plan Trustees. The Trustees may then allow participants to direct their investments within the plan. A QACA may have a Qualified Default Investment Alternative or QDIA. If participant direction of investments is allowed, and a participant doesn't select any investments, the Employer places their contributions in the QDIA.

SOLO 401(k) PLANS

A self-employed person with no employees other than the self-employed person and their spouse can have a 401(k) Plan. Solo 401(k) Plans are subject to ERISA. The Plan Document must be a Prototype, VS or IDP Document. Since there are no other employees, Solo 401(k) Plans usually don't have any age or service requirements.

The self-employed person and their spouse can contribute up to $18,000 each in 2016. Employees who are age least age 50 can contribute an additional $6,000 catch up contribution. Employees may have the option of designating these amounts as Roth contributions.

Maximum annual addition per employee is $53,000 in 2016. Maximum annual additions include 401(k), match, Profit Sharing and forfeitures allocated, but do not include catch up contributions. This means that an employee who is age 50 or older could have a total of $59,000 contributed on their behalf.

401(k) Plans usually allow Profit Sharing contributions. The company can make a discretionary contribution which may be based on profits. The contribution can range anywhere from 0 to 25% of the compensation of eligible employees. Maximum compensation which can be considered for each person is $265,000 in 2016. The definition of compensation is flexible and can exclude such things as bonuses, commissions, or overtime.

The allocation of profit sharing contributions in a Solo 401(k) Plan is usually allocated pro-rata based on the compensation of each eligible employee. There is usually no need for a vesting schedule, so 100% immediate vesting applies.

ADP/ACP testing does not apply. Top Heavy rules are already complied with by nature of plan provisions.

Form 5500 may be required to be filed, depending on the assets held by the Plan. Plan ssets must be $250,000 or more to require filing of Form 5500-EZ. Form 5500-EZ is only filed with the IRS, and is not filed electronically at this time.

Employees can only withdraw money subject to terms of plan. When allowed, distributions are subject to ordinary income taxes and a 10% penalty unless the employee is at least age 59 ½. The Plan may allow In-service distributions under certain circumstances, such as for an employee who reaches Normal Retirement Age but chooses to continue to work. Hardship distributions could be allowed subject to IRS rules on what constitutes a hardship. Solo 401(k) Plans can also allow loans to participants.

Plan investments are typically chosen by the Plan Trustees, who is the self-employed person.

The following chart compares IRA, SIMPLE IRA and 401(k) contributions for a sole proprietor with no employees:

	Compensation	**IRA**	**SIMPLE-IRA**	**401(k)**
Dr. Jane Smith	$265,000	$5,500	$12,500	$18,000
Match		$0	$7,950	$7,950
Total contribution		$5,500	$20,450	$25,950
Catch-up		$1,000	$3,000	$6,000
GRAND TOTAL		$6,500	$23,450	$31,950

Instead of Matching, Dr. Jane could make a Profit Sharing Contribution:

	Compensation	**IRA**	**SIMPLE-IRA**	**401(k)**
Dr. Jane Smith	$265,000	$5,500	$12,500	$18,000
Profit Sharing		$0	$0	$35,000
Total contribution		$5,500	$12,500	$53,000
Catch-up		$1,000	$3,000	$6,000
GRAND TOTAL		$6,500	$15,500	$59,000

OTHER PLAN TYPES

Employee Stock Ownership Plans or ESOPs are Plans to which contributions are made in the form of employer stock, Distributions are made in employer stock or cash for small balances. ESOPs have been a popular method to provide corporate finance, or buy out owners ready to retire. Special contribution and deduction limits apply to ESOPs.

Money Purchase Pension Plans require the Employer to contribute a fixed percent of compensation each year for eligible employees. Otherwise Money Purchase Pension Plans are similar to Profit Sharing Plans.

Until EGTRRA was passed in 2001, many employers had both Money Purchase Pension and Profit Sharing Plans so that they could contribute up to 25% of compensation. A common scenario was to have a 10% required contribution to the Money Purchase Plan and the flexibility to contribute 15% to the Profit Sharing Plan. EGTRRA allows 25% to be contributed to the Profit Sharing Plan now. Many employers merged their two plans, and no longer have the required Money Purchase contribution.

Target Benefit Plans are similar to Money Purchase Pension Plan because the Employer is required to contribute. Rather than contribute a fixed percent of compensation, the contribution is calculated each year to target a specific retirement benefit for each participant. The required contribution is the amount needed to fund for the targeted benefit based on each participant's age, service and average 3 to 5 years of compensation. Contributions are still limited to 25% of eligible compensation. Target Benefit Plans are no longer as popular as they once were. They have been replaced by the flexibility of allocations now allowed in Profit Sharing Plans.

Defined Benefit Plans also require the Employer to fund for a specific retirement benefit. The contribution is calculated based on amount needed to fund for specific benefit based on each participant's age, service and average compensation, and the rate of investment return. Contributions may well exceed 25% of eligible compensation. Defined Benefit Plans require an actuary to make calculations. In most plans, there is a premium paid to the Pension Benefit Guaranty Corp.

Defined Benefit Plans are not as popular for small employers because of the additional cost of administration and the required contribution which can be substantial. Defined Benefit Plans can be great plans for small medical or law practices where the owner is nearing retirement and hasn't saved much toward retirement benefits.

PLAN PROVISIONS

Different types of Plans have different eligibility requirements.

To be eligible to participate in SEPs, the requirements cannot exceed age 21 or 3 years of service out of the immediately preceding 5 years. The Employer can elect to exclude collectively bargained employees, and nonresident aliens. Employees must have earned $600 or more during the year.

To be eligible to participate in SIMPLE IRAs, the requirements cannot exceed age 21 or 3 years of service. The Employer can elect to exclude collectively bargained employees, and nonresident aliens. Employees must have earned $5000 or more during the year.

The eligibility rules are the same for Profit Sharing, Money Purchase, Target Benefit, ESOPs and 401(k) Plans. A plan using a vesting schedule cannot exceed age 21 or 1 year of service. A plan using immediate full vesting cannot exceed age 21 or 2 years of service.

A year of service is any consecutive 12-month period, based on either the plan year or anniversary of hire, during which the employee works 1000 hours or more. The first measurement period for eligibility purposes is from the hire date to the first anniversary, then the plan may switch to tracking hours on the plan year.

An hour of service is any hour for which an employee is paid for performance of duties, or for non-performance of duties, such as vacation or sick pay, or if employee is awarded back pay. There are special rules for salaried employees and employees who are paid by the project instead of hourly rates. This is called Elapsed Time in which equivalent hours are awarded for each day, week or month of service.

A Break in service occurs during a consecutive 12-month period during which an employee doesn't complete more than 500 hours of service. The same measuring period is used as for year of service. Some plans require a participant to have a Break In Service before they can receive a distribution of benefits.

Entry dates are defined in the plan and occur once the employee has satisfied the eligibility requirements. The employee is enrolled on the earlier of six months after completing eligibility requirements or first day of next plan year.

Common entry dates for Profit Sharing Plans are the first day of the plan year and the first day of month 7 which is January 1 and July 1 for calendar year plans. Many 401(k) Plans allow enrollment at the first of each quarter. Some 401(k) Plans allow for monthly enrollment, or even immediate enrollment.

ELECTIVE DEFERRALS

Employees can defer 100% of compensation up to $18,000 and an additional $6,000 catch up if they are age 50 or older. Most plans allow employees to defer up to the maximum allowed, although some plans place limits on elective deferrals. Elective deferrals can be changed by employees on entry dates, or some other administratively established time frame, but employees can stop deferrals at any time.

Automatic deferrals can be provided for in the plan document. This means that an employee who becomes eligible will automatically have a certain percentage taken from pay, unless that employee specifically elects another percentage, or elects not to participate. In the case of EACA or QACA, if the employee is automatically enrolled and lets employer know within 90 days that they didn't want to participate, contributions will be refunded to the employee.

MATCHING CONTRIBUTIONS

Employer Matching Contributions can be a set as a percentage or a flat dollar amount established in plan document, or can be a discretionary amount. If the plan provides for a discretionary amount, there is usually a cap placed on the percentage of compensation that can be considered for matching. If the plan is a Safe Harbor or QACA 401(k) Plan, the matching contribution is pre-determined. The Plan may allow an additional matching contribution subject to limitations.

Matching contributions can be "Tiered" based on levels of contributions, similar to how the Safe Harbor or QACA match is established, as long as it is not discriminatory.

RETIREMENT AGES

Most of us think of age 65 when we think of Retirement. Normal Retirement Age, when an individual is eligible for full Social Security benefits, is based on the year of birth. For those born in 1940, Normal Retirement Age is 65 and 6 months. For an individual born in 1960 or later, Normal Retirement Age is 67.

For Qualified Retirement Plans, however, Normal Retirement Age cannot exceed age 65. Qualified Plans can designate a lower Normal Retirement Age. Ages 60 and 62 are very common. The plan can also attach a participation requirement not to exceed 5 years. For example, the Normal Retirement Age is the later of age 62 or 5 years of plan participation.

Qualified Plans can also have an early retirement provision with a younger age and longer service requirement, such as age 55 after 10 years of service. Once an employee reaches Early or Normal Retirement Age, that doesn't mean that person has to retire. Many of us are working more years. The Plan may allow a continuing employee to take an in-service distribution after reach Normal Retirement Age.

PROFIT SHARING FORMULAS

Any Qualified Retirement Plan with a profit sharing feature has a wide range of choices for allocating contributions. The most common and easiest is the Pro Rata formula. Plan contributions are allocated to each eligible employee in proportion to their compensation.

Plans may use a permitted disparity allocation method. This takes into consideration the limit placed on Social Security benefits paid to higher wage earners. The formula is based on the current year Taxable Wage Base, or a percentage of the Taxable Wage Base.

Plans may use Uniform Points Allocation. A participant may receive points for each year of age and/or service, and based on compensation. Plans using Uniform Points Allocations must pass a special average allocation rate test each year.

New Comparability or Cross-Tested Allocations are a popular way to allocate higher amounts to higher wage earners. Participants are assigned to a rate group, and each rate group must satisfy coverage test. Plans using this allocation method must be tested on either allocations or Equivalent Benefit Rates each year.

Under an Age-based allocation, participants are allocated contributions based on age. Plans using this allocation method must be tested on either allocations or Equivalent Benefit Rates each year.

The Plan can provide a Prevailing Wage Contribution to satisfy the Davis-Bacon Act. Usually, the contribution can only be available to Non-highly Compensated Employees. There cannot be a minimum age or service requirements applied. All contributions made to satisfy Prevailing Wage are fully vested.

Employees may have to meet certain conditions to receive a Profit Sharing allocation. Plans can require employees to work at least a set number of hours, but not more than 1000. Plans may also require participants to be employed on the last day of the plan year. The Safe Harbor allocation condition is that employees must be employed on the last day of the plan year or have more than 500 hours of service for the plan year.

Allocation conditions can be waived for the year of death, disability or normal retirement.

DEDUCTIBLE CONTRIBUTIONS

The Employer's Deduction limit is 25% of compensation of eligible employees. The deduction does not necessarily depend on profits of the employer. Compensation for deduction purposes is gross compensation. Contributions must be deposited by the due date of the Employer's tax return including extensions.

Nondeductible Contributions, exceeding deduction limits, are subject to a 10% excise tax. Nondeductible Contributions are allocated in year contributed, even though not deductible. The Employer may carryover any Nondeductible Contributions.

COMPENSATION

Qualified Plans must define the compensation that will be used for Contribution purposes. The most commonly used definition is Total Compensation which is each employee's Gross compensation including 401(k) and cafeteria plan deferrals, or W-2 Compensation. The plan may also use safe harbor exclusions of fringe benefits.

The Plan may use an alternate definition that is reasonable and satisfies the compensation ratio test. The definition of compensation may exclude overtime, bonuses, commissions, etc.

The Plan may also exclude compensation prior to eligibility, especially for participants who enter plan on mid-year, quarterly, or monthly entry dates.

For Sub S Corporations, compensation cannot include distributions. For Example, An Owner is paid a salary of $30,000 and has $150,000 reported on Schedule K-1. The Owner's compensation for plan purposes is $30,000.

ANNUAL ADDITIONS LIMITATION

The Defined Contribution amount of allocations to a participant's account is limited each year according to Internal Revenue Code §415. The limit is the lesser of 100% of compensation or $53,000 for 2016. The limit is a per participant limit. Annual additions include 401(k) or Roth deferrals, matching contributions, after-tax contributions, profit sharing contributions and forfeiture allocations. Annual additions do not include catch up contributions, transfers or rollovers into the plan, repaid cash-outs, or investment gains or losses.

The Defined Benefit limit is based on benefits payable at Normal Retirement Age. For 2016, the maximum yearly benefit is the lesser of 100% of the average highest three years of compensation or $210,000.

VESTING

Vesting rules determine participant's ownership interest in their account balance. As a qualification condition, the plan must provide that each participant becomes 100% vested upon reaching normal retirement age.

Vesting schedules can be the 6-year graded schedule, 3-year cliff schedule or any schedule which is more liberal.

6 year graded

Years of Service	Vesting
0 – 1	0%
2	20%
3	40%
4	60%
5	80%
6	100%

3 year cliff

Years of Service	Vesting
0 – 2	0%
3	100%

Plan termination results in all participants to be 100% vested. A Partial Plan termination

Results in all affected participants to be 100% vested. This could happen if 20% or more of the employees are laid off, or part of a company is sold.

Vesting must generally count all of employee's service, but may disregard service before age 18 or service before the effective date of plan or a predecessor plan. A SEP does not count as a predecessor plan.

FORFEITURES

Forfeitures are result from an employee terminating without being 100% vested. Forfeitures can be used to reduce future employer contributions, added to employer contributions, or used to pay plan expenses.

When the plan terminates, all participants become 100% vested. The IRS discourages the return of plan assets to the plan sponsor. There is a 50% excise tax applied to returned assets, which are reported on Form 5500.

DISTRIBUTIONS

Most plans allow distributions after termination of employment. Some may provide distribution occurs as soon as practical after year end, after the end of a quarter or another specified time frame, or as soon as practical after termination occurs.

In-service distributions may be available after certain age or time frame, or under certain conditions, such as hardship. This is an optional plan provision. Not all plans allow in-service distributions. In-service distributions are subject to ordinary income taxes and may be subject to a 10% early withdrawal penalty if the participant is under age 59 ½.

The Employer must give a terminated participant a distribution form and Special Tax Notice 30 to 90 days prior to the distribution date.

If the distribution is an Eligible Rollover distribution, the plan must give the participant a choice to elect a direct rollover to an IRA or another eligible retirement Plan, or elect a lump sum distribution subject to 20% mandatory withholding. Automatic rollover rules may apply to distributions between $1000 and $5000, and the trustees may elect to cash out accounts less than $1000.

An Eligible Rollover distribution is any distribution that does not fall into one of the following categories:

1. Substantially equal periodic payments over a period of at least 10 years (or life expectancy.
2. Required Minimum Distributions
3. Hardship distributions
4. Corrective distributions
5. Loan default deemed distributions
6. Dividends on employer securities
7. PS 58 costs

Distribution options in the plan may include lump sum of cash or property, distribution of a portion of the vested account balance, installments for specified term, or the purchase of annuity.

Beneficiaries of married participants are the spouse under most circumstances. Married participants may only designate someone other than their spouse with written spousal consent. Unmarried participants may designate anyone. If a participant dies without a beneficiary designation, the terms of the plan determine who the beneficiary is.

REQUIRED MINIMUM DISTRIBUTIONS

Required Minimum Distributions or RMDs are included as part of the Plans qualification. For a 5% or more owner, RMDs occur by April 1 following calendar year of attaining age 70 ½ and then each year after that. For all other participants, RMDs occur on the later of April 1 following calendar year of attaining age 70 ½ or separation from service.

RMDs must be taken from each qualified retirement plan of the employer. For example. Dr. Smith has a Money Purchase Pension Plan and a Profit Sharing Plan. He cannot take the combined total from only one of the Plans. He also cannot combine his IRA RMDs with his qualified plan RMDs.

PARTICIPANT LOANS

Loans are a very popular feature especially in 401(k) plans. The Plan must have include participant loan provisions before loans can be allowed.

Loans must be available on a nondiscriminatory basis. The Plan can have a minimum loan requirement of $500 to $1000. The Plan cannot have a minimum loan requirement of $10,000 because this is discriminatory.

The Plan must charge a reasonable interest rate. The Plan must have adequate security for the loan. Loans are treated as a directed investment and have the participant’s pledge of 50% security of their account balance. The best way to secure repayment is through payroll deduction.

A Participant Loan is not taxable if it satisfies 4 requirements:

1. Enforceable agreement – promissory note
2. Repayment period limitation – 5 years with home loan exception
3. Level amortization requirement – repayments at least quarterly
4. Amount limited to the lesser of $50,000 or ½ of vested account balance.

If a loan is defaulted, IRS Form 1099-R is issued at end of the year of default. If the participant later repays all or part of an outstanding balance, that becomes basis in an account of after-tax money. Loans may be rolled into another employer’s plan, if the receiving plan allows this.

Loans may be refinanced, but cannot exceed original repayment period. A Loan taken out on 10/1/2012 for 7 ½% with repayment within 5 years (by 9/30/2017) could be refinanced at 6 ½ % on 1/1/2013, but must still be repaid by 9/30/2017.

HARDSHIP DISTRIBUTIONS

In order for a plan to grant Hardship distributions, they must be allowed under terms of plan. The Hardship must meet the definition set by Department of Labor. A Participant requesting a Safe Harbor Hardship must prove Immediate and Heavy Financial need.

In order to take a safe harbor hardship withdrawal, the participant must have obtained all other available distributions including loans under this and any other plan maintained by the employer, and cannot exceed the amount needed to satisfy the documented hardship including payment of taxes and penalties, There is no reduction in maximum amount of elective deferrals participants can make pursuant to Code Section 402(g) solely because of hardship distribution. Hardship distributions are not subject to the mandatory 20% withholding, but are taxable to the participant, and are subject to the 10% penalty if the participant is under age 59 ½. Hardship distributions are not eligible for rollover.

Non-safe harbor hardship distribution can be made at the employer's discretion, if allowed under the terms of the plan. A non-safe harbor hardship distribution is not available for 401(k) deferrals, QNECs, QMACs or Safe Harbor Contributions.

The IRS issued regulations regarding the events that can qualify for a hardship distribution from a Plan. The list of permissible events now includes the following:

- Expenses for medical care (described in Section 213(d) of the Internal Revenue Code) previously incurred by the participant, the participant's spouse or dependent, or necessary for the participant, the participant's spouse or dependent to obtain medical care;
- Costs directly related to the purchase of the participant's principal residence excluding mortgage payments;
- Tuition, related educational fees, and room and board expenses for the next twelve (12) months of post-secondary education for the participant, the participant's spouse or dependent;
- Amounts necessary to prevent the participant's eviction from their principal residence or foreclosure on the mortgage of their principal residence;
- Payments for burial or funeral expenses for the participant's deceased parent, spouse, children or other dependents; or
- Expenses for the repair of damage to the participant's principal residence that would qualify for the casualty deduction under the Internal Revenue Code.

VALUATIONS

Valuations can be periodic or daily. Most 401(k) Plans using individual accounts with an investment company or insurance company use daily valuations. A statement of account is only required to be given to the participant once a year, but most 401(k) plans provide these on a monthly or quarterly basis. Periodic valuations can be monthly, quarterly or annually. Most Profit Sharing, Money Purchase and Defined Benefit plans are valued annually.

Investment Gains or Losses can be allocated by using the balance forward method which is used if plans are valued annually, weighted average method, or adjusted percentage method.

OTHER PLAN PROVISIONS AND ISSUES

Plans can accept Rollover Contributions or direct Transfers from another qualified Plan. Plans can allow participants to invest in life insurance. Limitations apply as to how much of current or accumulated contributions can be used for premiums depending on the type of policy but term life policies are not allowed. The participant must pay tax annually on PS 58.

Plans can invest in real estate. The real estate must be titled in the Plan's name, and all expenses and taxes must be paid with plan assets.

Plans can allow participants to elect not to participate. However, this is a one-time irrevocable election made at inception of Plan, or prior to employee's eligibility.

Controlled Groups - For retirement plan purposes, ERISA requires that employees of all corporations classified as members of a controlled group of corporations be treated as though employed by a single employer. Tax or legal counsel can provide further information on a client's controlled group status. This may mean that the employer must include the employees of all companies in the same retirement plan or provide equivalent benefits.

Sarbanes-Oxley Notice of Blackout Period - The transfer of retirement plan funds from one investment institution to another will cause a blackout period when participants will not have the ability to direct or diversify the retirement funds maintained for their benefit under the plan, or obtain plan loans or distributions. Participants must be notified 30 days prior to the beginning of a blackout period. Clients may not be able to begin submitting contributions to a new investment institution until the end of the blackout period. If that is the case, participant contributions withheld during the blackout period should be held in an interest-bearing account.

IRS Tax Credit - The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 allows some employers to take a tax credit when they set up a new qualified retirement plan for their employees. Form 8881 gives tax credit for 50% of amounts paid or incurred up to $1000 (max credit is $500).

Pension Protection Act of 2006 – President Bush signed the PPA into law on August 17, 2006 "To provide economic security for all Americans, and for other purposes". Much of the legislation contains stricter defined benefit plan funding rules. There are also rules for defined contribution plans, employer securities, and nonqualified plans.

In 2006, Pensions and individual retirement arrangement provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 or EGTRRA were made permanent. These provisions were set to expire in 2010. These provisions Include Elective Deferral limits, Catch-up contributions, Employer deduction limits, Roth contributions, and indexing of traditional IRA deduction limits.

Qualified Retirement Plans are very flexible and complicated. QRPs provide an excellent benefit for the employees, and tax deductions for both the Employer and the Employees. It is very important for Plan Sponsors, Fiduciaries, Investment Advisors, and Third Party Administrators to work together to be sure the Plan is operated in compliance with the many regulations.

ANNUAL LIMITS SUBJECT TO COST OF LIVING ADJUSTMENTS

Code Section/Description	2020	2019	2018
Annual Limit on Includable Compensation in General/SEPs. This is the maximum amount of compensation that can be taken into account when determining an individual contribution or benefit.	$285,000	$280,000	$275,000
402(g) Elective Deferrals for 401k Plan CATCH UP Contribution if age 50+	$19,500 $6,500	$19,000 $6,000	$18,500 $6,000
Sec. 415 Limit for DC Plans Maximum annual addition is the lesser of 25% of compensation or annual limit	$57,000	$56,000	$55,000
SIMPLE IRA or SIMPLE 401k CATCH UP Contribution if age 50+	$13,500 $3,000	$13,000 $3,000	$12,500 $3,000
IRA Contributions CATCH UP Contribution if age 50+	$6,000 $1,000	$6,000 $1,000	$5,500 $1,000
Elective Deferrals for 403(b) Plans	$19,500	$19,000	$18,500
408(K)(2)(C) SEP Minimum Compensation	$600	$600	$600
414(q)(1)(B) Key Employee Highly Compensated Employee	$185,000 $130,000	$180,000 $125,000	$175,000 $120,000
Sec. 415 Limit for DB Plans Maximum yearly benefit allowed is the lesser of 100% of average highest three years' compensation or the indicated amount. Reductions may apply.	$230,000	$225,000	$220,000

BIBLIOGRAPHY

Except where otherwise noted, material for this report came from the following sources:

- Greg Makowski & Harris Nydick, CFS Investment Advisory Services
- Veronica Lee, 401(k) Advisors
- Darryl Marks, Retirement Plan Advisory Group
- Lawain McNeil & John Resnick, The Advisor Lab

Other References and Resources:

Internal Revenue Code

ERISA

www.irs.gov

www.dol.gov/ebsa

www.benefitslink.com

Some Reports the Authors have available upon request:

-Document Retention Checklist

-Fiduciary Self-Assessment

-Investment Committee Responsibilities Checklist

-A Plan Sponsor Guide to Advisor Selection

MORE INFORMATION

We hope you have found this report helpful. For more information or if you would like to get a plan review by a third party administrator (TPA) or a fee-only investment advisor who acts in a fiduciary capacity, please contact one of the professionals below.

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Monica Barnard, owner of Barnard & Associates Retirement Plan Specialists, LLC, has over 25 years of experience in retirement plan administration and consulting. Barnard & Associates Retirement Plan Specialists, LLC provides administrative services for 401k, Pension and Profit Sharing Plans, focusing on small businesses. Monica is:

The First person in the Pensacola area to become an Enrolled Retirement Plan Agent (ERPA) with the IRS.
The First person in the Pensacola area to earn Accredited Pension Administrator (APA) designation.
The First person in the Pensacola area to earn Certified Employee Benefit Specialist (CEBS) designation.

She received her bachelor's in Mathematics from the University of West Florida in 1979. She has seven years' experience teaching Math and Computer Science in public and private schools. Member of the National Institute of Pension Administrators

Eric Nager is an Investment Advisor Representative with Southern Capital Services where he has worked since 2000 after several years in the publishing industry. He earned a Master's in Business Administration (MBA) from the University of South Alabama and a Masters in History (ALM) from Harvard. In 2014 he earned the designation of Chartered Retirement Plans Specialist (CRPS®) from the College for Financial Planning.

Eric serves on the University of South Alabama Gift Planning Council and is a member of the university's Global Advisory Board. He retired as a Lieutenant Colonel in the US Army Reserve, is an adjunct faculty at the University of South Alabama, and coaches the chess team at Bayside Academy in Daphne. He is author of *Checklist for Checkmate: 15 Keys to Building a Successful Team* and *The Pawn Who Would be Queen: the Story of Alabama's First National Champions* as well as co-author of *Retirement Rescue: A Primer on How to Help Keep Your Retirement Afloat* and *Plan For America: How to Place the American Dream on a Sure Foundation Forever.*