THE ADVISORS GUIDE TO 401(k) PLANS

(2025 Edition)

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CHAPTER 1

INTRODUCTION

Overview

This introductory chapter provides an in-depth examination of 401(k) plans, a cornerstone of employer-sponsored retirement savings in the United States. The chapter begins with a historical review, tracing the evolution of 401(k) plans from their inception under the Revenue Act of 1978 to their current role, shaped by numerous legislative reforms such as the Tax Reform Act of 1986, the Pension Protection Act of 2006, the SECURE Act of 2019 and the SECURE 2.0 Act of 2022.

The chapter also analyzes the rapid growth of 401(k) plans, exploring how they have become a dominant feature of retirement planning. We will examine the factors contributing to their adoption, including tax advantages for both employees and employers, the shift from defined benefit to defined contribution plans, and advancements in plan design, such as auto-enrollment and target-date funds.

To conclude, the chapter offers insights into the future of 401(k) plans, addressing potential legislative changes, evolving trends in investment options, and the challenges posed by increasing life expectancy and market volatility. This foundational knowledge sets the stage for financial and insurance professionals to advise clients effectively on 401(k) plans.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Identify the key legislative acts that shaped the development of 401(k) plans.
- Explain the reasons behind the growth of 401() plans as the primary employer sponsored retirement savings vehicle for many Americans.
- Evaluate the impact of legislative and economic changes on the design and usage of 401(k) plans; and
- Assess the future growth and role of 401(k) plans.

The Evolution of 401(K) Plans

Today's 401(k) plan has its origin in defined contribution (DC) plans created well before the passage of the Employee Retirement Income Security Act (ERISA) of 1974 or the addition of Section 401(k) to the Internal Revenue Code (IRC) in 1978. In years before ERISA, many employers offered "*thrift-savings plans*," which allowed employees to make contributions to a plan–but only on an after-tax basis–and modern 401(k) plans copied the idea of participant contributions. At the same time, many employers made before-tax employer contributions to tax-qualified profit-sharing plans, which allowed employers to contribute part of their profits to a trust and allocate the monies to the accounts of eligible employees. Dating back almost to introducing the federal income tax code in 1913, tax rules allowed employees to defer taxation of employer profit-sharing contributions. In addition, taxation on investment earnings on employer and employee contributions was deferred until distributed from the plans.

In the mid-1950s, several companies, particularly banks, added to their profit-sharing plans a new feature that came to be called a "*cash or deferred arrangement*," or CODA. Each year, when employees were awarded profit-sharing bonuses, they were given the option to deposit some or the entire bonus into the plan instead of receiving the bonus in cash. Even though the employee had the right to receive the bonus in cash, which would trigger immediate income tax (under the *constructive receipt doctrine*–see below), a CODA sought to treat any amount the employee contributed to the plan as if it were an employer contribution, and therefore tax-deferred.

Note: Employer contributions, which are deductible as an expense to the employer and are not included in the income of the employee until distributed from the plan.

Principle of Constructive Receipt

Under the principle of "*constructive receipt*," a taxpayer must pay income tax on income earned in a tax year even if the income is not actually received in that year, so long as the income is available to the taxpayer without substantial restriction [Treas. Reg. § 1.451-2]. Accordingly, if an employee is given a choice between receiving compensation now or deferring it until a later tax year, the constructive receipt rule requires immediate taxation regardless of choice. A 401(k) plan is at its heart an exception to this rule because it allows an employee to choose to contribute compensation right before the compensation would otherwise have been paid in cash.

The IRS was somewhat wary of this arrangement but did issue some guidance in 1956. The IRS allowed for this arrangement if two requirements were met:

- The participant made an irrevocable election to defer the profit-sharing contribution before the close of the plan year for which the profit-sharing contributions were made; and
- More than half of the participants in the plan (who elected to defer) were among the lowest two-thirds of all eligible employees.

The IRS later reaffirmed that this type of arrangement could be a qualified plan. Subsequently, the IRS ruled that if such a plan met the nondiscrimination rules of Revenue Ruling 56-497, the deferred contribution would be exempt from the IRS doctrine of constructive receipt [Rev. Rul. 63-180, 1963-2 C.B. 189]. Further clarification of this position was issued in another IRS revenue ruling in 1968 [Rev. Rul. 68-89, 1968-1C.B. 402]. Despite these positive rules, CODAs never became wildly popular. By the early 1970s, there were fewer than 1,000 plans in existence.

Then in 1972, the IRS issued proposed regulations that would dramatically change its previous position. Under the proposed regulations, salary reduction contributions would have been treated, for tax purposes, as if the employee in cash had received them. Although the regulations did not deal directly with the profit-sharing deferral arrangements, they cast doubt on these arrangements.

However, Congress was concerned about the IRS's stance. When it passed *The Employee Retirement Income Security Act* (ERISA) of 1974, it contained a provision that froze the existing tax status of CODAs until the end of 1976. Any such arrangements in existence on June 27, 1974, retained their tax-favored status. The moratorium was deferred twice, the last time until the end of 1979.

Employee Retirement Income Security Act of 1974

The Employee Retirement Income Security Act of 1974 (ERISA) contained sweeping changes in the regulation of pension plans and created rules regarding reporting and disclosure, funding, vesting, and fiduciary duties. Although ERISA was aimed mostly at “assuring the equitable character” and “financial soundness” of Defined Benefit (DB) pension plans, the Act contained numerous provisions impacting Defined Contribution (DC) plans (like profit-sharing plans, and eventually 401(k) plans). For example, ERISA contained a provision that allowed DC plans to delegate investment responsibility to participants and thereby relieve the plan sponsor from investment responsibility, which today is the basis for participant-directed 401(k) plans. Also included in ERISA was a provision Congress described as a “*freeze of the status quo*,” which stated that the IRS could not disqualify any CODA plan adopted before June 27, 1974, but that no new plans could be created unless employee contributions were made solely on an after-tax basis.

The Revenue Act of 1978

In 1978, Congress, unhappy with the uncertainty surrounding CODAs, passed the *Revenue Act of 1978*, which contained a new Subsection (k) to Section 401 of the Internal Revenue Code (IRC). Subsection (k) allowed profit-sharing plans to adopt CODAs, subject to certain requirements, including:

- Restrictions on distributions during employment.
- A requirement that an employee’s contributions be fully vested; and
- A numerical nondiscrimination test.

At the same time, Congress added IRC § 402(a)(8) (now located at IRC § 402(e)(3)), which provided that an employee would not be taxed on compensation contributed to the plan pursuant to a CODA, it provided that amounts an employee elects to have contributed to a 401(k) account are not treated as amounts paid or made available to the employee, thereby explicitly trumping the constructive receipt rule (discussed above). This prevents the employee from being taxed on contributions under the constructive receipt doctrine. The section, after various amendments, is now IRC § 402(e)(3). It also treats the amounts an employee elects to have contributed to the plan as the employer, rather than the employee, contributes to it. These new provisions were effective for tax years beginning in 1979. Likely under the impression that very few employers would add a 401(k) feature to their retirement plans, Congress estimated in 1978 that the loss in tax revenue would be “negligible.”

On November 10, 1981, the IRS proposed regulations under the new Section 401(k): Internal Revenue Service, "*Certain Cash or Deferred Arrangements Under Employee Plans*," 46 Fed. Reg. 55544. The regulation clarified that 401(k) contributions could be made from an employee's ordinary wages and salary, not just from a profit-sharing bonus, as long as the employee agreed in advance to have funds taken from their pay and contributed to the plan. Because the proposed regulations essentially opened up 401(k) plans to ordinary wages and salary, November 10, 1981, marks the birth of the modern 401(k) plan. After that date, companies began to add 401(k) contributions to their profit-sharing plans, convert after-tax thrift-savings plans to 401(k) plans, or create new 401(k)-type DC plans.

At the 401(k)-plan inception, employee before-tax contributions were exempt from payroll, or Federal Insurance Contributions Act (FICA), taxes. Total employee and employer contributions were subject to an annual limit ($45,475 in 1982). Still, there was not a separate limit for employee contributions. The original 401(k) rules also imposed limits based on nondiscrimination tests and permitted loans and withdrawals.

Let's not forget that when introduced in 1981, 401(k) plans were expected to be supplemental plans, used in conjunction with a defined benefit (DB) pension or a traditional defined contribution (DC) pension.

Tax Equity and Fiscal Responsibility Act of 1982

In 1982, the unfavorable regulatory climate of 401(k) plans continued with the passing of the Tax Equity and Fiscal Responsibility (TEFRA), in which Congress reduced the maximum allowable annual contribution to a DC plan to $30,000. In 1983, Congress removed the payroll tax exemption, requiring all employee pre-tax contributions to be subject to FICA taxes.

Tax Reform Act of 1984

In 1984, the Treasury Department proposed eliminating Section 401(k) from the Internal Revenue Code. Although this proposal was never implemented, the Tax Reform Act (TRA) of 1984 modified rules for 401(k) plans in elusive ways. It eliminated the possibility of integrating 401(k) plans with Social Security nondiscrimination tests (which previously had been safe harbors). Instead, an alternative of testing under the general qualified plan nondiscrimination rules became mandatory. Congress changed the rules because it thought these plans did not adequately provide for rank-and-file employees. These plans should be secondary, not primary retirement plans. In addition, certain money purchase pension plans that allowed for salary reductions and were in existence before the passage of ERISA were grandfathered under the law.

Tax Reform Act of 1986

One of the new rules that Congress enacted with the Tax Reform Act (TRA) of 1986 effectively froze the $30,000 maximum annual amount of total contributions (employee and employer) to any DC plan. This freeze was effective for 17 years. Another TRA of 1986 provision added a new, more restrictive annual limit specifically applied to employee deferrals: an employee could contribute no more than $7,000 pre-tax to 401(k) plans. This rule was a significant restriction on employee contributions in two ways. Previously, any combination of employee and employer contributions could be used to reach the $30,000 contribution limit; now, only a portion of the limit could be funded with employee pre-tax contributions. Also, whereas all other restrictions on retirement plans are at the employer level, this new participant deferral limit was levied at the individual level. TRA of 1986 also tightened further the nondiscrimination rules that applied specifically to 401(k) plans.

In fact, at the time, the U.S. Senate Committee on Finance stated:

> *"The committee also believes that excessive reliance on individual retirement savings (relative to employer-provided retirement savings) could result in inadequate retirement income security for many rank-and-file employees. In particular, the committee believes that qualified [401(k) plans] should be supplementary retirement savings arrangements for employees; such arrangements should not be the primary employer-maintained retirement plan."*

Small Business Job Protection Act of 1996

It wasn't until the late 1990s that the regulatory climate began to change for 401(k) plans. In 1996, as part of a package of reforms aimed at bolstering small businesses–the Small Business Job Protection Act (SBJPA) of 1996–Congress encouraged employers to offer retirement plans, including 401(k) plans. The SBJPA simplified nondiscrimination tests and repealed rules imposing limits on the contribution that could be made to a retirement plan by an employee who also participated in a DB plan. In addition, starting in the late 1990s, the IRS issued a series of rulings allowing automatic enrollment.

Economic Growth Tax Relief Reconciliation Act of 2001

In 2001, the Economic Growth Tax Relief Reconciliation Act (EGTRRA) of 2001 took another step to spur saving through 401(k) and other DC plans. EGTRRA increased the annual DC plan contribution limit, albeit not higher than the $45,475 limit in place in 1982. In addition, the restrictions placed on employee deferrals were loosened as the limit on pre-tax contributions was increased, and additional "*catch-up"* contributions were allowed for employees age 50 and older. To preserve retirement account even when job changes occur, EGTRRA increased the opportunities for rollovers among various savings vehicles (401(k) plans, 403(b) plans, 457 plans, and IRAs). In addition, EGTRRA permitted 401(k) plans to offer a "*Roth*" feature for after-tax contributions, aka Designated Roth Accounts (DRAC) (see Chapter 7 for a full discussion of the Roth 401(k)). Because of Congressional budget rules, these changes were set to expire after 2010.

Pension Protection Act of 2006

Legislation passed in August 2006, the Pension Protection Act (PPA) of 2006, also aims to foster retirement savings and 401(k) plan participation. Among its many provisions, the PPA makes the EGTRRA pension rule changes permanent and makes some of the rules governing pension plans more flexible.

For example, the PPA encourages employers to enroll employees in their 401(k) plans automatically and allows employers to offer appropriate default investments (see Chapter 10 for a full discussion of default investments). These measures seek to increase participation in 401(k) plans and facilitate workers' best use of these plan options.

The American Taxpayer Relief Act of 2012

On January 2, 2013, President Obama signed the *American Taxpayer Relief Act of 2012 (ATRA)*. The new law permits 401(k) (as well as 403(b) and governmental 457(b)) plan sponsors to amend their 401(k) plans to permit *any* amount under the plan to be converted to a Designated Roth Account (DRAC) within the plan, even if the amount is not otherwise distributable. Converted amounts are treated as distributions and taxable in the year of conversion. The new law was effective January 1, 2013, but permits conversions of balances accumulated before 2013.

Prior to the new law, 401(k), 403(b), and governmental 457(b) plan sponsors could amend their plans to permit vested account balances to be converted to Roth amounts within the plan, but only if those amounts were otherwise distributable under the terms of the plan and qualified as eligible rollover distributions. This generally meant amounts were convertible only upon the participant’s severance from employment, death, disability, or attainment of age 59½ or, in the case of profit sharing or matching contributions, upon a stated age, stated event, or fixed number of years. However, traditional after-tax and rollover contributions and their earnings are generally freely distributable at any time. Under the new law, converted amounts were generally treated as distributions and taxable in the year of conversion.

The Tax Cuts and Jobs Act of 2017

On December 22, 2017, President Trump signed H.R. 1, the “*Tax Cuts and Jobs Act.*” Among the provisions of Title 1, Subtitle F, a couple of changes impact retirement plans involving: Hardship Distributions and Plan Loans.

SECURE Act of 2019

The Setting Every Community Up for Retirement Enhancement Act (SECURE Act) which President Trump officially signed into law on December 20, 2019, the most sweeping legislation affecting retirement savings since the Pension Protection Act passed in 2006. This Act was added as Division O to the “Further Consolidated Appropriations Ac, 2020 (H.R. 1865)..

There are many underlying aspects of this legislation to be aware of, including increasing access to 401(k) plans, the promotion of lifetime income options and providing incentives for businesses to create new retirement plans. Congress intends these changes to boost 401(k) participation and, through the following reforms, prevent future retirees from running out of money in old age.

The SECURE Act contains 125 pages of legislation containing 30 provisions. Here are some highlights of the Act:

- Enables small business owners to set up “safe harbor” retirement plans that are less expensive and easier to administer.
- Expanded benefits for many part-time workers, debt ridden students and new parents.
- Increased the age at which retirement plan participants need to take required minimum distributions (RMDs), from 70½ to 72, and allows traditional IRA owners to keep making contributions indefinitely.
- Eliminated the “stretch IRA” now mandates that most non-spouses inheriting IRAs take distributions that end up emptying the account within 10 years.
- Includes a safe harbor for plan fiduciaries in selection of insurer for a guaranteed retirement income contract.
- Increase in the maximum dollar limit allowed for the tax credit small businesses can use, and the Act provides a tax credit of up to $500 per year to employers that include automatic enrollment in their 401(k) plans and SIMPLE IRAs.

Many of the SECURE Act provisions became effective as of Jan. 1, 2020, while others had different effective dates.

SECURE 2.0 Act of 2022

Building on the improvements of made by the Setting Every Community Up for Retirement Enhancement Act (SECURE Act) of 2019, the SECURE 2.0 Act of 2022, signed by President Biden on December 29, 2022, as part of the “Consolidated Appropriations Act”, is one of the most comprehensive pieces of retirement legislation in decades.

SECURE Act 2.0 includes more than 90 provisions designed to help workers save more for retirement and expand access to retirement plans. Highlights of the Act include:

- Further raises the age for starting required minimum distributions (RMDs) for terminated employees who are participants, as well as 5% owners from 72 to 73 (and thereafter to 75 in 2033). The change applies to distributions made after Dec. 31, 2022, for individuals who turn 72 after that date.
- Decreases the penalty for failure to take required minimum distributions from 50% of the underpaid amount to 25% and possibly to 10%.
- Increases the maximum amount of an employee’s compensation that can be automatically deferred under a plan with an automatic enrollment safe harbor from 10% to 15%, beginning after the employee’s first plan year.
- Enables matching contributions for student loan payments.
- Extension of time to adopt an employer-sponsored retirement plan.
- Enables plans to include emergency savings accounts.
- Encourages automatic enrollment and automatic contribution increases.
- Increases catch-up contribution limit.
- Increases the tax credit for small businesses.
- Permits older workers to save more and stay invested longer.
- Simplifies disclosures.

- Provides new and enhanced credits for small businesses' sponsoring plans

The act's provisions have a variety of effective dates that extend to 2026 and 2027 and many of the provisions are optional choices for employers to add to their existing plans. (see Chapter 13).

The Growth of 401(k) Plans

Despite the legislative and regulatory measures aimed at restricting 401(k) plans in their early years, the number of firms offering 401(k) plans has grown dramatically since their formal introduction in 1981. Since 1984, we have seen the number of plans grow from 17,303 to 685,9971 in 2022 (see Table 1.1). The growth in participation rates among workers at employers sponsoring plans also has grown considerably, from 7.5 million active participants to over 79.4 million active participants in 2022 (latest data available), according to Form 5500 filings with the U.S. Department of Labor (see Table 1.1).

Table 1.1
Number of 401(k) Type Plans, Active Participants, Assets, Contributions, and Benefits, 1984-2022

Year	Number of Plans	Active Participants (thousands)	Total Assets	Total Contributions (millions)	Total Benefits (millions)
1984	17,303	7,526	$91,754	$16,291	$10,617
1990	97,614	19,466	384,854	48,998	32,028
1995	200,813	27,759	863,918	87,416	62,163
2000	348,053	39,847	1,724,549	169,238	172,211
2005	436,207	54,623	2,395,792	223,533	189,822
2006	465,653	58,351	2,768,242	251,233	229,217
2007	490,917	59,566	2,981,522	273,235	262,108
2008	511,583	59,976	2,230,188	285,773	233,452
2009	512,464	60,285	2,734,064	258,357	208,467
2010	518,675	60,510	3,142,141	267,584	245,474
2011	513,496	61,371	3,146,851	285,679	252,692
2012	516,293	63,088	3,530,122	306,092	284,677
2013	527,047	64,495	4,179,351	327,886	328,680
2014	533,769	62,651	4,399,891	349,216	365,657
2015	546,896	65,307	4,382,033	377,743	385,907
2016	560,373	67,121	4,738,481	398,920	391,540
2017	571,841	68,187	5,476,365	429,440	425,013
2018	588,499	70,335	5,229,194	464,578	473,790
2019	604,424	72,202	6,242,230	499,522	519,038
2020	621,509	72,214	7,068,770	517,108	614,814
2021	644,671	74,905	8,020,485	582,681	680,261
2022	685,997	79,444	6,785,812	589,784	617,149

Source: Form 5500 filings with the U.S. Department of Labor. Released September 2024 Table E-23-E24. https://www.dol.gov/sites/default/files/ebsa/researchers/statistics/retirement-bulletins/private-pension-plan-bulletin-historical-tables-and-graphs.pdf

Future of 401(k) Plans

The 401(k)-retirement plan has come a long way since its humble beginnings in the early 1980s. However, several things need to be fixed to provide today's workers with a retirement income that can protect their lifestyles in retirement.

In recent years, changes have been made to encourage workers to save more in their 401(k) plans (automatic enrollment), to simplify the process of deciding how to invest their contributions (target date funds), and requirements to have participant statements that clearly show how much monthly or annual income that the person's 401(k) sum can generate. But, probably the most important change that is taking place and will change the future of 401(k) plans is the demand for more fee transparency. Most 401(k) plans are riddled with so many hidden fees that the typical 401(k) participant isn't aware they're even paying them. And while 401(k) sponsors (employers) have a fiduciary duty to protect their employees against newfangled retirement plan fees, most employers themselves are clueless. Even worse, some employers are acting in collusion with 401(k) providers to obscure the true cost of their company's 401(k) plan.

A study by the U.S. Government Accountability Office (GAO) proves this. The GAO study revealed that revenue sharing, whereby a mutual fund company shares its fee income with the 401(k) plan's administrator, is common. The actual compensation can range from 0.05 percent to 1.25 percent. Why is it a problem? Because it creates a hidden incentive for the 401(k)-service provider to recommend investment choices with higher fees, some of which may even include proprietary funds with substandard performance.

The bottom line: 401(k) plans of the future will need to be shaped by innovation and be able to provide the participant with smartly designed systems that use multiple investment products, with genuine diversification, offer 100% fee transparency, and provide the participant with statements that clearly show how much monthly or annual income that the person's 401(k) sum can generate.

Table 1.2
Timeline for 401(k) Plans

1913	16th Amendment to Constitution Allows Personal Income Tax
1935	Social Security Act Creates Social Security
1942	Revenue Act Introduces Nondiscrimination Rules
1950	Employers Introduce Cash or Deferred Arrangements (CODAs)
1956	IRS Revenue Ruling First Approves CODAs
1972	IRS Proposes Regulations to Eliminate CODAs
1974	Employee Retirement Income Security Act (ERISA) Grandfathers Existing CODAs Until 1/1/1977; Prohibits Creation of New CODAs; Allows Plan Sponsors to Delegate Investment Responsibility to Participants; Creates Formal Pension Plan Contribution Limits
1976	Tax Reform Act of 1976 Extends Moratorium on CODAs
1978	Revenue Act of 1978 Creates New Section 401(k); Foreign Earned Income Act of 1978 Extends CODA Moratorium Again
1981	IRS Proposes Regulations for 401(k)

1982	Tax Equity and Fiscal Responsibility Act Reduces Total DC Plan Contribution Limit and Imposes Required Minimum Distribution Rules on All Retirement Plans
1983	Social Security Amendments of 1983 Makes 401(k) Participant Contributions Subject to Employment Taxes
1984	Department of Treasury Proposes Repeal of 401(k)
1986	Tax Reform Act of 1986 Effectively Freezes Total DC Plan Contribution Limit; Places Additional Restrictions on Participant Contributions; Tightens Nondiscrimination Tests
1992	Department of Labor Releases Final 404(c) Regulations on Investments in Participant-Directed Plans
1996	401(k) Plan Assets Top $1.0 Trillion
1996	Small Business Job Protection Act (SBJPA) Simplifies Rules to Encourage Employer Adoption of Plans
2001	Economic Growth and Tax Relief Reconciliation Act (EGTRRA) Loosens Restrictions on Participant Contributions; Creates Catch-Up Contributions; Increases Rollover Opportunities Between Plans; Creates Roth 401(k)
2005	401(k) Plan Assets Reach $2.4 Trillion
2006	Pension Protection Act (PPA) Makes Permanent the EGTRRA Higher Contribution Limits; Encourages Automatic Enrollment
2012	The American Taxpayer Relief Act of 2012, enacted at the beginning of 2013, broadened participants' ability to convert their pre-tax account to a DRAC by removing the requirement that the employee must be eligible for an in-service distribution, effective for conversions after December 31, 2012.
2017	Tax Cuts and Jobs Act, Title 1, Subtitle F amended several provisions that impact 401(k) plans:
2020	The Setting Every Community Up for Retirement (or SECURE) Act, which was officially enacted on January 1, 2020, is now the largest retirement reform to impact the economy since the Pension Protection Act of 2006
2020	The Coronavirus Aid and Relief and Economic Security (or the CARES) Act the $2.2 trillion Act signed into law March 27, 2020, contains a number of provisions affecting 401(k) plans.
2021	SECURE Act of 2019, The Setting Every Community Up for Retirement Enhancement Act (SECURE Act) the most sweeping legislation affecting retirement savings since the Pension Protection Act passed in 2006, provides a number of provisions with the objectives to expand access to increase the number of employers offering 401(k) plans and to improve retirement security for individuals and increase the number of participants.
2022	SECURE 2.0 Act of 2022, was signed into law by President Biden on Dec. 29, 2022, as part of a $1.7 trillion omnibus spending bill. This massive piece of legislation (including 92 provisions) builds on the foundation that was laid by the SECURE 2019 Act to further improve upon the success of the private employer-based retirement system by making it easier for businesses to offer retirement plans and for individuals to save for retirement.
2024	401(k) Plan Assets Reach $8.0 Trillion as of June 30, 2024, accounting for 20% of all retirement assets of $40.0 trillion.

Chapter 1
Review Questions

1. What significant changes in retirement planning did the introduction of 401(k) plans bring about?

   ( ) A. Increased employer contributions to retirement savings
   ( ) B. Shift from defined benefit to defined contribution plans
   ( ) C. Decreased employee participation in retirement plans
   ( ) D. Reduction in overall retirement savings

2. What major legislative changes have impacted 401(k) plans since their inception?

   ( ) A. The introduction of the Employee Retirement Income Security Act (ERISA)
   ( ) B. The passage of the Sarbanes-Oxley Act
   ( ) C. The Pension Protection Act of 2006
   ( ) D. The Health Insurance Portability and Accountability Act (HIPAA)

3. Which of the following is a primary advantage of 401(k) plans for employees?

   ( ) A. Guaranteed investment returns
   ( ) B. Employer matching contributions
   ( ) C. No contribution limits
   ( ) D. Immediate access to funds without penalties

4. How might demographic shifts in the workforce influence the future of 401(k) plans?

   ( ) A. Increased focus on defined benefit plans
   ( ) B. Reduced importance of retirement savings
   ( ) C. Greater emphasis on plan portability and flexibility
   ( ) D. Less reliance on employer-sponsored retirement plans

5. Which trend is likely to shape the future of 401(k) plans?

   ( ) A. Decreasing employee participation
   ( ) B. Increased focus on automated investment advice
   ( ) C. Elimination of employer matching contributions
   ( ) D. Reduced regulatory oversight

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CHAPTER 2

401(k) GENERAL QUALIFICATION REQUIREMENTS

Overview

For a 401(k) plan to qualify for the tax benefits–deductible employer contributions, pre-tax employer contributions, and tax-deferred growth–it must both contain language that meets certain tax law requirements. It must be operated in accordance with the plan’s provisions.

This chapter will examine the general qualification requirements for setting up and operating a 401(k) plan. It will then examine the eligible employers who can set up a 401(k) plan, the employees who can participate in the plan, and the advantages and disadvantages for both the employer and employee. And finally, at the end of the chapter, we will examine the employer costs for setting up a 401(k) plan and the tax credit available for certain employers (plan sponsors) after the enactment of the SECURE Act.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Describe the general requirements for establishing a 401(k) plan.
- Identify the various elements in operating a 401(k) plan.
- List the entities that are eligible to set up a 401(k) plan.
- Analyze the advantages and disadvantages for both the employer and the employee in setting up and participating in a 401(k) plan.
- Evaluate the costs associated with setting up a 401(k) plan.
- Explain the benefits and amount of the small business tax credit.

General Requirements for Establishing a 401(k) Plan

When an employer (plan sponsor) is looking to establish a 401(k) plan, the employer must take certain basic actions. One of the employers' first decisions will be whether to set up the plan themselves or consult a professional or financial institution–such as a bank, mutual fund provider, or insurance company–to help with establishing and maintaining the plan.
In addition, there are four basic qualification rules necessary to have a tax-advantaged 401(k) plan. They are:

- Adopt a written plan.
- Arrange a trust fund for the plan’s assets.

- Develop a record-keeping system; and
- Provide plan information to participants.

Let’s review each of these basic qualification requirements in greater detail.

Adopt a Written Plan Document

ERISA requires that the 401(k) plan be established and maintained pursuant to a written plan document that serves as the foundation for day-to-day plan operations. If the employer has hired someone to help with their plan, that provider may provide the written document (prototype) approved by the IRS.

A prototype plan provides standardized language normally used in plans routinely approved by the Internal Revenue Service (IRS). Many major financial institutions that participate in the 401(k) business make available IRS-approved prototype plans.

The employer (plan sponsor) executes an adoption agreement to adopt such a plan and selects various plan options. Some organizations offer what is called a flexible pre-approved prototype document, which allows the plan sponsor to select various options in the design phase of the plan with the knowledge that the IRS has already approved the plan for use by the clients of the financial institution. In other words, the plan does not have to obtain separate IRS approval. In an adopting employer, it is the responsibility of the financial institution that maintains the prototype document to keep the plan updated and current with any changes in pension law that might affect it.

This can provide huge savings in legal costs to the employer (plan sponsor) because the registration fee is nominal. This is particularly true if there are 401(k) plans where the plan options are relatively limited and standardized. But it is important to remember it is only as good as the entity that uses it.

Alternatively, employers (plan sponsors) have the choice to design their own custom-made plans. The benefit, of course, is that the employer will be allowed to custom design their document that will allow options that are more flexible and provide for easier amendment. Under the IRS’s “*volume submitter*” program, a practitioner can gain blanket approval for the standard language used in all of its plan documents and request IRS approval only on the language of the plan that varies from the pre-approved language [Rev. Proc. 2000-20]. This may be the best solution to the prototype versus a custom plan for many employers (plan sponsors) because it provides the convenience and cost savings of a prototype document and provides specific customized language provisions appropriate for their individual company requirements.

Whether the employer (plan sponsor) uses a prototype or customized document or something in between, the most important element is the person or people who are advising the client concerning the design features to become part of the plan. The most relevant inquiry is the level of experience and depth of knowledge of the individual organization involved here.

If an employer (plan sponsor) decides not to use a pre-approved prototype document, the plan sponsor has the option to seek advance determination about the qualified status of its retirement plan by the IRS. This written application procedure results in the issuance of a determination letter. A favorable response from the IRS indicates that, in its opinion, the plan meets all of the criteria needed for it to be deemed qualified under the Internal Revenue Code (IRC) if the plan complies, in operation, with applicable rules [IRC§ 401(a)].

Note: The receipt of a determination letter is not an absolute requirement under the IRC regulations. However, as a practical matter, it makes inherent good sense to undergo this procedure because it will provide the employer (plan sponsor) some assurance that its 401(k) plan is qualified under current law and that it will remain so unless there are plan amendments or changes in the law (or if the plan does not comply in operation-discussed below). Further, if the IRS examines (audits) the plan in the absence of a determination letter, the IRS may suspect that the plan is not in compliance and would subject it to intense scrutiny and penalties.

There are no significant filing and procedural requirements associated with obtaining a determination letter. Employers (plan sponsors) looking to set up a new 401(k) should seek good legal assistance.

Arrange a Trust for the Plan Assets

With limited exception, under Section 403 of ERISA, all assets of the 401(k) plan must be held in trust by one or more trustees to assure that assets are used solely to benefit the participants and their beneficiaries. Under Treas. Reg. § 1.401-1(a)(3), the following tests must be met to constitute a qualified trust under IRC § 401:

- It must be part of a pension, profit-sharing, or stock bonus plan established by an employer for the exclusive benefit of his employees or their beneficiaries:
  - It must be formed or availed of to distribute to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan. And, in the case of a plan which covers any self-employed individual, the time and method of such distribution must satisfy the requirements of IRC § 401(a)(9) with respect to each employee covered by the plan.
  - It must be impossible under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries:
    - The trust instrument must be part of a plan which satisfies the requirements of IRC § 410 (relating to minimum participations standards); and
    - The contributions and benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of IRC § 414 (q).
- The trust shall not constitute a qualified trust unless the plan satisfies the requirements of IRC § 411 (relating to minimum vesting standards);
- It must, if the plan benefits any self-employed individual who is an owner-employee, satisfy the additional requirements for qualification contained in IRC § 401(a)(10) and (d); and

- For taxable years beginning after December 31, 1962, self-employed individuals may be included in qualified plans.

In addition to the above requirements, the trust must have at least one trustee to handle contributions, plan investments, and distributions. Since the financial integrity of the plan depends on the trustee, selecting a trustee is one of the most important decisions an employer will make in establishing a 401(k) plan. The trustee(s) need to be named in the trust document or plan document or be appointed by the named fiduciary in the plan. The named fiduciary refers to one or more representatives designated in the plan instrument by name or title responsible for the plan operation. The named fiduciary requirement provides participants of the plan or other interested parties to identify the person responsible for plan operations.

Note: If an employer sets up a 401(k) plan through insurance contracts, the contracts do not need to be held in trust.

Develop a Record-keeping System

An accurate record-keeping system will track and properly attribute contributions, earnings and losses, plan investments, expenses, and benefit distributions. If a contract administrator or financial institution assists in managing the plan, that entity typically will help keep the required records. In addition, a record-keeping system will help the employer (plan sponsor), plan administrator, or financial provider prepare the plan's annual return/report that must be filed with the federal government (discussed below).

Provide Plan Information to Participants of the Plan

Treas. Reg. 401.1(a)(2) requires that plan information be communicated to employees. In addition, the Department of Labor (DOL) has regulations that also contain this requirement and detail the content and method for this communication.

These regulations require the employer (plan sponsor) to notify employees eligible to participate in the plan about certain benefits, rights, and features. In addition, a summary plan description (SPD) must be provided to all participants. The SPD is the primary vehicle to inform participants and beneficiaries about the plan and how it operates. SPD is typically created with the plan document.

Operating a 401(k) Plan

Once an employer (plan sponsor) decides to establish a 401(k) plan, the employer (plan sponsor) assumes certain responsibilities in operating it. If the employer hired someone to help set up their plan, that arrangement might have included help operating the plan. If not, the employer will have to make another important decision whether to manage the plan themselves or hire a professional or financial institution–such as a bank, mutual fund provider, or insurance company–to take care of some or most aspects of operating the plan.

Elements of operating 401(k) plans include:

- Participation.
- Contributions and Vesting.
- Coverage and Nondiscrimination Rules.
- Investing 401(k) plan monies.
- Fiduciary responsibilities.
- Disclosing plan information to participants and Reporting to government agencies; and
- Distributing plan benefits.

Eligible Entities to Setup a 401(k) Plan

Virtually all organizations, except for state and local governments, can establish 401(k) plans:

- *Sole Proprietors.* The sole proprietor, or self-employed person, is treated as their own employee. The calculations involved are more difficult since the compensation of the self-employed individual (a sole proprietor) is reduced by the contributions made on behalf of common-law employees. Also, the self-employed individual's compensation must be reduced by one-half of the Social Security contribution (SECA deduction).
- *Partnerships.* If the self-employed individual is a partner, they are treated as an employee of the partnership. Special rules apply to a partnership's profit-sharing plan if it includes CODA. A partnership may maintain a CODA, and individual partners may make cash-or-deferred elections concerning compensation attributable to services rendered to the partnership. Generally, the same qualification rules apply to a partnership CODA as they apply to other CODAs. A partner's compensation is deemed available on the last day of the partnership taxable year. Accordingly, an individual partner may not make a cash-or-deferred election concerning compensation for a partnership taxable year after the last day of that year.
- *Corporations.* Regular (or C), S, and limited liability corporations (LLC) are eligible.
- *Tax-exempt organizations.* Tax-exempt organizations were prevented from adopting 401(k) plans from 1987 to 1997 until the Small Business Job Protection Act of 1996 repealed earlier legislation. (Plans that were in effect prior to 1987 with tax-exempt organizations and state and local governments were grandfathered and allowed to continue); and
- *Indian Tribal governments.*

It is important to remember that under IRC § 401(k)(1), the 401(k) plan must be part of a profit-sharing plan, a stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan, meaning the employer must be eligible to offer one of those plans.

401(k) Plan Advantages

From the employer's perspective (plan sponsor), there are a number of advantages to offering a 401(k) plan to employees. Let’s examine some of those advantages:

- *Lower costs.* Compared to other types of qualified retirement plans, such as defined benefit (DB) plans, the cost of contributing to a 401(k) are relatively small, especially if most of the 401(k) contributions are employee elective contributions.
- *Higher tax deductions.* Total annual employer and employee elective contributions can exceed 25% and are deductible by the employer. Employer deductions for employer and employee elective plan contributions can exceed 25% of plan participant’s compensation.
- *Limited fiduciary responsibility and minimizes risk exposure*. Most 401(k) plans allow participants to choose how to invest the money in their plan accounts. By offering participants the right to direct their investments and complying with the other requirements of ERISA Section 404(c), the employer helps to protect itself from fiduciary liability and minimizes its exposure to investment risk.
- *Credit for 401(k) elective deferrals.* The tax credit may increase the amount of elective deferrals made by non-highly compensated employees (NHCE). If this happens, it will permit larger elective deferrals by highly compensated employees (HCE) and make it easier for 401(k) plans to pass the ADP test; and
- *Optional profit-sharing features.* An employer can use the discretionary profit-sharing features of a 401(k) profit-sharing plan to implement an age-weighted or cross-tested allocation formula that favors shareholders or key employees.

From the employee’s perspective, the 401(k) plan offers the following advantages:

- *Pre-tax contributions.* The 401(k) plan allows participants to contribute before-tax dollars to the plan, thereby reducing their W-2 taxable incomes.
- *Investment choices.* In “*participant-directed*” plans, employees allocate their contributions among the range of choices offered through their particular plans. This range of choices can be very broad.
- *Credit for 401(k) elective deferrals.* Low-income employees may receive a tax credit. This provides a strong monetary incentive for low-income employees to participate in a 401(k) plan.
- *Hardship withdrawals*. In-service withdrawals by employees for certain hardships are permitted. However, hardship withdrawals are taxable and subject to potential penalties under certain circumstances; and
- *Loans.* A plan generally may permit participants to borrow against their plan accounts. However, both the IRS and DOL have rules governing the operation of the loan program (as previously discussed with profit-sharing plans above).

401(k) Plan Disadvantages

There are several disadvantages to establishing a 401(k) plan for both employers and employees. First, let's examine the disadvantages of a 401(k) plan from the employer's perspective. They include:

- *Administration of the plan can be costly and complex*. Employers are required to maintain ongoing administrative costs, intensive communication throughout their lifecycle.
- *Fiduciary responsibilities*. Employers are required to maintain fiduciary responsibility of the plan and follow all ERISA requirements; and
- *Nondiscrimination funding and contribution requirements.* The government imposes special nondiscrimination requirements on all 401(k) plans. The purpose of these requirements is to maintain a reasonable balance between amounts deferred by highly compensated employees (HCEs) and those deferred by non-highly compensated employees (NHCEs). These requirements can be costly and difficult to administer.

Next, let's examine the disadvantages from the perspective of the employee, they are:

- *Inadequate retirement balance.* Unless the employer also offers another plan such as a combination plan, employees who enter the plan later in life may have account balances at retirement that will not satisfy their retirement income needs.
- *Investment risk*. If employees direct their investment choices, they run the risk of picking poor investments; and
- *Lack of security of* employees' contributions.

Costs of Setting up a 401(k) Plan

An employer who considers adopting a 401(k) plan must consider its financial impact. The biggest portion of the cost of a 401(k) plan is employer contributions to the plan. The employer needs to measure the level of its contributions on both an initial and ongoing basis. In addition, the employer will also incur other costs as a result of adopting a 401(k) plan, including:

- *Installation Costs.* The installation of a 401(k) plan can be a significant cost, involving a consultant to design the plan, an attorney to draft the plan and other related documents, and programmers to make changes to the payroll system or website. Installation costs can be reduced if a master or prototype plan or volume submitter plan is used.
- *Enrollment Costs*. Enrollment costs can also be a factor. Although the cost of enrollment materials and a consultant's time may be nominal, the cost to the employer (plan sponsor) of meetings for all employees could be substantial. Enrollment costs are highest when the plan is installed but ongoing as new employees become eligible for the plan. In some cases, re-enrollment meetings will be held to increase the participation of existing participants. Many employers have found that existing participants in the 401(k) plan do an excellent job of "selling" the plan to their fellow employees.
- *Administration Costs.* Ongoing administrative costs should be factored in as well. The cost of participant record-keeping can vary, ranging from as little as $10 per head to close

to $50 or more per head, depending on the size of the employer, the investment choices allowed by the participants, and the frequency of reports. The trustees' fees for trust record-keeping may be nominal or substantial, depending on the types of investment used in the plan. In some cases, the administrative costs will be deducted from plan assets, thus minimizing the employer's direct costs. However, caution should be used in this approach, as this could significantly impact the rate of return realized by employees in a new 401(k) plan. On the other hand, the impact of deducting costs from plan assets in an existing 401(k) plan with substantial assets should be minimal. If the employer chooses to pay fees directly, such costs will be tax-deductible:

  - One way to compute costs for administrative expenses, divide the net expenses (for instance, $12,000) by the total value of the plan (let's say $1.5 million). Multiply that percentage–0.8% (.008) in this example–by the total account balance. That will give the plan sponsor a figure of the total plan expenses that are deducted from the 401(k) plan; and
- Compliance costs. Estimating these costs will require decisions regarding the plan's design, funding, and reporting frequency. It is also important to remember that the DOL has issued new regulations to disclose more detailed information about fees and expenses to plan sponsors. It may not lead to fees going down, but at least plan sponsors may be a little less in the dark about these costs.

Tax Credit for Startup Costs for Small Businesses

As discussed above, the startup costs for a 401(k) plan have always been a major hurdle, especially for small businesses that want to offer a 401(k) plan. However, the Economic Growth and Tax Relief and Reconciliation Act (EGTRRA) of 2001 was set up to help small businesses scale this barrier and give their employees a saving opportunity. EGTRRA implemented a credit for employers to offset the startup cost and the cost of educating employees about the 401(k) plan.

Tax Credit Prior to the SECURE Act of 2019

Before the SECURE Act of 2019, a small business could claim a tax credit equal to 50% of the ordinary and necessary costs of starting a 401(k) plan (including a SEP, SIMPLE, or qualified plan). The tax credit equaled 50% of the cost to set up and administer the plan and educate employees about the plan, up to a maximum of $500 per year for each of the first three years (total deduction is $1,500). The tax credit was available for plans that become effective after 2002, or the employer could have chosen to start claiming the credit in the tax year before the tax year in which the plan becomes effective.

To qualify for the credit, a small business must have had 100 or fewer employees who received at least $5,000 in compensation from the employer for the preceding year. At least one participant had to be a non-highly compensated employee (NHCE). The employees generally cannot be substantially the same employees for whom contributions were made or benefit accrued under a plan of any of the following employers in the three-tax-year period immediately before the first year to which the credit applies:

- The owner.
- A member of the controlled group that includes the owner; and
- A predecessor of the owner or a member of a controlled group that includes the owner.

The credit is part of the general business credit, which can be carried back or forward to other tax years if it cannot be used in the current year. However, the general business credit part attributable to the small employer pension plan startup cost credit cannot be carried back to a tax year beginning before January 1, 2002. The employer (plan sponsor) will file IRS Form 8881, Credit for Small Employer Pension Plan Startup Costs, to take the credit.

The SECURE Act of 2019, Expands the Tax Credit

Thanks to the SECURE Act of 2019, Section 104, it created a hefty incentive to help employers get a new plan off the ground! It dramatically expanded the tax credit to cover potentially more than half of the cost of a new small business retirement plan. Here's how:

Under Section 104, the amount of the tax credit was capped at $250 times the number of non-highly compensated employees (NHCE) compensation eligible to participate in the plan up to a $5,000 annual maximum (but never less than $500), limited to 50% of the start-up costs. The credit will apply for 3 years.

Ordinary and necessary eligible costs included installation or administrative fees and educating employees about their benefits and options under the plan.

Tax credit is only available when an employer establishes a new retirement plan, including 401(k) Plans, 403(b) Plans, Profit Sharing Plans, Cash Balance Plans, SIMPLE IRAs, and SEP IRAs. If the employer offered a retirement plan during the previous three years, which covered substantially the same employees as the new plan, the tax credit is not available.

Wait, there's more! The SECURE Act of 2019, Section 105, added an additional 3-year tax credit for small employers who added an eligible automatic enrollment arrangement (EACA) to their new SIMPLE IRA or qualified retirement plan (401(k) plan). For a Plan that implemented an EACA in 2020 or later, a $500 credit is available in the year the ECAC is implemented and each of the next 2 years. Unlike the start-up tax credit, the $500 tax credit is available to a small business owner who elects to add an EACA to their existing plan, and a new plan with an ECAC is eligible for both the start-up tax credit and this tax credits.

Let's do the math for a small employer:

- Small business has 15 employees that are eligible NHCEs.
    - 15 x $250 = $3,750. Max tax credit
    - The new plan is going to cost $4,500. 50% is $2,250–> cap of the start-up costs eligible for tax credit.
- Add on automatic enrollment to the plan for another credit: + $500
- Total: $4,500-$2,250-$500 = $1,750 (62% off!)

Don't forget. The employer can claim this tax credit for the plan's first three years!

For a slightly larger small employer:

- 60 NHCEs
    - $250 = $15,000–> Max tax credit is $5,000
    - The new plan is going to cost $8175–> $4,087.50.
- Add on automatic enrollment to the plan for another credit: +$500
- Total: $8,175 - $4,087.50 - $500 = $3,587.50 (56%)

Reminder: The tax credit is not a deduction. The tax credit reduces the employer's tax liability dollar-for-dollar. If this tax credit equals $2,000, then the employer's tax liability is reduced by $2,000.

SECURE 2.0 Act, Section 102

The SECURE Act, Section 102, significantly expands the available tax credits for small employer plans:

- Increases the start-up credit for administrative costs from 50% to 100% for ERs with up to 50 employees (EEs) who made at least $5,000 in prior year.
    - The maximum credit is the lesser of $5,000 or $250 times the number of eligible NHCE generally those who earn less than $155,000 from the business for the prior year in 2024 or $160,000 from the business for the prior year in 2025. Must have at least 1 NHCE, minimum credit is $500. eligible for up to three tax years.

Also added a new tax credit for small ERs that provide ER contributions to a new DC plan. The credit is the lesser of actual ER contribution or $1,000 each EE making $100,000 or less in FICA wages. An ER is eligible for the tax credit if the ER had not more than 100 EEs making at least $5,000 in the prior year as follows:

- Years 1 and 2: 1 - 50 EEs in year of adoption 100% of eligible ER contributions; 51-100 EEs 100% minus 2% times number of EEs over 50.
- Year 3: 1 – 50 EEs: 75% of eligible ER contribution; 75% minus 1.5% times number of EEs over 50.
- Year 4: 1 – 50 EEs: 50% of eligible ER contribution; 51 – 100 EEs 50% minus 1% times number of employees over 50.
- Year 5: 1 – 50 EEs: 25% of eligible ER contribution; 51 -100: 25% minus 0.5% times number of EEs over 50.

Chapter 2
Review Questions

1. Identify the Section of the Internal Revenue Code (IRC) that a 401(k) plan must meet to be considered a "qualified" retirement plan.

( ) A. IRC § 401(a)
( ) B. IRC § 457
( ) C. IRC § 408
( ) D. IRC § 408A

2. Determine which of the following entities is NOT allowed to set up a 401(k) plan.

( ) A. Corporations
( ) B. Sole Proprietors
( ) C. Tax-exempt entities
( ) D. State and local governments

3. Analyze the costs associated with setting up a 401(k) plan and identify the highest cost for an employer.

( ) A. Installation costs
( ) B. Administrative costs
( ) C. Employer contributions
( ) D. Compliance costs

4. Assess the qualification requirements for the startup tax credit for small businesses and identify the highest number of employees who earned at least $5,000 from the employer in the prior year.

( ) A.100 or fewer employees
( ) B. 50 or fewer employees
( ) C. 500 or fewer employees
( ) D. 25 or fewer employees

5. Determine which of the percentages listed is the change made by the SECURE 2.0 Act, Section 102, and identify the increased employer startup tax credit percentage for employers meeting the requirements in the preceding tax year?

( ) A. 60%
( ) B. 75%
( ) C. 80%
( ) D. 100%

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CHAPTER 3

401(k) PLAN CONTRIBUTIONS

Overview

As was discussed in Chapter 1, a 401(k) plan is an employer-sponsored defined contribution (DC) plan that is either a profit-sharing plan or a stock bonus plan that contains what is known as a cash or deferred arrangement (CODA). All 401(k) plans, permit, CODAs. For this reason, the terms CODA and 401(k) are used interchangeably, though technically, CODA is merely a feature of the 401(k) plan. Term 401(k) governs only the employee's elective contributions (CODA). Other types of contributions are governed under different sections of the Internal Revenue Code (IRC). Yet, it is common for employers and employees to use 401(k) in reference to the whole plan.

This chapter will examine the various types of contributions allowed in a 401(k) plan, the minimum participation rules, as well as the maximum contribution limits for 2025. It will also examine the top-heavy rules by defining a key employee and a highly compensated employee (HCE), the aggregation rules, vesting schedules, and the timing of making contributions to the plan.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Identify the four basic types of contributions to a 401(k) plan.
- Describe the minimum participation requirements.
- Describe the minimum participation requirements.
- Relate the Top-Heavy Contribution Rules and aggregation of plans.
- Distinguish the various vesting schedules; and
- Identify the time frame for making contributions.

Types of Contributions

A 401(k) plan provides four basic types of contributions. They may include:

- Elective (salary) deferral contributions (pre-tax, after-tax and catch up);
- Employer matching contributions.
- Discretionary non-elective contributions; and
- Catch-up contributions.

Next, we will examine each of these types of contributions in greater detail, beginning with elective deferral contributions.

Elective Deferral Contributions

An elective deferral contribution, commonly called a salary deferral, is a contribution made by an employer pursuant to and after an employee's cash or deferred election is made [Treas. Reg. §§ 1.401(k)-1(g)(3), 1.401(k)-6]. Elective deferrals are amounts employees elect to contribute to the 401(k) plan out of their wages. The maximum amount that any employee may elect to contribute to a 401(k) plan will increase to $23,500 in 2025, compared to $23,000 in 2024 [IRC § 402(g)(1)]. This calendar limit is adjusted annually.

Table 3.1 illustrates the historical elective deferral limits.

Table 3.1
Historical Elective Deferral Limits

Year	Limit
2006	$15,000
2007 - 2008	$15,500
2009 - 2011	$16,500
2012 -2013	$17,000
2014	$17,500
2015 - 2017	$18,000
2018	$18,500
2019	$19,000
2020-2021	$19,500
2022	$20,500
2023	$22,500
2024	$23,000
2025	$23,500

Source : Internal Revenue Code (IRC) Section 402(g)(1)

The 401(k) plan can be a profit-sharing, stock bonus, pre-ERISA money purchase pension, or a rural cooperative plan. The deferred wages (elective deferral) are not subject to federal income tax withholding at the time of deferral. They are not reflected as taxable income on the employee's individual income tax return. Beginning in 2005, after the passage of the Economic Growth Tax Relief Reconciliation Act (EGTRRA) of 2001, Section 402A, 401(k) plans are now permitted to allow their employees to make "*Designated Roth Accounts*" (DRACs) that are generally subject to taxation under the rules applicable to Roth IRAs. This option does not increase the amount ($23,000 for 2024) that may be contributed to the plan through elective deferrals. Rather, if the employer allows these DRAC contributions, the employee may choose to have part of all of their regular elective deferrals in the 401(k)-plan contributed into a DRAC in the plan rather than into a regular account. The employer must maintain separate records for the DRAC and non-DRAC accounts [IRC § 402A(b)(2)]. The DRAC deferrals will be included in the employees' taxable income in the year of the deferral.

A 401(k) plan that provides for elective deferrals must provide that for each participant, the amount of elective deferrals under the plan and all other plans, contracts, or arrangements of an employer maintaining the plan may not exceed the amount of the limitation of $23,500 in 2025 [IRC § 402(g)(1); IRC § 401(a)(30)]. In addition, elective deferral contributions are subject to discrimination testing under the ADP test (discussed in Chapter 4) unless it meets the rules and requirements of a Safe-Harbor plan (discussed in Chapter 5). Elective contributions are 100 percent vested and are subject to the limitations on distributions.

The Role of Employer Contributions

Employers choose whether, how, and how much to contribute to their employees' 401(k) accounts. Employers can choose to make contributions to their employees' 401(k) plan accounts, either through:

- Matching employee contributions; or
- Making automatic contributions without regard to employee contribution behavior.

The Department of Labor (DOL) Form 5500 Research File data for large 401(k) plans indicate that employers made contributions in 87 percent of large 401(k) plans in 2021 which has not changed much over the past few years (see Table 3.2).

Table 3.2
Percentage of Participants in 401(k) Plans
with Employer Contributions by Plan Assets (2011-2020)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Less than $1m	63	63	63	64	66	66	68	69	68	68
$1m-$10m	78	76	78	79	80	80	82	82	81	77
$10m-$50m	88	89	90	91	91	91	92	92	92	91
$50m-$100m	93	93	93	94	94	94	95	91	92	93
$100m- $250m	95	97	97	98	96	97	95	94	94	94
$250m-$500	98	98	98	98	98	98	98	98	96	97
$500m-$1b	98	99	97	97	99	99	98	99	98	97
More than $1b	94	95	95	94	95	95	95	96	96	97
All	88	88	89	89	90	90	91	91	91	90

Source: Investment Company Institute tabulations of US Department of Labor 2020 Form 5500 Research File
Source: BrightScope/ICI Defined Contribution Plan Profile: A Close Look At 401(k) Plans, 2021, August 2024, Appendix A-3; The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans,2021

In addition, relatively consistently, about nine out of ten large 401(k) plan participants were in plans with employer contributions, reflecting the fact that larger 401(k) plans are more likely to have employer contributions.

Larger 401(k) plans were more likely than smaller plans to provide employer contributions. For example, in 2021, more than 90 percent of 401(k) plans with more $10 million in plan assets had employer contributions, compared with 83 percent of 401(k) plans with $1 million to $10 million (see Table 3.2 above).

Employer contributions represent a significant portion of contributions flowing into large 401(k) plans. According to ICI/Brightscope report, in 2021 $148 billion, or 30 percent of total contributions into large 401(k) plans, was from employer contributions. Employer contributions have represented a relatively steady share of contributions over the past several years—ranging from 30 percent to 33 percent of total contributions between 2006 and 2021.

Matching Contributions

A matching contribution is an employer contribution that is allocated based on a participant's elective deferral contributions or, less typically, a participant's employee after-tax contributions [IRC § 401(m)(4)(A); Treas. Reg. 1.401(m)-5]. The rate of matching contributions may be specified in the plan document or determined at the employer's discretion. It may be made ongoing, as elective contributions are paid into the 401(k) plan or at or after the plan year's end. Matching contributions are subject to discrimination testing under the ACP test unless they meet the safe-harbor rules (see Chapter 5 Nondiscrimination Testing).

If the employer chooses to match employee contributions, the options include:

- A simple match formula.
- A tiered match formula; or
- A maximum dollar match formula.

With a simple match formula, employee contributions are matched up to a fixed percentage of salary (for example, the employer matches 50 percent of employee contributions for the first 6 percent of the employee's salary for a maximum employer contribution of 3 percent of the employee's salary). With a tiered match formula, different levels of employee contributions are matched at different rates (for example, matching 100 percent of the first 4 percent of salary contributed and 50 percent of the next 2 percent for a maximum employer contribution of 5 percent of the employee's salary). With a maximum dollar match formula, employee contributions are matched up to a given dollar threshold (for example, matching 50 percent of the first $2,000 in contributions for a maximum employer contribution of $1,000). In addition, employers can choose to make automatic contributions without regard to participant behavior, either alone or in addition to a matching contribution.

Simple matching formulas were the most common type of employer contribution. In 2021, 41 percent of large 401(k) plans with employer contributions contributed through a simple matching formula alone, and another 7 percent of large 401(k) plans had automatic contributions in addition to a simple match (see Table 3.3).

About one-fifth of large 401(k) plans with employer contributions used a tiered matching formula, 1 percent used a maximum dollar match, and more than one-quarter contributed money to the plan without regard to how much the employee contributed. Overall, 51 percent of large 401(k) plans with employer contributions had a simple matching formula, and 16 percent made automatic contributions (see Table 3.3).

Many large 401(k) plans across all plan sizes with employer contributions had simple matches (see Table 3.3). Larger plans tended to be more likely to make automatic employer contributions—for example, this feature was seen in 13 percent of plans with $10 million or less in plan assets, compared with nearly one-quarter of plans with more than $50 million in plan assets.

Table 3.3
Employer Contribution Matching Formulas
(Percentage of large 401(k) plans with employer contributions by plan assets, 2021

	Plan Assets					
	$10M or less	>$10M to $50M	>$50M to $100M	>$100M to $250M	More than $250M	All Plans
No match data[1]	21.6	14.9	14.0	15.5	15.3	17.8
No match data[1] + automatic contributions[2]	8.0	12.1	14.0	10.4	9.1	10.2
Maximum dollar match[3] only	1.9	1.0	2.6	1.2	1.1	1.6
Maximum dollar match[1] + automatic contribution[2]	0.2	0.2	0.7	0.2	0.3	0.2
Tiered match[4] only	21.8	16.9	16.8	18.1	17.3	19.1
Tiered match[4] + automatic contribution	1.4	2.8	3.6	4.3	5.2	2.4
Simple Match[5] only	42.0	42.5	37.0	37.2	39.0	41.4
Simple match[5] + automatic contribution	3.1	9.7	11.3	13.2	13.1	7.3

Source: BrightScope/ICI Defined Contribution Plan Profile: A Close Look At 401(k) Plans, 2021, September 2024 Page 19; The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans,2021

Simple Match Formulas

For simple match formulas, the employer chooses the percentage of employee contributions to match and the maximum contribution percentage to match. Among the 48.7 percent of large 401(k) plans with employer contributions with simple match formulas, the most common formula was matching 50 percent of contributions up to 6 percent of employee salary, with 25.4 percent of large 401(k) plans using this formula for their matching contributions (see Table 3.4). The next most common simple match formula, used by 13.5 percent of large 401(k) plans with simple matches, was a 100 percent match of contributions up to 4 percent of employee salary. Altogether, the most common match rates for employer contributions (with various limits on the maximum employee contribution matched) were 50 percent (used by 42.1 percent of large 401(k) plans with simple matches) and 100 percent (used by 37.2 percent of large 401(k) plans with simple matches). The most common percentage of employee contributions matched (with a variety of limits on the percentage of the contribution matched) was 6 percent, used by 40.8 percent of large 401(k) plans with simple matches.

Table 3.4
Employers with Simple Matches Use a Variety of Matching Formulas

Percentage of Plans									
Maximum deferral percentage matched									
	<3%	**3%**	**4%**	**5%**	**6%**	**7%, 8%, or 9%**	**10% or more**	**Other**	**Total**
Percentage of deferral matched									
25%	0.2	0.4	2.7	1.3	4.1	1.5	0.5	(*)	10.7
50%	0.7	1.3	6.2	4.2	25.4	3.7	0.6	(*)	42.1
75%	0.0	0.0	0.1	0.1	0.7	(*)	0.1	(*)	1.0
100%	2.6	5.7	13.5	6.8	7.1	0.4	0.4	0.7	37.2
Other	0.6	0.6	0.4	2.1	3.5	0.5	0.8	0.3	9.0
Total	4.2	8.0	22.8	14.5	40.8	6.2	2.4	.1.1	100.0

(*) = less than 0.05 percent
Source: BrightScope/ICI Defined Contribution Plan Profile: A Close Look At 401(k) Plans, 2021, September 2024, Page 21; The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans,2021

Some 401(k) plans have a "*true-up*" feature to help employees get the maximum match. The employer looks at the employee's account to determine if the average percentage the employee contributed would result in the higher match; if that's the case, the employer makes the "*true-up*" contribution.

According to Vanguard's "*How America Saves Report 2024*", in 2023, Vanguard administered more than 100 distinct match formulas for plans offering an employer match. Among those plans, 69% (covering 59% of participants) provided a single-tier match formula, such as $0.50 per dollar on the first 6% of pay. Less common, used by 23% of plans (covering 30% of participants), were multitier match formulas, such as $1.00 per dollar on the first 3% of pay and $0.50 per dollar on the next 2% of pay. Another 6% of plans (covering 10% of participants) had a single- or multitier formula but imposed a maximum dollar cap, such as $2,000, on the employer contribution. Finally, a small percentage of plans used a match formula that varied by age, tenure, or other variables.

As the advisor, you should always take time to review your client's 401(k) plan annually to make sure that they are maximizing all of the possible employer contributions to their 401(k) plan. Don't allow your clients to miss the "free money."

Discretionary (Non-Elective) Contributions

A discretionary contribution, sometimes referred to as a profit-sharing or non-elective contribution (NEC), in a 401(k) plan is an employer contribution allocated based on compensation or in some manner other than based on elective contributions or employee after-tax contributions. Discretionary non-elective contributions do not need to be included in any of the special nondiscrimination rules under IRC § 401(a)(4). Discretionary non-elective contributions may sometimes help satisfy the ADP and ACP tests. A participant's right to receive an allocation of a discretionary non-elective contribution cannot depend on whether h/she had made elective contributions [IRC § 401(k)(4)(A); Treas. Reg. § 1.401(k)-1(e)(6)(i)].

Catch-Up Contributions

Congress added the catch-up contribution option to retirement plans because Baby Boomers hadn't been saving enough for retirement. So, to encourage more savings by older workers, the *Economic Growth Tax Relief Reconciliation Act* (EGTRRA) of 2001 added "*catch-up"* contributions, which allow additional deferrals by employees (participants) who turn age 50 or older within the end of the plan year. Age-50 catch-up contributions are possible in 401(k), 403(b). and 457 plans and IRAs, but the rules differ among plans.

For the tax year 2025, the standard catch-up contributions will remain at $7,500 (same as in 2024). The taxpayer must be age 50 – 59 or age 64 and older. That means an active participant ages 50-59 or 64 or older can contribute a total of $31,000 in 2025 [IRC § 414(v)(2)(B)(i)].

Under SECURE 2.0 of 2022, Section 109, beginning in 2025, individuals ages 60, 61, 62, and 63 will be eligible for an increased catch-up contribution in their 401(k) (also includes Solo 401 (k) and SIMPLE 401(k) retirement plans) to a maximum of $11,250 ($7,500 + $3,750)[IRC § 414(v)(2)(E)(i)]. This enhanced catch-up contribution limit is $10,000 or 150% of the standard age 50+ catch-up contribution limit whichever is greater [IRC § 414(v)(2)(B)(i)]. That means an active participant aged 60 - 63 can contribute a total of $34,750 in 2025 (see Table 10.1)

Table 3.5
2025 Catch-up Contribution

Participant Age in 2025	2025 Standard Annual Deferral Limit	Catch-up Contribution for 2025	Total 2025 Annual Contribution Limit
50-59 or 64 or older	**$23,500**	**$7,500**	**$31,000**
60, 61, 62, and 63	**$23,500**	**$11,250**	**$34,750**

Note: The catch-up contribution is not counted towards the IRC § 415 limits.

Eligible employees must have reached the standard deferral limit to avail themselves of this enhanced catch-up. However, this change is conditional upon the employer's decision to adopt it, granting plan sponsors a significant say in its implementation.

Overall Contribution Limitation

All 401(k) plans are profit-sharing plans. Profit-sharing plans have a deductibility limit for employer contributions of 25% of eligible compensation (20% if self-employed). Still, elective deferrals do not count towards the 25% limit [IRC § 404 (a)(3)].

As was discussed above, employer contributions include Matching, Discretionary (profit sharing), and Safe Harbor contributions. The annual allocation limit for each employee, including the non-catch-up salary deferral and all contributions and forfeitures allocated during the plan year, is the lesser of 100% of compensation or $70,000 in 2025, up from $69,000 in 2024 [IRC § 415].

> ***For Example:*** $23,500 401(k) salary deferral plus $46,500 discretionary contribution = $70,000; this meets the $70,000 limit in 2025. This employee (if age 50 -59 or 64 and older or over) could also defer an additional $7,500, for a total of $77,500. If the employee is aged 60-63, they may contribution at total contribution of $81,250 in 2025.

Note: As discussed above, the catch-up contribution of $7,500/$11,250 if age 50 or above, is not counted towards the IRC § 415 limit. .

Under IRC § 401(a)(17) and 404(I), the maximum annual compensation of each employee that can be considered under a plan for any year must not exceed $350,000 for 2025 (up from $345,000 in 2024) and subject to cost-of-living adjustments in later years.

Minimum Participation Requirements

To participate in a 401(k) plan, an employer may choose to have no eligibility requirements, which means the employee becomes eligible on the date of hire, or the employer may be allowed to impose two eligibility requirements. They are:

- Year of Service requirements [IRC §§ 410(a)(1)(B)(ii)]; and/or
- Age requirements [IRC § 410(a)(1)(A)(ii)].

Year of Service

The year of service requirement may require a certain number of months of employment or may require up to one year of employment before becoming eligible to participate in the 401(k) plan. The biggest confusion regarding eligibility provisions surrounds the year of service calculation. A year of service is generally calculated as a twelve-month (12) period beginning on the first day of employment during which an employee completes at least 1,000 hours of service. If the employee does not complete 1,000 hours of service during the initial eligibility computation period, the next period begins on the anniversary date of employment or, if provided in the plan, on the first day of the plan year, during which the anniversary date falls.

SECURE Act of 2019, Section 112, now requires that a plan (except collectively bargained plans) allow an individual to participate the earlier of:

- One year of service; or
- Three consecutive years during which the employee had at least 500 hours of service and the employee was at least 21 years old in the third year.

Regardless of the nondiscrimination requirements, an employer is not required to make a matching or non-elective contribution on behalf of employees who are eligible to participate because of the 500-hour rule. An employer would also be allowed to elect to exclude such employees from non-discrimination testing, including the coverage IRC § 410(b), contribution IRC § 401(a)(4), Actual Deferral Percentage (ADP), and Actual Contribution Percentage (ACP), Safe Harbor plans, and Automatic Contribution plans. Such employees also may be excluded from top heavy testing. For vesting purposes, each 12-month period in which at least 500 hours of service are performed will be considered a year of service.

SECURE 2.0 Act of 2022, Section 125, Long-Term, Part-Time Eligibility effective for plan years beginning in 2025 changed the 401(k)-plan eligibility service requirement from three consecutive years to two consecutive years (as it was before the rule changed) and includes 403(b) plans subject to ERISA; eligibility and vesting service prior to 2023 is excluded. The rule for part-time employees who work 1,000 or more hours per year is the same; they are eligible for enrollment after 1 year.

Note: Plan sponsors relying on the part-time employee (anticipated to work less than 20 hours) or the student employee exceptions to the universal availability requirement may need to start tracking those employees' hours in 2023 for purposes of complying with this rule in 2025.

Age Requirement

The second eligibility that plans may impose is an age requirement. The maximum age requirement that a plan may impose for eligibility in the plan is twenty-one (21) years.

Excluding Employee Groups

Employers may exclude certain groups of employees from their 401(k) plan regardless of whether the employees meet any of the age or service requirements detailed below. Employers have discretion in defining the excluded group(s). For example, a 401(k) plan could exclude:

- Certain job classifications, like hourly or union employees.
- Identifiable job positions, like associate producers; or
- Specific divisions or units, like the Alabama office.

Employers need to be careful when defining the excluded group. The definition cannot indirectly refer to age or service. For example, excluding part-time or seasonal workers. Referring to age or service in defining the group is impermissible because it sidesteps the minimum age or service requirements below.

In addition, the exclusion of certain groups may cause the 401(k) plan to fail the annual coverage test, required by the IRS, which may result in additional costs and administrative burden. You should work closely with your provider if you are going to exclude employees as a group.

Top-Heavy Contributions

The top-heavy plan rules were added to the Internal Revenue Code by the *Tax Equity and Fiscal Responsibility Act* (TEFRA) of 1982. To be qualified under IRC § 401(a), a 401(k) plan must contain provisions which meet the requirements of IRC § 416 and which will become effective if the plan becomes top-heavy [IRC § 401(a)(10)(B)].

General Requirements

In general, a plan is top-heavy if 60 percent of the aggregate accrued benefits or account balances under the plan are for the benefit of certain "*key employees*." For the tax year 2025, a key employee is:

- A 5 percent (or more) owner of the business.
- A 1 percent owner with a salary of $150,000 or more [IRC § 416(i)]; and
- An officer of the company making over $230,000 (and subject to cost-of-living adjustments in later years) in compensation from the employer [IRC § 416(i)(1)(A)(i)].

Plans covering few employees are more likely to be top-heavy than plans covering a large number of employees.

> ***For Example:*** If key employees make up a substantial percentage of the workforce, it is more likely the plan will become top-heavy. Plans of larger employers can also be top-heavy, where the employer maintains separate plans for its divisions. If the smaller division employs many highly paid employees who are key employees, their plans may be top-heavy.

Even if a plan passes a nondiscrimination test of IRC § 401(a)(4), it must be examined for top-heaviness. Accrual or allocation rates under a plan can be nondiscriminatory. Still, the total allocations in the key employees' accounts (or their benefit accruals) could cause them to have too large a share of the plan assets and result in a top-heavy plan.

A top-heavy plan does not include a SIMPLE IRA under IRC § 408(p). Also, a SIMPLE IRA would not be included if it meets the plan requirements of IRC § 401(k)(11) and permits no contribution other than those required by IRC § 401(k)(11) [IRC § 401(k)(11)(D)(ii)]. A top-heavy plan does not include a plan for any year that it meets the "*Safe-Harbor*" requirements under IRC § 401(k)(12) for minimum contributions for participants, and matching contributions that meet IRC § 401(m)(11) [IRC § 416(g)(4(H)].

Key Employee

The general rules which apply to a key employee are as follows:

- Any employee who at any time during the plan year containing the determination date (the determination date year) is an officer who meets a compensation threshold, a 5% owner of the employer, or a 1% owner of the employer who meets a compensation threshold [IRC § 416(i)];
- Compensation includes elective deferrals under a qualified cash or deferred arrangement (CODA) and other elective deferrals under IRC § 402(g)(3), as well as any amount which is contributed or deferred by the employer at the election of the employee and which is not includible in the gross income of the employee by reason of IRC §§ 125, 132(f)(4) or IRC § 457 [IRC § 416(i)(1)(D)]; and
- The compensation received from each employer is aggregated under IRC § 414(b), (c), and (m) to determine who is a key employee [Reg. 1.416–1, T–20].

Officer Defined

The general rules which apply to an officer are as follows:

- An officer of the employer having annual compensation more than $230,000 (up from $220,000 in 2024) is a key employee [IRC § 416(i)(1)(A) and Reg. 1.416–1, T–12].
- An officer is determined based on the source of the officer's authority, the term for which he is elected or appointed, and the nature and extent of the duties. If an employee has the title of an officer but not the authority, that employee is not an officer to determine who is a key employee. An employee who does not have the title of an officer but who has the authority of an officer is an officer for key employee purposes [Reg. 1.416–1, T–13];
- Officers (see Reg. 1.416–1, T–15) are in:
    - Corporations.
    - Sole proprietorships.
    - Partnerships.
    - Trusts.
    - Labor organizations; and
    - Associations.
- For purposes of determining the number of officers considered; employees described in IRC § 414(q)(5) are excluded [IRC § 416(i)(1)(A) and IRC § 414(q)(5)]; and
- There is no minimum number of officers that may be considered. The maximum number of employees who can be treated as officers for counting as key employees is 50, or, if lesser, the greater of 3, or 10% of the employees. If there are more than 50 officers who meet these requirements, select the 50 officers who had the largest annual compensation during the year of the determination date [IRC § 416(i)(1) and Reg. 1.416–1, T–14].

Five Percent Owner Defined

An employee who is a 5% owner of the employer during the determination date year is a key employee (without regard to compensation). A 5% owner of a corporation is any person who owns more than 5% of the outstanding stock of a corporation or stock possessing more than 5% of the total combined voting power of all stock of the corporation. Use the constructive ownership rules of IRC § 318 to help determine the 5% owner. In determining who is a 5% owner, ownership is determined without aggregating any employers under IRC § 414(b), (c) or (m) [IRC § 416(i)(1)(B)(i)].

One Percent Owner Defined

An employee who is a 1% owner of the employer at any time during the determination year and whose compensation exceeds $150,000 in 2025 for the determination date year is a "*key employee*" [IRC § 416(i)(1)(A)(iii)]. Use the constructive ownership rules of IRC § 318 to help determine the 1% owner. In determining who is a 1% owner, ownership is determined without aggregating any employers under IRC § 414(b), (c), or (m).

Top-Heavy Minimum Contributions

If a 401(k) plan is top-heavy, the employer must contribute to each non-key employee's account who is a plan participant equal to at least 3% of the participant's compensation.

Forfeitures allocated to a participant's account are included in determining whether a 3% minimum contribution has been made, but elective contributions are not. Matching contributions under IRC § 401(m)(4)(A) are considered for years after 12/31/01.

The 3% minimum contribution requirement is reduced if the largest percentage contribution made on behalf of a key employee for the plan year is less than 3%.

The minimum contribution cannot be reduced due to Social Security contributions. If the required aggregation group includes a defined contribution (DC) plan and a defined benefit (DB) plan aggregated to meet the requirements of IRC §§ 401(a)(4) or 410, then a 3% minimum contribution is generally required in the defined contribution plan even if the highest contribution rate for a key employee is less than 3% [IRC § 416(c)(2) and Reg. 1.416–1, M–7].

> ***Example 1:*** Plan A is a top-heavy plan. The largest percentage contribution made on behalf of a key employee during the 2025 plan year is to Employee M. Employee M's compensation is $375,000. The employer contributes $10,500 to Employee M. Because Employee M's compensation is limited to $350,000 for contribution purposes by IRC § 401(a)(17), the percentage contribution made on behalf of Employee M is 3% (10,500 ÷ 350,000 = 3%). Each non-key employee must receive a contribution equal to 3% of compensation.

> ***Example 2:*** The facts are the same as the example above, except that the employer contributed $6,900 to Employee M in 2025. The percentage contribution made on behalf of Employee M is 2% (6,900 ÷ 350,000 = 2%). Each non-key employee must receive a contribution equal to 2% of compensation.

If the employer maintains only one defined contribution plan, each non-key employee covered by the plan must receive the minimum defined contribution. If the employer maintains more than one defined contribution plan and a non-key employee participates in more than one, then only one defined contribution plan has to provide a minimum contribution for the employee [Treas. Regs. 1.416–1, T–10, M–8, and M–12].

Aggregation of Plans

To determine whether a plan is top-heavy, it must be aggregated with certain other plans of the employer. This type of aggregation is known as the *"required aggregation group*." Under certain circumstances, an employer may use "*permissive aggregation*" to aggregate plans not part of a required aggregation group [IRC § 416(g)(2)].

Required Aggregation Group

The "*required aggregation group*" is defined in IRC § 416(g)(2)(A)(i). It consists of each plan of the employer in which a key employee participates during the determination date year (or participated in during any of the four preceding years), and any other plan of the employer which, during this period, is aggregated with a plan in which a key employee participates to meet the nondiscrimination requirements of IRC § 401(a)(4) or IRC § 410.

If the required aggregation group is top-heavy, each plan in the required aggregation group is top-heavy, even if it would not be top-heavy if tested independently or if it covered no key employees. Similarly, if the required aggregation group is not top-heavy, no plan in the required aggregation group is top-heavy. All plans in a required aggregation group that are top-heavy must satisfy the vesting requirements of IRC § 416(b) and the minimum benefits requirements of IRC § 416(c). [Treas. Reg. 1.416–1, T–10].

Only one defined contribution plan needs to satisfy the minimum contribution requirements for any non-key employee who participates in more than one defined contribution plan in the required aggregation group [Treas. Reg. 1.416–1, M–8 and T–10].

Permissive Aggregation Group

An employer may also aggregate plans that are not part of a required aggregation group with plans in a required aggregation group to create a permissive aggregation group, if the permissive aggregation group satisfies IRC § 401(a)(4) and IRC § 410 [IRC§ 416(g)(2)(A)(ii)].

If a permissive aggregation group is not top-heavy, none of the plans are top-heavy. If a permissive aggregation group is top-heavy, then the top-heavy requirements apply only to those plans in the required aggregation group [IRC § 416(g)(2) and Treas. Regs. 1.416–1, T-1(b) and (c), T-6, T-7, and T-9–11].

> ***For Example:*** An employer maintains Plan A, which covers key employees and other employees and independently satisfies the requirements of IRC § 401(a)(4) and IRC § 410. Assume that Plan A is top-heavy when tested on its own. The employer also maintains Plan B. Plan B has no key employees. Plan B is not top-heavy. The employer may permissively

aggregate these plans to test top heaviness if the permissive aggregation group satisfies IRC § 401(a)(4) and IRC § 410.

Vesting

Vesting refers to the extent to which a participant's interest in a 401(k) plan is non-forfeitable. Any portion of that interest not vested is subject to possible forfeiture.

Under IRC § 411, it provides the minimum vesting requirements that each employee vest or own, at a minimum, a stated percentage of their interest in the plan each year. A plan's vesting schedule will be set out in the plan document. Amounts that are not vested may be "forfeited" by the employees when they separate from service with the employer. The plan must describe how these forfeitures will be used: either to increase benefits or fund future benefits for other plan participants.

Contributions to Be 100% Vested

The following kinds of contributions must always be 100% vested:

- Elective contributions [Treas. Reg. §§ 1.401(k)-1(c), 1-401(k)-6];
- Qualified matching contributions (QMACs) [Treas. Reg. §.1.401(k)-6];
- Qualified non-elective contributions (QNECs) [Treas. Reg. § 1.411(a)-1(a)(2)];
- Deemed IRA contributions [IRC § 408(q)];
- Rollover contributions; and
- Non-elective and matching contributions in a SIMPLE 401(k) or Safe Harbor 401(k) Plan.

Also, all a participant's interest in a 401(k) plan must be 100 percent vested upon the participant's attainment of normal retirement age (NRA), upon the termination or partial termination of the plan, or upon the complete discontinuance of contributions to the plan [Treas. Reg. §§ 1.411(a)-1(a)(1), 1.411(d)-2(a)(1)]. Although this is not legally required, nearly all 401(k) plans will provide 100 percent vesting upon a participant's death or disability.

Contributions Not Subject to 100% Vesting

In a 401(k) plan that does not qualify as a SIMPLE plan or a Safe Harbor 401(k) plan, non-elective contributions and matching contributions are not required to be 100 percent always vested.

Vesting Schedules

Prior to the enactment of the Pension Protection Act (PPA) of 2006, a 401(k) plan satisfied the minimum vesting requirements with regard to employer non-elective contributions if the vesting schedule was at least as fast as a five-year "*cliff*" vesting schedule or a three-to-seven year "*graded*" vesting schedule (see Table 3.7). The passage of the Pension Protection Act (PPA) of 2006, reenacted faster vesting rules for 401(k) plans. Effective for plan years beginning in 2007 and thereafter, a 401(k) plan must provide for a participant to become vested in *employer* *contributions* made in plan years after December 31, 2006, over a schedule that does not exceed one of the following two alternatives:

- *Three-year cliff vesting.* After completing three years of service, the participant is fully vested in his or her account. Should the employee terminate service with the employer prior to the completion of three years of service, the employee would not be entitled to any portion of the plan account attributable to employer contributions other than IRC § 401(k) contributions that are 100% vested (see Table 3.6);
- *Two- to six-year graded vesting.* After completing two years of service, the participant becomes 20% vested in his or her employer's contributions. For each additional year of service after three years, an increase in vesting must occur at a rate of at least 20% per year. The participant is fully vested at the end of six years of service (see Table 3.7).

Table 3.6
Vesting Table for Non-Elective and Matching Contributions
Prior to PPA of 2006

Non-Elective Contributions		Matching Contributions	
Years of Service	Vested %	Years of Service	Vested %
Fewer than 3	0	Fewer than 2	0
3	20	2	20
4	40	3	40
5	60	4	60
6	80	5	80
7 or more	100	6 or more	100
Fewer than 5	0	Fewer than 3	0
5 or more	100	3 or more	100

Table 3.7
Three-Year Cliff Vesting

Years of Service	Vested %
0-2	0%
3	100%

Table 3.8
2/20 Graded 6 Year Vesting

Years of Service	Vested %
2	20%
3	40%
4	60%
5	80%
6	100%

Alternative vesting schedules can be used as long as those schedules are as favorable to employees as the two schedules described above:

- *Employer matching contributions*. Under prior law, if the employer matches employee (or employee elective) contributions, the vesting schedules for employer matching contributions may not exceed a two-to six-year graded vesting schedule or three-year cliff vesting. The PPA did not modify the vesting rules for employer matching contributions, nor did it modify the top-heavy vesting rules; and
- *Dual vesting schedules*. Because the faster vesting schedules enacted by PPA apply to employer contributions (other than employer matching contributions that were already subject to faster vesting requirements) made in plan years after December 31, 2006, a plan may choose to vest employer contributions made for plan years prior to 2007 ("old money") according to the prior law slower vesting schedule used for employer contributions; e.g., five-year cliff vesting or three-to seven-year-graded vesting. The simultaneous use of a prior law vesting schedule (or old vesting schedule) for old money and a new vesting schedule for contributions made after a certain date (plan years after December 31, 2006) is known as "dual vesting." Although dual vesting might achieve cost savings for an employer that maintains a large plan, the cost associated with additional recordkeeping and administration would probably make this impractical for a small plan.

The IRS refers to dual vesting as "*bifurcated vesting*" (see IRS Notice 2007-7). Among other things, a qualified plan must separately account for contributions made before and after December 31, 2006, and give a participant with at least three years of service the right to elect to have the pre-amendment vesting schedule apply.

Note: The top-heavy vesting rules apply to all employer contributions held in a participant's defined contribution plan account (or all a defined benefit plan participant's accrued benefits), including those made in plan years prior to 2007. Therefore, a top-heavy defined contribution plan (or defined benefit plan) cannot maintain dual vesting schedules.

Nondiscrimination Tests

One major requirement of any 401(k) plan is that it cannot discriminate in favor of certain employees, known as *Highly Compensated Employees* (HCEs). To prevent this from happening, the IRS has developed different tests that a 401(k) must meet depending on the types of contributions, based on the source of contribution and tax treatment.

Coverage Requirements

In addition, the 401(k) plan must be set up to meet the minimum coverage requirements required under IRC § 410, which requires that the employees covered by the plan must meet one of the following three tests designed to ensure that the plan covers at least 70 percent of the non-highly compensates (NHCEs). They are:

- Coverage of 70 percent of non-highly compensated employees.

- The ratio percentage test; and
- The average benefit test.

Definition of "Highly Compensated Employee"

Under IRC § 414(q)(1), for the 401(k) plan to be considered "qualified," employee elective contributions and benefits cannot discriminate in favor of HCEs who are defined as any employee who owns:

- 5% or more of the company; or
- Received compensation from the company during the previous year in excess of the compensation threshold for that year. (The "look-back" year for 2025 is 2024. The compensation threshold for 2024 was $155,000. The compensation threshold in effect for 2025 has increased to $160,000).

An employer (plan sponsor) can elect to count as HCEs only employees who rank in the top 20% of compensation in the firm but must include anyone who owns 5% or more of the company.

Time Frame for Depositing 401(k) Contributions

The Department of Labor has enforceable regulations governing when the employer (plan sponsor) has to deposit employer contributions to a 401(k) plan [DOL Reg. § 2510.3-102]. Below we will examine the rules for participant elective contributions and other employer contributions (matching and discretionary non-elective contributions).

Elective Contributions

Under DOL Reg. § 2510.103, the regulations required that participants' elective contributions to a 401(k) be deposited to the plan on the earliest date that the employer can be reasonably segregated from the employer's general assets. Originally, the DOL regulations imposed a 90-day outer limit, but this was shortened because some employers were abusing the system. In its 1996 amendments, the DOL issued Reg. § 2510.3-102(b)(1); the regulations now allow an ultimate outer limit deposit deadline in no event later than the fifteenth (15) business day of the month following the month in which the participant elective contributions are deducted from their pay. However, this does not mean an employer can routinely wait until the 15th business day to deposit the funds. The 15th business day is not a safe harbor. Rather, the general rule is that the deferrals be deposited as soon as is reasonably possible after payday. If the employer can segregate and deposit the contributions before this deadline, they must do so.

Most companies get it transferred within just a few days. Once at the investment company or plan custodian, it can take a day or so to get invested and reflected in the participant's account.

The DOL has made another 401(k) (and other retirement plans) change with fewer than 100 participants. In such plans, contributions must now be deposited with the 401(k) no later than the seventh (7) business day following the day when such amount was deducted from the employee's paycheck. According to DOL analysis cited in the preamble:

> *"...accelerated remittances could result in $34.5 million in additional income to be credited annually to participant accounts under the plans if no employers choose to delay remittances in response to the safe harbor and $15 million annually even if all eligible employers were to delay remittances to the full duration of the safe harbor."*

To obtain these figures, the DOL used an annual return of 8.3 percent, which they note is "an estimate of the long-term rate of return on defined contribution plan assets implicit in the flow of funds account of the Federal Reserve [Board]."

An employer can request an extension of 10 business days beyond the 15 allowed. Still, most don't because it involves time-consuming administrative procedures. To obtain the extension, the employer must comply with the following requirements set out in the regulation [DOL Reg. § 2510.3-102(d)]:

- Making the contribution to the plan (but not segregating it);
- Notifying the employees and the DOL; and
- Providing a performance bond or letter of credit that must stay in effect for three months after the month in which the extension expires.

For many employers, this would be too time-consuming and embarrassing to consider.

Other Employer Contributions

Under IRC § 404(a)(6), it provides a different deadline for employer contributions, whether matching or discretionary non-elective, may be made until the due date of the employer’s federal income tax return, including extensions.

Contributing to Multiple Plans

Participants with access to both a 401(k) plan, used by most private employers, and a 403(b) plan, used by many nonprofits–perhaps the account holders have two jobs–can contribute to both the 401(k) and the 403(b) plan, but both plans share a combined annual limit ($23,500 in 2025). Each dollar a participant puts in a 403(b) plan reduces their 401(k)-plan contribution.

However, the annual limit for a IRC § 457(b) plan sponsored by a state or local government employer is treated as separate from the 401(k)/403(b) limit. Many large government employers offer their employees both 401(k) and 457(b) plans, which enables employees to contribute to both plans, and thus have an opportunity to supercharge their retirement savings. In 2025, the elective deferral limit is $23,500 or 100% of includible compensation to a 457(b) plan. A government 457(b) plan may allow age-50 catch-up contributions.

The plan may also allow a special “last 3-year catch-up,” which allows the employee to defer in the three years before they reach the plan’s normal retirement age:

- Twice the annual 457(b) limit (in 2025, \$23,500 x 2 = \$47,000), or
- The annual 457(b) limit, plus amounts allowed in prior years that the employee didn’t contribute.

Note: No double-dipping. If the employee is eligible for both the 50-plus and 3-year catch-up contributions, the IRS will only allow the employee to take advantage of the one that adds the most to their retirement account. The employee can’t do both.

SECURE 2.0 Act, Section 101: Automatic Enrollment

Beginning in 2025, Section 101 requires 401(k) and 403(b) plans to automatically enroll participants in the respective plans upon becoming eligible (and the employees may opt out of coverage). The initial automatic enrollment amount is at least 3 percent but not more than 10 percent. Each year thereafter that amount is increased by 1 percent until it reaches at least 10 percent, but not more than 15 percent. All current 401(k) and 403(b) plans are grandfathered. There is an exception for small businesses with 10 or fewer employees, new businesses (i.e., those that have been in business for less than 3 years), church plans, and governmental plans.

Chapter 3
Review Questions

1. Recognize **w**hich of the following contributions can be made to a 401(k) plan?

( ) A. Elective contributions
( ) B. Excess Deferrals
( ) C. Loan Repayments
( ) D. Non-Qualified Deferred Compensations

2. Which of the following statements about elective contributions is FALSE?

( ) A. Elective contributions are treated as employer contributions
( ) B. Elective contributions are subject to discrimination testing under the ADP test
( ) C. Elective deferrals are subject to federal income tax withholding
( ) D. Age 50 catch-up contributions are not subject to discrimination testing under the ADP test

3. Assess which of the following is **the** minimum percentage of a participant's compensation that must be contributed by the employer if a 401(k) plan is top-heavy.

( ) A. 3%
( ) B. 5%
( ) C. 6%
( ) D. 10%

4. For the tax year 2025, what is the compensation threshold for key employees under the top-heavy rules (IRC Section 416)?

( ) A. $160,000
( ) B. $350,000
( ) C. $135,000
( ) D. $250,000

5. A 401(k) plan with fewer than 100 participants, contributions must now be deposited no later than how many business days following the day on which such amount was deducted from the employee's paycheck?

( ) A. 3 business days
( ) B. 7 business days
( ) C. 20 business days
( ) D. 90 business day

CHAPTER 4

NONDISCRIMINATION TESTING

Overview

For a 401(k) plan to retain its tax-qualified status under IRC § 401(a), the Employee Retirement Income Security Act (ERISA) requires several tests each year to prove the plan does not discriminate in favor of employees with higher incomes, known as highly compensated employees (HCEs).

Even though nondiscrimination testing is likely performed by a plan's record-keeper or a third-party administrator (TPA), advisors need to understand the basics of the tests, including the types of contributions that are tested, the methods used, and the consequences of failing.

This chapter will identify the four nondiscrimination requirements under the Internal Revenue Code (IRC). Then it will examine the various coverage requirement tests under IRC § 410(b), the ADP, and the ACP tests. The end of the chapter will examine the steps that need to be taken if a 401(k) plan fails the nondiscrimination and coverage tests.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Clarify the purpose of the nondiscrimination tests.
- Demonstrate the applicability of the four nondiscriminatory requirements.
- Apply the three basic coverage tests required under IRC § 410(b).
- Identify the purposes of the ADP and ACP tests.
- Apply the ADP and ACP test requirements; and
- Relate the steps to be taken if a plan fails the nondiscrimination and coverage tests

Background

Like other qualified retirement plans, a 401(k) plan will retain its qualified status only if the plan contributions or benefits do not discriminate in favor of highly compensated employees (HCEs). As was discussed in Chapter 3, the Internal Revenue Service (IRS) defines a "highly compensated employee" as an individual who:

- Owned more than 5% of the interest in the business at any time during the year or the preceding year, regardless of how much compensation that person earned or received; or

- For the preceding year, received compensation from the business of more than $155,000 (if the preceding year is 2024). In the 2025 tax year, the amount increases to $160,000, and, if the employer so chooses, was in the top 20% of employees when ranked by compensation.

To meet this requirement, the IRS has created certain coverage and nondiscrimination rules that limit the extent to which plan sponsors may maintain a 401(k) plan that exclusively or primarily benefits only highly compensated (HCE) or key employees. The nondiscrimination rules can be broken down into four parts:

- The plan must meet certain minimum standards concerning coverage of employees [IRC § 410(b)];
- The plan must not discriminate in favor of highly compensated employees (HCEs) with respect to the amount of contributions or benefits, and with respect to the availability of benefits and features of the plan [IRC § 401(a)(4)].
- Elective contributions, matching contributions, and other contributions must meet special nondiscrimination tests: ADP/ACP [IRC § 401(k)(3)(A)(ii) and IRC § 401(m)(2)]; and
- A plan that is top-heavy must meet additional rules concerning minimum contributions or benefits [IRC § 416].

Next, we will examine the rules in greater detail to ensure broad coverage of employees under the IRC § 410(b) coverage test.

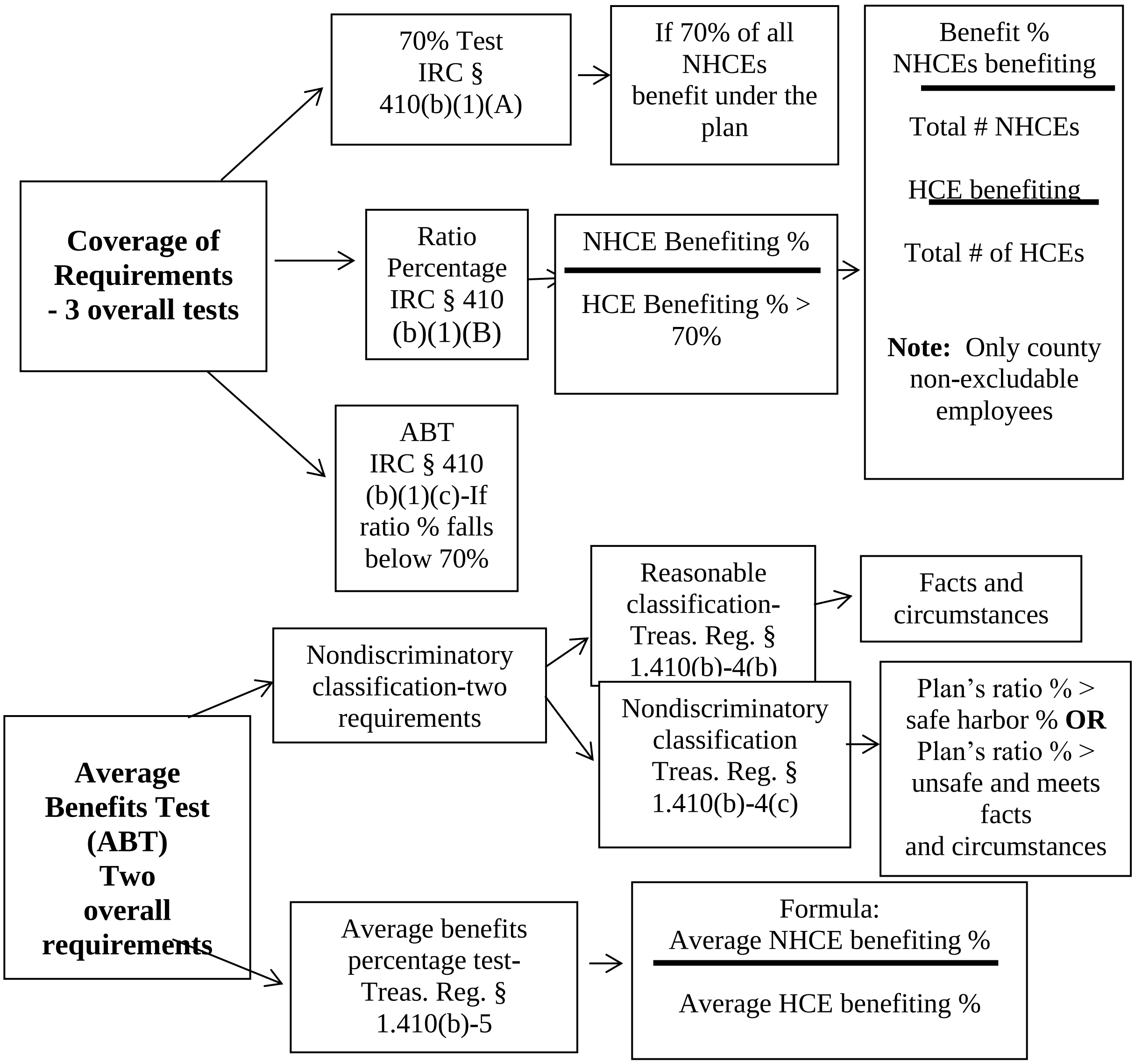
Minimum Coverage Rules IRC § 410(b)

Under IRC § 410(b), every employer (plan sponsor) must perform certain coverage tests to demonstrate that their plan benefits a nondiscriminatory cross-section of employees. To meet this requirement, the IRS has created three basic tests. They are:

- *The Percentage Test*. Under IRC § 410(b)(1)(A), the plan must benefit at least 70 percent of the employer's non-highly compensated employees (NHCEs) (*the percentage test*);
- *The Ratio Percentage Test.* Under IRC § 410(b) (1)(B), the plan must benefit a percentage of NHCEs that is at least 70 percent of the highly compensated employees (HCEs) benefiting from the plan (the *ratio-percentage test*); or
- *The Average Benefit Test*. Under IRC § 410(b)(1)(C), the average benefit test compares the average benefit of non-highly compensated employees (NHCEs) with the average benefit of highly compensated employees (HCEs).

The employer (plans sponsor) should first try to satisfy either the percentage test (70%) test or the ratio percentage test (70%). If the ratio percentage test is not met, the average benefit test must be satisfied (see Figure 4.1). A plan only has to pass one of the coverages tests each year. The coverage test being used can change from year to year. This is not a document issue but rather an administrative testing issue. A plan may call for the correction of the ratio percentage test and preclude using the average benefits test.

Figure 4.1
IRC § 410(b) Flowchart of Coverage



The above coverage tests demonstrate that a 401(k) plan provides benefits to a significant percentage of an employer's NHCE. The coverage tests were developed to measure the ratio of NHCEs to HCEs benefiting under the plan. Individuals benefit under the 401(k) plan if they are eligible to make elective deferrals. The coverage requirements may be tested daily, quarterly, or annually; 401(k) elective deferrals and matching contribution percentage testing must be done on an annual basis.

The Ratio Percentage Test

The ratio percentage test is a test that requires that the percentage of NHCEs benefiting under the plan be at least 70 percent of the percentage of HCEs benefiting under the plan [Treas. Reg. § 1.410(b)-2(b)(2)]. Thus, the relative number of NHCEs and HCEs benefiting is compared under the plan. The plan is not required to benefit an absolute percentage of NHCEs of the employer.

> ***For Example:*** If a plan benefits 35 percent of an employer's NHCEs and 65 percent of the employer's HCEs, then the plan's ratio percentage is 54 percent (35% of NHCEs /65% of HCE), which is less than the required 70 percent.

Alternatively, the test can be performed by calculating the coverage of the HCE group, by determining what 70 percent of that coverage is, and by comparing the percentage to the NHCE coverage. Here, the HCE coverage is 65 percent; 70 percent is 45.5 percent. Thus, the NHCE coverage must be at least 45.5 percent to pass the test. The plan fails the test since the NHCE coverage is only 35 percent.

The Average Benefit Test

As discussed above, the ratio (70%) percentage test is typically done first as it is administratively much easier to perform. If the plan fails the ratio percentage test, the employer can take steps to pass the ratio percentage test by providing a benefit to enough individuals to pass the ratio test, or the employer may perform the "*average benefits test*" to see if the coverage requirement can be passed using that test.

The Average Benefit Test (ABT) consists of two separate tests:

- The Nondiscriminatory Classification Test; and
- The Average Benefits Percentage Test.

Both parts of the ABT must be passed to satisfy coverage testing.

The Nondiscriminatory Classification Test

The first part-nondiscriminatory classification test has two tests. They are:

- The Reasonable Classification; and
- The Nondiscriminatory Classification [Treas. Reg. § 1.410(b)-2(b)(3)].

The *reasonable classification* test is a facts and circumstances analysis, whether the classification satisfies "*reasonable business criteria*." Under Treas. Reg. Section 1.410(b)-4(b), the classification must be reasonable and established under objective business criteria that identify the category of employees who benefit under the plan.

Under Treas. Reg. § 1.410(b)-4(a*), the nondiscrimination test* is a test that requires the 401(k) plan to benefit a class of employees established by the employer that is both *reasonable and nondiscriminatory*.

Under Treas. Reg. § 1.410(b)-4(b), *a reasonable classification* is one established under objective business criteria that identify the group of employees who are eligible to participate in the 401(k) plan. Reasonable classifications include the following:

- Job categories.
- Nature of compensation (hourly or salaried); and
- Geographical location.

A list of named employees eligible to participate in the plan would not be considered a reasonable classification.

Under Treas. Reg. § 1.410(b)-4(c)(2), a classification is automatically considered nondiscriminatory if the 401(k) plan's ratio percentage (discussed above) is greater than or equal to the safe harbor percentage. If the plan's ratio percentage is less than the safe harbor percentage, a classification can still be considered nondiscriminatory if:

- The plan's ratio percentage is greater than or equal to the plan's unsafe harbor percentage; and
- Based on all relevant facts and circumstances, the classification is determined by the IRS to be nondiscriminatory.

Under Treas. Reg. § 1.410(b)-4(c)(4)(i), the safe harbor percentage is 50 percent, reduced by three-quarters of a percentage point (.75 percent) for each whole percentage point by which the NHCEs concentration percentage exceeds 60 percent. The NHCE concentration percentage is simply the percentage of employees who are NHCEs, excluding any excludable employees.

Under Treas. Reg. § 1.410(b)-4(c)(4)(ii), the unsafe harbor percentage is 40 percent reduced by three-quarters of a percentage point (.75) for each whole percentage point by which the NHCE concentration percentage is greater than 60 percent. However, in no event can the unsafe harbor percentage be less than 20 percent.

An employer's NHCE concentration percentage is the percentage of all employees of the employer who are NHCEs. This percentage is determined by considering only non-excludable employees [Treas. Reg. § 1.410(b)-4(c)(4)(iii)]. Table 4.2 shows the safe and unsafe harbor percentages for any given NHCE concentration percentage.

The facts-and-circumstances test is satisfied if a plan's ratio is greater or equal to the unsafe harbor percentage, and the classification satisfies the factual determination test [Treas. Reg. § 1.410 (b)-4(c)(3)]. The unsafe harbor percentage is calculated similarly to the safe harbor percentage, using 40 percent instead of 50 percent. The minimum unsafe harbor percentage is 20 percent. If the ratio percentage does not equal or exceed the unsafe harbor percentage, the plan is discriminatory, and it is unnecessary to consider if the factual determination test is met.

Treas. Reg. § 1.410(b)-4(c)(3)(ii) cites several examples of facts and circumstances that will be considered in determining whether a classification is nondiscriminatory:

- The underlying business reason for the classification. The greater the business reason for the classification, the more likely the classification is nondiscriminatory. Reducing the employer's cost of providing retirement benefits is not considered a relevant business reason [Treas. Reg. § 1.410(b)-4(c) (3) (ii)(A).
- The percentage of the employer's employees benefiting under the plan. The higher the percentage, the more likely the classification is nondiscriminatory [Treas. Reg. § 1.410(b)-4 (c) (3) (ii)(B)].
- Whether the number of employees benefiting under the plan in each salary range represents the number of employees in each salary range of the employer's workforce. In general, the more representative the percentages of employees benefiting under the plan in each salary range, the more likely the classification is nondiscriminatory [Treas. Reg. § 1.410(b)-4(c) (3) (ii)(C)].
- The difference between the plan's ratio percentage and the safe harbor percentage. The smaller the difference, the more likely the classification is nondiscriminatory [Treas. Reg. § 1.410(b)-4(c) (3) (ii)(D); and
- The extent to which the plan's average benefit percentage exceeds 70 percent [Treas. Reg. § 1.410(b)-4(c) (3) (ii)(E)].

The following examples illustrate the computation of the safe harbor rule and the ratio percentage test.

> ***Example 1:*** The Able Company has 130 non-excludable employees. Of those employees, 120 are NHCEs, and 10 are HCEs. Able Company maintains a 401(k) plan that benefits 60 NHCE and 9 HCEs. Thus, the plan's ratio percentage is 55.56 percent [60/120)/(9/10) =0.5556], which is below the percentage (70 percent) necessary to satisfy the ratio percentage test.
>
> Able Company's NHCE concentration percentage is 92.3 percent (120/130); thus, Employer's A's safe harbor percentage is 26 percent. Its unsafe harbor percentage is 20 percent (see Table 4.2). Because the plan's ratio percentage is greater than the safe harbor percentage, the plan's ratio percentage is greater than the safe harbor percentage, the plan's classification is considered nondiscriminatory.
>
> ***Example 2:*** The Swift Company has 10,000 non-excludable employees. Of those employees, 9,600 are NHCEs, and 400 are HCEs. Swift Company maintains a 401(k) plan that benefits 500 NHCEs and 100 HCEs. Thus, the plan's ratio percentage is 20.83 percent [500/9,600)/(100/400) = 0.2083], which is below the percentage necessary (70 percent) to satisfy the ratio percentage test.
>
> Swift Company's NHCE concentration percentage is 96 percent (9,600 / 10,000); thus, the plan's safe harbor percentage is 23 percent. Its unsafe harbor percentage is 20 percent. Because the plan's ratio percentage (20.83 percent) is above the unsafe harbor percentage (20 percent) and below the safe harbor percentage (23 percent), the IRS may determine

that the classification is nondiscriminatory after considering all the facts and circumstances.

Table 4.2
Safe and Unsafe Harbor Percentages

NHCE Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
0-60%	50.00%	40.00%
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75
64	47.00	37.00
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75
68	44.00	34.00
69	43.25	33.25
70	42.50	32.50
71	41.75	31.75
72	41.00	31.00
73	40.25	30.25
74	39.50	29.50
75	38.75	28.75
80	35.00	25.00
85	31.25	21.25
86	30.50	20.50
87	29.75	20.00
88	29.00	20.00
89	28.25	20.00
90	27.50	20.00
91	26.75	20.00
92	26.00	20.00
93	25.25	20.00
94	24.50	20.00
95	23.75	20.00
96	23.00	20.00
97	22.25	20.00
98	21.50	20.00
99	20.75	20.00

Source: Legal Information Institute;
https://www.law.cornell.edu/cfr/text/26/1.410(b)-4

Average Benefits Percentage Test

The second part of the ABT is the average benefits percentage test (ABPT). This test requires an average of the "*employee benefit percentages*" of both the highly compensated employees (HCEs) and the non-highly compensated employees (NHCEs). The plan's average benefit percentage must be equal to or greater than 70%. The average benefit percentage is calculated:

$$\frac{\text{Average benefit \% of NHCEs}}{\text{Average benefit \% of HCEs}}$$

The average benefit percentage of the NHCEs, determined individually for each NHCE, is the average of all NHCEs' actual benefit percentages as a percentage of their compensation. The plans considered for this test are all of the employer's plans (including controlled groups) in the "testing group" for that testing period. The same calculation is used for the NCE average benefit percentage.

Note: For purposes of this test, all non-excludable NHCEs and HCEs are considered even if they are not benefiting under any plan that is considered [Treas. Reg. §1.410(b)-(5)(c)].

In summary, the ABPT test is done as follows:

- Step 1. The employer determines an annual contribution or accrual rate for each employee covered under the plan. Alternatively, an accrued-to-date method may be used.
- Step 2. The contribution or accrual rate determined in Step 1 is divided by the employee's compensation to determine a percentage.
- Step 3. If the plan may use and utilizes permitted disparity, the percentage determined in Step 2 may be increased by an amount representing the employer-provided portion of Social Security. This provides a higher rate for those earning lower amounts. The resulting percentage is added to the percentage for plans that cannot use permitted disparity (for example, CODAs and ESOPs), and the result is the benefit percentage for each employee; and
- Step 4. The individual benefit percentages are then averaged for both HCEs and NHCEs to determine whether the average benefit percentage for NHCEs is at least 70 percent of the ABP for HCEs.

Average Benefit Test (ABT) Example

If a plan sponsor has: 4 non-excludable HCEs, all benefiting, and 9 non-excludable NHCEs, of which 6 were benefiting:

- *Calculate the HCE Benefit Percentage***.** Each HCE Benefit Percentage (Based on benefit/compensation); and
- *Calculate the NHCE Benefit Percentage***.** Each NHCE Benefit Percentage (Based on benefit/compensation).

If the allocation fails the average benefits percentage test on a contribution allocation basis, the allocation may be cross tested to see if the allocation passes on a benefit accrual basis.

Table 4.3
Average Benefit Test Example

Calculate the HCE Benefit Percentage Each HCE Benefit Percentage (Based on benefit/compensation)		Calculate the NHCE Benefit Percentage Each NHCE Benefit Percentage (Based on benefit/compensation)	
HCE 1	7.05%	NHCE 1	9.32%
HCE 2	6.01%	NHCE 2	8.75%
HCE 3	5.31%	NHCE 3	6.32%
HCE 4	4.54%	NHCE 4	5.32%
Total	22.91%	NHCE 5	5.18%
Divided by Number of Non-excludable HCEs	22.91% / 4 = 5.72%	NHCE 6	4.87%
HCE benefiting percentage	5.72%	NHCE 7	0%
		NHCE 8	0%
		NHCE 9	0%
		Total	39.76%
		Divided by Number of non-excludable NHCEs	39.76%/9 = 4.41%
		NHCE Benefiting Percentage	4.41%
		*NOTE: NHCEs 1-6 are covered by the plan; NHCEs 7-9 are not covered but must be included in the test as zeros.	

4.41%/5.72% = 77.1%. This plan sponsor passes both parts of the ABT test.

Employees Who Must Be Considered in Coverage Testing

For purposes of the coverage requirements, all eligible (some exclusions permitted-see below) employees of the employer must be considered, including leased employees and those employed by Controlled Groups and Affiliated Service Groups (multiple companies–common ownership and/or shared revenue).

Excludable Employees

The concept of non-excludable and excludable employees is important for determining who is counted for coverage and nondiscrimination. If an employee is considered excludable, that employee is not counted for coverage and nondiscrimination purposes [Treas. Reg. § 1.410(b) 6]. Thus, these employees are "invisible" and are not counted in either the numerator or denominator of the NHCE or HCE benefiting percentages. Excludable employees are as follows:

- Employees that have not met the statutory age (21) or service requirements (1 year of service based on 1,000 hours in a 12-month period).

Note: *Plans that permit earlier entry can test affected employees separately. Specifically, the plan would test the "otherwise excludable group," that is, those under age 21 and those with less than 1 year of service as a separate testing group:*

- Terminated participants who have completed less than 500 hours of service during the year tested.
- Employees who are members of a collective bargaining unit (union) if retirement benefits have been the subject of good faith bargaining.
- Nonresident aliens with no U.S. source of income; and
- Employees of an employer which is part of the controlled group but are considered a separate business line (generally separate business with 50 or more employees).

Note*: Employees eligible and cannot be excluded as described above are considered "non-excludable" and therefore must be included in testing.*

Nondiscriminatory Contribution Rules

Once the plan has determined enough NHCEs covered, the next test is to determine that the plan's benefits, rights, and features are not discriminatory. The following test this:

- Actual Deferral Percentage Test; and
- The Actual Contribution Percentage Tests.

Next, we will examine these two tests in greater detail, beginning with the ADP.

Actual Deferral Percentage (ADP) Test

The ADP test is considered the central test applied to 401(k) plans when determining if the 401(k) plan is discriminatory. It is designed to limit the extent to which elective contributions made on behalf of HCEs exceed those made on behalf of NHCEs. If the ADP test is satisfied, the plan is treated as satisfying IRC § 401(a) (4) requirements concerning elective contributions only.

The purpose of the ADP test is to determine whether HCEs are taking significantly greater advantage of the plan than the NHCEs (the rank-and-file employees). The ADP test limits the unbridled use of 401(k) arrangements by HCE by limiting their deferrals based on the deferrals of other employees (participants). If the 401(k) plan fails the ADP test, corrective actions will be taken. Such corrective actions are discussed below.

The ADP test must be calculated each plan year to determine whether the 401(k) plan meets the strict nondiscrimination limitations. Several steps must be understood and followed to apply for this test accurately. Employers (plan sponsors) should hire a qualified professional plan administrator to apply for these tests.

Basic Mechanisms of the ADP Test

The first step to determine if the 401(k) plan meets the ADP test requirements, the plan administrator will compare the ADPs of HCEs and NHCEs. This requires the calculation of the actual deferral ratio (ADR). The ADR is merely the ratio of the employee's elective contribution to their compensation [IRC § 401(k)(3)(B)].

For example, consider ABC Company. ABC Company has four employees, Bob, Ed, Mary, and Kevin. ABC Company sponsors a profit-sharing plan that includes a 401(k) plan. Both Bob and Ed are HCEs. Mary and Kevin are NHCEs. Table 4.4 shows their compensation, elective deferrals, and ADRs for the current plan year.

Table 4.4
ABC Company ADP Test

Employee	Compensation	Elective Deferrals	Actual Deferral Ratio (ADR)
Bob	$200,000	$12,000	6%
Ed	$115,000	$11,500	10%
Mary	$40,000	$ 1,200	3%
Kevin	$30,000	$ 900	3%

The next step in the ADP test process is to compute the ADP for both the HCEs and NHCEs employees. The ADP for highly compensated employees is determined by taking the average of the ADRs for all HCEs who are eligible under the plan. The same procedure is performed for all NHCEs eligible under the plan.

In the case of ABC Company, the ADP for the NHCEs is 3 percent (6 percent/2), and the ADP for the HCEs is 8 percent (16 percent/2). As will be discussed later, this plan would fail the ADP test because the ADP for the HCEs exceeds the ADP of the NHCEs by more than the allowable margin.

Once the plan administrator has performed the calculations described above to determine if the ADP for both HCEs and NHCEs is more than the allowable margin, they then perform the actual ADP test to determine whether the ADP for the HCEs exceeds the ADP for the NHCEs. Generally, a plan will pass the ADP test if at least one of the following tests is met:

- *Basic/General Test: 1.25 Requirement.* To meet this requirement, the ADP for the highly compensated employees cannot be more than 125% of the ADP for the non-highly compensated employees [I.R.C. § 401(k)(3)(A)(ii)(I)]; and
- *Alternate Test: Two percentage/200% requirement (2 +2 Test).* To meet this requirement, the ADP for the highly compensated employees cannot be more than two percentage points greater than the ADP for the non-highly compensated employees. The ADP for the highly compensated employees cannot be more than two times the ADP of the non-highly compensated employees [IRC § 401(k)(3)(A)(ii)(II)].

In the ABC Company example, the plan fails the ADP test in this particular plan year because of the following two facts:

- *The Basic Test: 1.25 times test:* The limit is 3.75% (3% x 1.25). The ADP for HCEs of 8.0% exceeds the limit. Test: *FAILED*; and
- *Alternate Test: 2 + 2 test:* The 8% ADP for the HCEs is greater than 5.0% (the NHCEs ADP of 3.0% plus 2). The 8.0% ADP for the HCEs is greater than 6.0% (the NHCEs ADP of 3.0% multiplied by 2 percent). Test: *FAILED*.

The following simple rule of thumb is useful in understanding the ADP test alternatives:

- If the average ADP of NHCEs is less than 2%, then the test used to determine the maximum average ADP of HCEs is the Alternative Test–2 x the average NHCEs ADP.
- If the average ADP of NHCEs is between 2% and 8%, then the test used to determine the maximum average ADP of HCEs is the Alternative Test–plus 2% of the average NHCEs ADP; and
- If the average ADP of NHCEs is more than 8%, then the test used to determine the maximum average ADP of HCEs is the Basic Test–1.25 times average NHCEs ADP.

Applying this simple rule of thumb to the ABC Company reveals that the highest contribution the HCEs would be made would be 5 percent. Because the NHCEs are contributing at a rate of 3 percent, applying the above rule would allow the HCEs to contribute at a rate two percentage points higher. Table 4.5 displays a guide to applying the 1.25 times test and the 2+2 test, given an ADP for NHCEs.

Table 4.5
Maximum ADP for HCEs, Given an ADP for NHCEs

ADP for Non-highly Compensated Employees (NHCEs)	Maximum ADP for Highly Compensated Employees (HCEs)	Rule Used
1.0%	2.00%	Times 2
2.0%	4.00%	Plus 2
3.0%	5.00%	Plus 2
4.0%	6.00%	Plus 2
5.0%	7.00%	Plus 2
6.0%	8.00%	Plus 2
7.0%	9.00%	Plus 2
8.0%	10.00%	Times 1.25
9.0%	11.25%	Times 1.25
10.0%	12.50%	Times 1.25

Choosing Plan Year Method for ADP Calculation for NHCEs

Under Treas. Reg. § 401(k)-2 (a)(2)(ii), the employer (plan sponsor) has a choice of determining the ADP for eligible NHCEs using either the prior-year testing method or the current-year testing method. The plan document must specify its choice of the current-year or prior-year testing method [Treas. Reg. § 401(k)-1(e)(7)].

The prior-year testing method will use the ADP for NHCEs from the 401(k)-plan year immediately before the plan year being tested. It uses the eligible employees who were NHCEs in that year, regardless of whether they were eligible employees or NHCEs in the plan year being tested. The current-year method uses the ADP for the eligible NHCEs in the plan year being tested. Both methods use the current year ADP for HCEs [Treas. Reg. § 401(k)–2(a)(2)(ii)].

Under Treas. Reg. § 401(k)–2(c)(2), unless the 401(k) plan is a successor to another plan, in its first year, a plan that elects the prior-year testing method is allowed to use either its ADP in that first plan year or 3 percent as its ADP.

A 401(k) plan can change from the prior-year testing method to the current-year testing method for any year [Treas. Reg. § 401(k)–2(c)(1)(i)]. Plans deciding to change to the prior-year testing method must meet certain requirements set out in the regulations. Under Treas. Reg. § 401(k)–2(c)(1)(ii), one of the general requirements is that the plan must have used the current-year testing method for each of the five plan years preceding the year of change or, if less, the number of years the plan has been in existence.

Under Treas. Reg. § 401(k)–2(c)(4), a 401(k) plan that chooses to use the prior-year testing method and has changed in the group or groups of eligible employees during a plan year may be required to use special rules to calculate the ADP for NHCEs. For the special rules to apply, the change must be due to:

- The establishment or amendment of a plan.
- A plan merger, consolidation, or spinoff.
- A change in the way plans is combined under the permissive aggregation rules;
- A reclassification of employees that has the same effect as a plan amendment; or
- A combination of these [Treas. Reg. § 401(k)–2(c)(4)(iii)(A)].

In addition, the change must affect more than ten (10) percent of the NHCEs. If it does not, the plan can provide that it will use the ADP for the eligible NHCEs for the prior year [Treas. Reg. § 401(k)–2(c)(4)(ii)].

Note: The advantage of using the prior-year testing method is that the ADP for the NHCEs for the prior year is known early in the current year. The employer and plan administrator can then calculate the ADP limit for HCEs for the current year. They can then monitor the ADP for HCEs and reduce the likelihood that the plan will fail the ADP test. Because HCEs may leave the employer, new ones may become participants, change their contributions, their compensation may change, or other occurrences can change their Actual Deferral Ratio (ADR), it is unlikely that a plan can determine if it satisfied the ADP test until the end of the plan year.

Determining Compensation

IRC § 401(k)(9) defines "*compensation*" in a 401(k) plan under IRC § 414(s). This section of the Code generally looks to the definition of compensation in IRC § 415(c)(3), which provides several safe harbor rules for the definition of compensation. These safe harbor rules include the definition of wages under IRC § 3401(a) for income tax withholding purposes [Treas. Reg. § 1.415-2(d)(3)] and amounts included on the employee's Form W-2 for the year [Treas. Reg. § 1.415-2(d)(4)]. Compensation also includes an employee's elective deferrals to the 401(k) plan as well as IRC § 125 (cafeteria) plan deferrals, qualified transportation fringes, and deferrals to an I.R.C. § 457 plan [IRC § 415(c)(3)(D)].

In the tax year 2025, an employee's compensation used to compute the ADR cannot exceed the compensation limit of $350,000 (up from $345,000 in 2024) [IRC § 401(a)(17)].

Note: Treas. Reg. § 1.414(s)-1(d)(2)(ii) allows the employer to use a broad definition of compensation that will reduce the ADRs, and which produces a lower ADP. For example, a plan that excludes irregular or additional compensation such as overtime pay, and shift differentials will have lower total compensation for an employee who receives that type of compensation than if the plan included such compensation.

Making QMACs and QNECs to Comply with ADP

A 401(k) plan can include employer contributions that qualify as qualified matching contributions (QMAC) and qualified non-elective contributions (QNEC) in addition to elective deferrals in calculating an employee's ADR.

QMACs and QNECs are available corrections when a 401(k) plan fails the required ADP testing. If the plan is deemed to have failed the ADP tests, a correction must be made by either returning excess deposits to the HCEs or making either a QMAC or QNEC (sometimes both) to all eligible NHCEs, to increase their average percentage deferrals or match in comparison to the HCEs.

QMACs are immediately vested matching contributions made by the employer (plan sponsor), calculated based on the employee's elective deferral percentage. The total amount the NHCE receives from the QMAC cannot exceed:

- 5% of their compensation, two times the plan representative *matching*; or
- The total amount of the NHCE elective deferrals.

QNECs are also immediately vested contributions by the employer (plan sponsor) to an employee's (participant's) account. QNECs are calculated based on a percentage of the participants' compensation, which is limited to 5%. An exception, however, is if the plan has implemented a representative contribution rate, which is the lowest percentage of compensation the NHCE can receive from a QNEC. In this case, the maximum percentage of compensation the NHCE can receive cannot exceed two times the representative contribution rate.

An employer must contribute a QMAC or QNEC by the end of the 12-month period after the plan year or applicable year. If the plan uses the prior-year testing method, the contribution for NHCEs must be made by the end of the plan year being tested.

If the plan treats QMACs or QNECs as elective contributions to satisfy the ADP test, they cannot be used in determining if a plan meets the ACP test or the ADP test for the same or any other plan or any other year [Treas. Reg. § 1.401(k)-2(a)(6)(vi)].

Special Rules

There are several special rules for determining if a plan violates the ADP test. They are:

- An employee's elective deferrals are considered employer contributions [IRC § 401 (k)(3(D)(i)];
- An employer may elect to include matching contributions and qualified non-elective (QNECs) in computing the ADP test if the requirements set out in the regulations are met [IRC § 401(k)(3) (D)(ii); Treas. Reg. 1.401(k)-2(a)(6)].
- In a plan's first year, the ADP for NHCEs is 3 percent unless the employer elects to use the ADP for the NHCEs determined for the plan year [IRC § 401 (k) (3(e)].
- If all eligible employees in a plan year are HCEs, the plan is deemed to satisfy the ADP test for that plan year [Treas. Reg. 1.401(k)-2(a)(1)(ii)].
- Elective deferrals made for a partner or sole proprietor are treated as if they are allocated to the partner's account on the last day of the proprietor's or partnership's tax year [Treas. Reg. 1.401(k)-2(a)(4)(ii)].
- Elective deferrals of HCEs include any excess contributions, even if the excess deferrals are distributed [Treas. Reg. 1.401(k)-2(a) (4)(ii)]; and
- A participant's catch-up contributions are subtracted from the participant's elective deferrals for the plan year in determining the participant's ADR [Treas. Reg. 1.401(k)-1(d) (2) (i)].

Chapter 5 will discuss alternative methods to meet/avoid the ADP Test.

Actual Contribution Percentage (ACP) Test

In addition to the ADP test discussed above, a special nondiscrimination test required under IRC § 401(m), the *Actual Contribution Percentage* (ACP) test, applies to employer matching contributions and employee after-tax (non-Roth) contributions. Fortunately, the ACP test is similar to the ADP for employee elective deferral contributions, except that it uses employer matching contributions and employee non-deductible (after-tax) contributions as its testing base.

The ACP testing is based on each participant's actual contribution ratio (ACR): current year after-tax contributions and matching contributions divided by compensation. All participants who could have made salary deferrals are included in the ACP test IF they are eligible to receive a match. However, if the individual's ability to receive a match is conditioned on additional service (e.g., a 1,000 hours of service requirement in the current plan year) or employment at the end of the plan year, and the individual does not meet these conditions, the individual is excluded from the ACP testing. However, when such a condition applies to the receipt of the match, the group of participants who are eligible to receive matching contributions (e.g., those not excluded because they were employed on the last day of the plan year) must satisfy the IRC §410(b) minimum coverage requirements. Basically, a participant so excluded is treated as not benefiting [Treas. Reg. §1.401(m)-1(a)(2)].

A plan may not exclude participants from the ACP test who are not eligible to receive a match simply because they choose not to make a deferral. An individual will have a contribution ratio in the ACP test of "0" [Treas. Reg. §1.401(m)-1(f)(4)(i).].

After-tax employee contributions are also tested under the ACP test, even if the plan isn't a 401(k) plan. After-tax contributions cannot generally exceed 10% of the employee's taxable compensation. [Rev. Rul. 80-350, 1980-2 C.B. 133]. And remember that after-tax employee contributions are part of the employee's annual addition limitation under IRC § 415(c) [IRC § 401(m)(1) and (m)(4)].

Basic Mechanisms of the ACP Test

The first step consists of classifying all eligible employees as HCEs or NHCEs. The next step is determining the "actual percentage ratio" (APR) for each participant: the sum of the employer's matching contributions and other ACP contributions divided by the participant's annual compensation. A nondiscriminatory definition of compensation must be used for the test. A critical decision must be made in ACP testing whether an employee is considered an NHCE based upon the current year or the prior one.

The average ACP percentage for HCEs and NHCEs is then calculated. The average percentage of the HCEs must not exceed the average percentage of the NHCEs by specified margins to satisfy the ACP test.

Like the ADP tests discussed above, the ACP for the group of HCEs must:

- Not be greater than 125% of the ACP of the group of NHCEs cannot be more than 125 percent of the ACP of the eligible NHCEs (Basic/General test); or
- Not be higher than the ACP of the NHCEs by more than two percentage points and not be more than 2 times the ACP of the group of NHCEs (The Alternate test) [Treas. Reg. § 1.401(m)-2(a)(1)].

Table 4.6 displays these limits to show the maximum ACP for HCEs, given an ACP for NHCEs.

As a rule, employer matching contributions and employee non-deductible (after-tax) contributions are combined for ACP testing purposes. However, if qualified non-elective (after-tax) contributions (QNECs) are treated as elective contributions for purposes of satisfying the ADP test, these contributions do not have to satisfy the ACP test; furthermore, they cannot be used to help a 401(k) plan satisfy the ACP test.

Table 4.6
Maximum ACP for HCEs, Given an ACP for NHCEs

ACP of Mach and Voluntary Contributions for NHCEs	Maximum ACP Permitted for the HCEs	Rule Used
1.00%	2.00%	Times 2
2.00%	4.00%	Plus 2
3.00%	5.00%	Plus 2
4.00%	6.00%	Plus 2
5.00%	7.00%	Plus 2
6.00%	8.00%	Plus 2
7.00%	9.00%	Plus 2
8.0%	10.00%	Times 1.25
9.0%	11.25%	Times 1.25
10.0%	12.50%	Times 1.25
12.0%	15%	Times 1.25

Example 1: If the ACP of the NHCEs is 1.23 percent, the ACP of the HCEs can be no greater than 1.23 times 2, or 2.46 percent.
Example 2: If the ACP of the NHCEs is 7.87 percent, the ACP of the HCEs can be no greater than 7.87 plus 2, or 9.87 percent; and
Example 3: If the ACP of the NHCEs is 10.98 percent, the ACP of the HCEs can be no greater than 10.98 times 1.25, or 13.73 percent.

A 401(k) plan can also run into trouble with the IRS if it makes excessive aggregate contributions on behalf of HCEs as a group. An excess contribution is the excess of employee contributions (this includes mandatory employee contributions and voluntary contributions) and matching contributions made to a 401(k) plan for the benefit of HCEs during a particular plan year over the maximum amount of such contributions allowed under the ACP test for that plan year. If the ACP test for a plan year is not satisfied, the plan will no longer be qualified. However, the regulations provide the following five mechanisms for correcting an ACP test that does not meet the requirements of the law:

- The employer makes QNECs that are treated as matching contributions for the ACP test and that, when combined with the employee and matching contributions, cause the ACP test to be satisfied. The QNECs enhance the fairness by increasing contributions to NHCE s, promoting plan participation and compliance.
- Elective contributions are treated as matching contributions for purposes of the ACP test and when combined with the employee and matching contributions, cause the ACP test to be satisfied.
- Excess aggregate contributions and allocable income are distributed.

- If the plan provides, excess aggregate contributions, to the extent attributable to non-vested matching contributions, and allocate income are forfeited; and
- The portion of the 401(k)-plan attributable to employee and matching contributions is restructured.

A plan may use one or more of these correction methods [Treas. Reg. §§ 1.401(m)-2(b)(1), 1.401(m)-2(a)(6), 1.401(m)-2(a)(1)(iii)].

Failing Nondiscrimination or Coverage Requirements

A 401(k) plan that fails the general nondiscrimination test of IRC § 401(a)(4) or the coverage requirement tests under IRC § 410(b) will be disqualified and lose the benefits provided to qualified retirement plans. In addition, the plan's assets become subject to tax, and the plan is governed by the rules applicable to nonqualified plans–IRC § 83, IRC § 401(b)(1), and IRC § 409A. Employees must recognize income when they become substantially vested in the benefits. Employees cannot deduct contributions to the plan. Rather their deduction is delayed until benefits are paid to participants. This obviously creates a mismatch between when the employee includes the benefits in income and when the employer can deduct them.

Under IRC § 401(b)(4(B)), there is a special rule that will allow the 401(k) plan (as well as other defined contribution plans) to continue to apply to NHCEs if the only reason the plan is disqualified is its failure to meet IRC § 410 (b) coverage test.

ADP Test Failure

If the ADP test for a 401(k)-plan year is not satisfied, the portion of the 401(k)-plan attributable to elective contributions–and, most likely, the plan in its entirety–will no longer be qualified. Fortunately, under Treas. Reg. § 1.401(k)-2(b) (1)(ii), plan administrators have several mechanisms for making corrections and can use one or a combination of them to bring the plan into compliance with the test:

- The portion of the 401(k)-plan attributable to elective contributions is restructured to prevent excess contributions [Treas. Reg. § 1.401(k)-2(b) (1)(ii)].
- The employer can make fully vested qualified non-elective contributions (QNECs) or qualified matching contributions (QMACs) treated as elective contributions for the ADP test. When combined with elective contributions, these may satisfy the ADP test [Treas. Reg. § 1.401(k)-2(b) (1)(i)(A)].
- Excess deferrals and allocable income are distributed [Treas. Reg. § 1.401(k)-2(b) (1)(i)(B)]; and
- Excess deferrals or contributions are recharacterized. Excess contributions may be recharacterized as employee after-tax contributions if allowed by the plan [Treas. Reg. § 1.401(k)-2(b) (1)(i)(C)].

If a combination of methods is used, QNECs and QMACs are considered before distributions or recharacterizations. Under Treas. Reg. § 1.401(k)-2(b)(1)(iii), a plan cannot leave excess contributions unallocated, allocate them to a suspense account, or correct them using the retroactive correction rules under Treas. Reg. § 1.401(a)(4)-11(g).

A plan can allow an HCE to elect excess contributions distributed or recharacterized. If an HCE made both pre-tax contributions and Roth contributions, the plan could allow them to elect whether the excess contributions are attributed to the pre-tax contributions or Roth contributions [Treas. Reg. § 1.401(k)-2(b) (1)(ii)].

Correcting Excess Contributions

The most used method for correcting excess contributions is the distribution of the contributions. Under this method, the excess contribution is distributed to the employee along with earnings (if any) on the excess contributions. The total is treated as taxable income.

To determine the excess contributions, the excess contribution amount is the excess of the total employer contributions for HCEs for the plan year over the maximum amount of HCE contributions permitted if the plan meets the ADP test.

For example, ABC employer has three HCEs. Their elective deferrals for the current year are:

Employee	**Compensation including Deferrals**	**Elective Deferrals**	**Actual Deferral Ratio (ADR)**
A	$120,000	$9,000	7.5%
B	$110,000	$8,250	7.5%
C	$80,000	$10,000	12.5%

The actual deferral percentage (ADP) for the NHCEs is 4.0 percent. This means the maximum actual deferral percentage (ADP) for the HCEs is 6.0 percent. The HCEs ADP, before any corrective action, is 9.17 percent.

The excess contributions for an individual HCE are the amount that the HCE contributions must be reduced to equal the highest permitted actual deferral ratio (ADR) under the plan. The procedure set out in the regulation is to start with the HCE, who has the highest actual deferral ratio (ADR) and reduce their ADR to equal the ADR of the HCE with the next highest ADR. A smaller reduction is used if the ADP test can be met with a smaller reduction. The process continues until the ADRs have been reduced enough for the HCEs ADP to meet either the 1.25 or 2+2 tests. While this procedure is used to determine the excess contributions, it is not used to determine the required reduction in each HCEs contribution.

Using the information from ABC Company in the above example, employee C‘s ADR would be reduced to 7.5 percent, reducing their contribution to $6,000. This reduces the ADP to 7.5 percent, still above the 6 percent allowable. The ADPs for all three employees must then be reduced to 6 percent each, reducing their contributions to $7,200, $6,600, and $4,800, respectively. The maximum allowable contribution for the HCEs is $21,000. The excess contributions are $8,650 ($27,250 total contributions minus $18,600).

The same result should be produced by multiplying the HCEs compensation by the maximum ADP for the HCEs. Using the example above, this would involve multiplying the maximum ADP of 6 percent by $350,000, the total compensation for the HCEs. This also produces a maximum contribution for the HCEs of $18,600 and excess contribution of $8,650.

This excess is allocated to the HCEs based on the amount of contributions by or for each employee. This means that the contributions of the HCE with the largest contributions are reduced first until reaching the amount of contributions of the HCE with the next most contributions. The order of reduction is based on the amount of contributions and ignores the ADR. If sufficient, a smaller amount can be allocated to allocate all of the excess contributions. Once the reduced contributions of the HCEs with the largest contributions equal the contributions of all HCEs at the next highest contribution, the reduction applies to the contribution of all HCEs at that contribution level. If an HCE makes elective contributions to more than one plan of the employer, the allocation is limited to the amount that HCE contributed to the plan during the year. The process continues until all of the excess contributions have been allocated among HCEs [Treas. Reg. § 1.401(k)-2(b) (2)].

Using the same facts as above, to allocate the $8,650 of excess contributions, ABC Company first reduces Employee C's compensation by $1,000 to $9,000. It then reduces both Employee A's and Employee C's contribution by $750 each, to $8,250. Finally, it must reduce the contribution of all three employees by $2,050 each, to $6,200.

Employee	Compensation including Deferrals	Elective Deferrals	Actual Deferral Ratio (ADR)
1	$120,000	$6,200	5.17%
2	$110,000	$6,200	5.64%
3	$80,000	$6,200	7.75%

The HCEs ADP is not retested after the excess contributions are distributed, even though the revised ADP is 6.17 percent still exceeds the maximum allowable ADP of 6 percent.

In addition to the excess contributions, the plan must also determine and distribute the income allocable to the excess contributions. For this purpose, only the income on the excess contributions allocable to the plan year must be distributed. The plan does not have to distribute the income attributable to the excess contributions earned between the end of the plan year and the date of distribution. Under Treas. Reg. § 1.401(k)-2(b) (2)(iv), the plan may use any reasonable method to compute the income allocable to the excess contributions, if the method:

- Does not violate the nondiscrimination rules of IRC § 401(a)(4);
- Is applied consistently for all participants and all corrective distributions under the plan for the plan year; and

- Is used by the plan for allocating to participants' accounts.

The income allocable to excess contributions must be determined no more than seven (7) days before the distribution.

The regulation provides an alternative method. The plan would first determine the income for the plan year allocable to elective contributions and amounts treated as elective contributions. It would then multiply that income by a fraction, using the employees' excess contributions for the plan year as the numerator and the beginning of the year plan balance of elective contributions and amounts treated as elective contributions plus any additional contributions for the plan year as the denominator.

> ***For Example:*** A plan determines that the income allocable to the excess contributions is $5,000. At the beginning of the year, HCE's account balance was $100,000 and the employee made $8,000 of elective contributions, including $1,000 found to be an excess contribution. Under the alternative method, the allocable income is:
>
> $5,000 x ($1,000/($100,000 + $8,0000)) = $46.30

Distributing Excess Contributions

To avoid being disqualified, the plan must distribute the excess contributions allocated to each HCE and the related income within 12 months after the end of the plan year. Under IRC § 401(k)(8), the plan may make the corrective distribution without regard to any other provision in the law. The employer must designate the distribution as a corrective distribution. If an HCE receives a distribution of their entire account before the corrective distribution is made, a portion of the distribution is deemed a corrective distribution to the extent one would have been made to that employee [Treas. Reg. § 1.401(k)-2(b) (2)(v)].

If the plan completely terminates in the year an excess contribution occurs, the corrective distribution must be made as soon as administratively feasible after the date of the plan termination. Under Treas. Reg. § 1.401(k)-2(b) (2)(iv), it must occur no later than 12 months after the date of the plan termination.

The corrective distribution does not require any consent from the employee or the employee's spouse [Treas. Reg. § 1.401(k)-2(b) (2)(vii)(A)]. They are treated as employer contributions for purposes of IRC § 404 and I.R.C. § 415. If the plan makes a partial distribution to an HCE, it is treated as a pro-rata distribution of the excess contributions and allocable income [Treas. Reg. § 1.401(k)-2(b) (2)(vi)(D)].

Tax Treatment of Corrective Distribution

Any corrective distribution distributed to HCE will be considered taxable income to the HCE for the year distributed. Under Treas. Reg. § 1.401(k)-2(b) (2)(vi)(A), the additional 10 percent penalty tax of IRC § 72(t) does not apply. Designated Roth contributions distributed as part of a corrective distribution are not included in income, but the allocable income is [Treas. Reg. § 1.401(k)-2(b) (2)(vi)(C)].

Recharacterizing Excess Contributions

A plan may allow HCEs to elect to have the excess contributions treated as distributed to them and then contributed to the plan. The excess contributions cannot be recharacterized if the plan does not allow employee contributions. Recharacterization causes the excess contributions to be treated as employee contributions for purposes of IRC § 72, the nondiscrimination rules under IRC § 401(a)(4) and IRC § 401(m) and Treas. Reg. § 1.401(k)-2 and the distribution limitation of Treas. Reg. § 1.401(k)-1(d). The recharacterization must be reported as employee contributions [Treas. Reg. § 1.401(k)-2(b) (3)(ii)]. For all other purposes, they are treated as employer contributions.

The recharacterization is deemed to have occurred on the date that the last HCE with excess contributions to be recharacterized receives the required notice that the recharacterization was treated as employee contributions. The recharacterization must be made within 2 ½ months after the plan year's end. The total of the recharacterization excess contributions and the HCEs employee contributions cannot exceed the maximum amount of employee contributions permitted for the plan year in which the excess contributions were made. For this purpose, the maximum amount is computed before the actual contribution percentage limit is applied [Treas. Reg. § 1.401(k)-2(b) (3)(iii)(C)].

Applicability of the 10% Excise Tax on Excess Contributions

The plan must meet the deadline of the end of the following plan year to distribute excess contributions to avoid disqualification. To avoid the ten percent (10%) excise tax on excess contributions imposed on the employer under IRC § 4979, the excess contribution must be distributed within 2 ½ months after the end of the plan year. In addition, QNECs and QMACs do not need to be made within the 2 ½ month period if they are timely made. Under IRC § 4979(f), this period is extended six (6) months if the plan includes an eligible automatic contribution arrangement (EACA). The six-month period applies only if all HCEs and NHCEs are covered by the plan for the entire year (or the portion for which they are eligible to participate [Treas. Reg. § 54.4979-1(c)].

ACP Test Failure

When a 401(k) plan fails the ACP test, the plan is said to have "*excess aggregate contributions*." The excess aggregate contributions are the total matching contributions (after-tax employee contributions) that must be distributed or forfeited to the HCEs to satisfy the ACP testing. The employer (plan sponsor) has several options to correct any "excess aggregate contributions" in the plan. They include:

- The employer (plan sponsor) can make qualified matching contributions (QMACs) to the accounts of some or all of the NHCEs in an amount sufficient to raise the average contribution percentage (ACP) for the group of NHCEs to pass the ACP test [Treas. Reg. § 1.401(m)-2(b) (1)];

- To the extent matching contributions are vested, they are distributed (along with earnings) to the HCEs before the end of the next plan year or forfeit the "excess aggregate contributions" by the end of the following plan year [Treas. Reg. § 1.401(m)-2(b) (1)];
- To the extent matching contributions are not vested, they can be forfeited; or
- A combination of these methods.

In addition, it may limit employee contributions or matching contributions to prevent excess aggregate contributions from being made. If a plan chooses a combination of these methods, it must first consider the additional made before making any distributions or forfeitures [Treas. Reg. § 1.401(m)-2(b) (1)(ii)]. Under IRC § 401(m)(6)(B), "excess aggregate contributions" are the excess of the total matching contributions and employee contributions (and any QNECs or elective contribution included in computing the ACP) made for HCEs for the plan year less the maximum contributions permitted under the ACP tests.

Corrections cannot be made by forfeiting vested matching contributions, distributing non-vested matching contributions, recharacterizing matching contributions, or not making required matching contributions. In addition, the excess aggregate contributions cannot remain unallocated or be allocated to a suspense account for future allocation. Under Treas. Reg. § 1.401(m)-2(b) (1)(iii), the retroactive rules of Treas. Reg. § 1.401(a)(4)-11(g) are not available.

If a plan provides for the forfeiture of matching contributions, they are treated as employer contributions, even if distributed from the plan. Under Treas. Reg. § 1.401(m)-2(b)(3)(ii), any forfeitures reallocated to other participant accounts are included in determining if the annual contribution limits are met.

As with corrective distributions for the ADP test, a plan's distribution of excess aggregate contributions may be made without regard to any other provision of the law [IRC § 401(m)(6)(A)] or any notice or consent that would otherwise be provided [Treas. Reg. § 1.401(m)-2(b) (3)(i)]. The tax treatment for corrective distributions made to correct a failed ACP test is the same as the tax treatment for corrective distributions for a failed ADP test, except these distributions may not be recharacterized as catch-up contributions. HCE will only receive a refund to the extent they are vested in the matching source. The vested portion is distributed to HCE, and the unvested portion is forfeited.

Note: If a corrective distribution of designated Roth contributions is made, those distributions are not taxable, but the income allocable to them is [Treas. Reg. § 1.401(m)-2(b) (2)(vi)]. Corrective distributions are not considered in determining if a plan meets the required minimum distribution (RMD) requirements [Treas. Reg. § 1.401(m)-2(b) (3) (iii)]. Chapter 5 will discuss alternative methods to meet/avoid the ACP Test.

Nondiscrimination Tests for P/S Plan

IRC § 401(m) contains special nondiscrimination requirements relating to the amount of employee contributions and employer matching contributions under a plan. A plan will fail to satisfy the general nondiscrimination requirements under IRC § 401(a)(4) unless it satisfies the special nondiscrimination requirements of IRC § 401(m). Matching contributions and after-tax employee contributions to a profit-sharing (P/S) portion of a 401(k) plan must meet the same nondiscrimination tests of IRC § 401(a)(4) and the coverage tests of IRC § 410 (b) as the 401(k) portion. Instead of the ADP test, they must satisfy an actual contribution percentage (ACP) contributions and employee contributions to compensation for the NHCEs and HCEs for the year [Treas. Reg. § 1.401(m)-2]. Any employee who is eligible to make an employee contribution or to receive a matching contribution is considered an eligible employee for purposes of the ACP test [IRC § 401(m)(5)(A)].

Matching Contributions

The IRC defines a matching contribution as follows:

- Any employer contribution made to a defined contribution plan for an employee based on a contribution made by the employee (other than elective deferral) [IRC § 401(m)(4)(A)(i)].
- Any employer contribution made to a defined contribution plan for an employee based on the employee's elective deferral [IRC § 401(m)(4)(A)(ii)]; and
- Any forfeiture allocated based on employee contributions, matching contributions, or elective deferrals [Treas. Reg. § 401(m)-1(a)(2)(C)].

Under Treas. Reg. § 401(m)-2(a)(4)(iii), to be included in the actual contribution ratio for an eligible employee, each of the following requirements must be met:

- The matching contribution must be allocated to the employee's account as of a date within the year being considered.
- The matching contribution is made or allocated based on the employee's elective deferrals or contributions for the year; and
- The matching contribution is paid to the trust by the end of the 12-month period immediately following the year, including the allocation date.

The regulation also specifies certain employee contributions and matching contributions not considered under the ACP test. Under Treas. Reg. § 401(m)-2(a)(5), these include matching contributions that do not meet the requirements previously discussed. Instead, those contributions must satisfy the general nondiscrimination test of IRC § 401(a)(4). Other contributions not included in the ACP test are disproportionate matching contributions, qualifying matching contributions used to satisfy the ADP test, and matching contributions considered under safe harbor provisions.

Employee Contributions

Under Treas. Reg. § 1.401(m)-1(a)(3), employee contributions are contributions treated as after-tax employee contributions and allocated to an individual account for each eligible employee. An employer treats contributions as after-tax employee contributions by subjecting them to withholding. The definition of employee contributions excludes certain amounts to be paid to a plan on a participant's behalf, including Designated Roth contributions, loan repayments, rollover contributions, and employee contributions transferred from another plan [Treas. Reg. § 1.401(m)-1(a)(3)(ii)]. Matching contributions made for self-employed persons are not considered elective employee contributions [IRC § 402 (g) (8)]. Employee contributions also include contributions applied to the purchase of whole life insurance protection or survivor benefit protection and excess contributions and related income recharacterized as employee contributions to satisfy the ADP test [Treas. Reg. § 1.401(m)-1(a)(3)].

Chapter 4
Review Questions

1. *The Ratio Percentage Test* must benefit a percentage of NHCEs, at least what percent of the highly compensated employees (HCEs) benefit from the plan?

( ) A. 25%
( ) B. 70%
( ) C. 85%
( ) D. 50%

2. Which of the following would NOT be considered an excludable employee?

( ) A. Employee who has not met the statutory age or service requirement
( ) B. Employees who are members of a collective bargaining unit (union)
( ) C. Terminated participants who have completed more than 500 hours of service during the year tested
( ) D. Nonresident aliens with no U.S. source of income

3. An employee's compensation used to compute the Actual Deferral Ratio (ADR) cannot exceed the compensation limit of IRC § 401(a)(17), as adjusted for inflation. For 2025, what is that limit?

( ) A. $350,000
( ) B. $220,000
( ) C. $275,000
( ) D. There is no compensation limit

4. Which of the following is NOT one of the three basic tests the IRS has created to demonstrate that a plan benefits a nondiscriminatory cross-section of employees?

( ) A. The Percentage Test
( ) B. The Actual Contribution Percentage Test
( ) C. The Ratio Percentage Test
( ) D. The Average Benefits Test

5. To avoid a 401(k) plan from being disqualified, the plan must distribute the excess contributions allocated to each HCE and the related income within how many months after the end of the plan year?

( ) A. 2 ½ months
( ) B. 6 months
( ) C. 9 months
( ) D. 12 months

CHAPTER 5

SAFE HARBOR 401(k) PLANS

Overview

The Safe-Harbor 401(k) plan is increasingly becoming a popular choice among plan sponsors. A Safe Harbor 401(k) plan is not actually a separate plan from the traditional 401(k). Rather it is an optional provision added to the 401(k)-plan document. Electing to be a Safe Harbor 401(k) plan is simple. A traditional 401(k) plan can easily be amended to allow Safe Harbor contributions.

However, employers must work through additional layers of complexity to achieve this simplicity. There are many nuances to ADP/ACP safe harbor requirements that present traps for the unwary, rendering them unsafe. Still, the same complexity that creates these traps also creates planning opportunities.

This chapter will examine the rules and requirements of the "*traditional*" Safe Harbor plan under IRC § 401(k)(12) and the Safe Harbor plan with Qualified Automatic Contribution Arrangement (QACAs) under IRC § 401(k)(13). In addition, we will examine the rules and requirements for two additional types of 401(k) plans that may qualify as a Safe Harbor plan: the SIMPLE 401k plan and the Individual (Solo) 401(k) plan.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Recognize the benefits of a Safe Harbor 401(k) plan.
- Identify the entities eligible to set up a Safe Harbor 401(k) plan.
- Describe the "traditional" Safe Harbor 401(k)12 plan rules and requirements.
- Identify the rules and benefits of Safe Harbor 401(k)(13) with qualified automatic contribution arrangements.
- Relate to features of and benefits of a SIMPLE 401(k) plan; and
- Present the rules and benefits of an Individual (Solo) 401(k) plan.

Background

Plan sponsors (employers) are interested in Safe Harbor plan designs because they free the 401(k) plan from ADP/ACP testing. Generally, it is not the testing itself that concerns the plan sponsors (employers), as the plan's record-keeper often does the testing, but rather the impact on HCEs that results from failing the test, such as reduced limits on deferrals and matching contributions, refunds of elective deferrals, and distributions or forfeitures of matching contributions, as was discussed in Chapter 4. These refunds, forfeitures, and distributions can come as an unwelcome surprise.

Safe Harbor 401(k) plan designs have become increasingly prevalent. Plan sponsors (employers) increasingly rely on these designs to provide certainty that HCEs will maximize their use of the 401(k) plan. The "core" of the Safe Harbor designs is a quid pro quo between the plan sponsor (employer) and the government. The plan sponsor (employer) agrees to make contributions at (or above) a threshold amount (under a relatively fast vesting schedule) and, in exchange, the government grants the employer a "free pass" on ADP and ACP testing. However, many ancillary rules are also a part of obtaining Safe Harbor status. Plan sponsors (employers) focus heavily on the major components of the Safe Harbor tests, such as minimum contribution levels, vesting, and restrictions on in-service withdrawal. However, IRS is focused on the full range of ancillary rules, in effect "guarding" Safe Harbor status. As a result, plan sponsors (employers) that do not pay attention to this full set of requirements are exposed to the risk that their "*Safe Harbor*" design may not be so safe after all. In fact, IRS has put investigations of Safe Harbor plans high on its work plan.

First, let's explain the business entities allowed to set up a Safe Harbor plan.

Eligible Business Entities

The same business entities that can sponsor a traditional 401(k) plan can sponsor a Safe Harbor 401(k) plan. The Safe Harbor 401(k) plan is one of the most popular plan designs, especially for small employers. Any non-governmental employer can establish a Safe Harbor 401(k) plan. There are no requirements pertaining to the number of employees in the organization; thus, large and small employers are eligible.

According to Vanguard's, "*How America Saves Report 2024*", as of year-end 2023, 29% of all plans had adopted a safe harbor design.

Safe Harbor Plan Designs

There are two distinct basic ADP/ACP safe-harbor plan designs (see Table 5.1). They are:

- 401(k)(12) Safe Harbor plan. Referred to as *traditional* Safe Harbor plan. These Safe Harbor plans offer minimum matching contributions or non-elective contributions (NECs); and
- 401(k)(13) Safe Harbor plan. Plans offer qualified automatic contribution arrangements (QACAs) with minimum matching or non-elective contributions (NECs).

In addition, there are additional types of 401(k) Safe Harbor plans that can avoid the nondiscrimination ADP/ACP testing rules. They are:

- SIMPLE 401(k) plans.

- Individual (Solo) 401(k) plans; and
- Combination Plans under IRC § 414(x) Safe Harbor. Combined defined benefit plans and 401(k) plans (also known as “DB/K plans”).

401(k)(12) Safe Harbor Plan

The *Small Business Job Protection Act (SBJPA) of 1996* introduced the first ADP/ACP Safe Harbor design effective in 1999. Under IRC § 401(k)(12), the traditional 401(k) Safe Harbor plan requires the plan sponsor (employer) to make specified contributions for NHCEs, meet withdrawal and vesting restrictions, and notify eligible employees of the rights and obligations under the plan. If it does, it will limit the ADP test (as was discussed in Chapter 4). If it meets those requirements and complies with limits on matching contributions, it will also satisfy the ACP test for matching contributions [IRC § 401(m) (11)(A)]. There is no provision for satisfying the ACP test for employee after-tax contributions using this safe harbor. The safe harbor contributions must be fully 100% vested and subject to the same distribution restrictions as elective deferrals [IRC § 401(k)(12) (E)(i)].

Safe-Harbor Contribution Requirement: ADP Test

There are two alternative contribution requirements under a 401(k)(12) Safe Harbor plan:

- A matching contribution requirement; or
- A non-elective contribution (NEC) requirement [IRC § 401(k)(12) (B)].

There are no restrictions in the statute or the regulations on the employer’s switching back and forth between the matching and NEC methods of satisfying the safe harbor contribution requirements, so long as:

- The plan permits switching from year to year.
- The employer determines which test will satisfy before the beginning of the year; and
- The notice requirement is met before the beginning of the year.

The matching contribution or non-elective contribution (NEC), whichever is used, must be made on behalf of all eligible employees under the plan; meaning, for example, that the plan cannot restrict these contributions to employees employed on the last day of the plan year or to employees who have at least 1,000 hours of service in the plan year. In addition, both the safe harbor matching contributions and safe-harbor NECs must be 100% vested and have specific withdrawal restrictions. Hardship distributions and in-service withdrawals prior to age 59 ½ are not allowed from safe harbor contributions. The safe-harbor matching contribution must match elective deferrals and catch-up contributions.

Safe harbor matching contributions and NECs can be used to satisfy the safe harbor requirements for only one plan. The safe harbor contribution requirements must be satisfied without regard to IRC § 401(l).

Safe Harbor Matching Contribution

The safe harbor matching contribution requirement is satisfied if, under the plan, qualified matching contributions are made on behalf of each eligible non-highly compensated employee (NHCE) in an amount determined under a "*basic matching formula*" or an "*enhanced matching formula*," and certain other conditions are met [IRC § 401(k) (12)(B)].

- *Basic Match Formula:* The basic matching formula provides for matching contributions to be made on behalf of each non-highly compensated employee (NHCE) equal to:
    - 100 percent of the employee's elective contributions up to 3 percent of the employee's compensation.
    - 50 percent of the employee's elective contributions that exceed 3 percent of the employee's compensation but do not exceed 5 percent of the employee's compensation [Treas. Reg. § 1.401(k)-3(b)(2)]; and
    - Thus, the maximum matching contribution required for an employee to meet the safe harbor is equal to four percent (4%) of compensation.
- *The Enhanced Matching Formula:* The enhanced matching formula provides matching contributions for each eligible non-highly compensated employee (NHCE) under a formula that:
    - Provides an aggregate amount of qualified matching contributions at least equal to the aggregate amount that would have been provided under the basic matching formula at any elective contribution rate [Treas. Reg. § 1. 401(k)-3(c)(13)].
    - The rate of matching contributions may not increase as an employee's rate of elective contributions increases; and
    - One example of an enhanced matching formula that would meet the requirements is a match equal to 100 percent of elective contributions up to 4 percent of compensation.
- If the plan involved allows for employee after-tax contributions, additional rules apply to satisfy the safe harbor matching formula [Treas. Reg. § 1.401(k)-3(c)(5)(i)].

The additional requirements regarding vesting, eligibility, and withdrawal restrictions are applicable. A last day and/or hour requirement is not allowed for the safe harbor matching contribution.

Let's review a couple of examples.

> ***Example 1****:* A 401(k) plan provides a fixed matching contribution equal to 100% of elective deferrals up to a maximum of 4% of compensation; this formula satisfies the safe harbor matching contribution because all participants who are deferring will get a contribution at least equal to the contribution which would be made under the safe harbor basic matching contribution described above.
>
> ***Example 2:*** A fixed matching contribution equal to 150% of elective deferral up to a maximum of 3% of compensation, and then a 100% match for elective deferrals exceeding 6% of compensation is not a safe harbor matching contribution because of the prohibition for an escalating formula.

The type of safe harbor matching contribution selected (basic or enhanced) must be described in the plan document and the annual notice to eligible participants. Unlike the NEC, there is no flex matching contribution option.

Safe Harbor Non-Elective Contribution

In lieu of satisfying the matching contribution safe harbor, an employer may satisfy the safe harbor by making a non-elective contribution (NEC) equal to:

- At least three percent (3%) of the employee's safe harbor compensation (commonly known as the “3% NEC”), without regard to whether the employee makes elective contributions [IRC § 401(k)(12)(C); Treas. Reg. §1.401(k)-3(b)].

This contribution can be greater than 3%. Generally, the 3% NEC must be provided to all employees eligible to make elective deferrals to the plan regardless of whether the employee makes elective deferrals to the plan. The NEC may be a guaranteed contribution or a flexible (“tentative”) contribution. The employer will make this selection in the plan document. The guaranteed contribution requires that an NEC be made each plan year unless the employer amends the plan and removes the provision before starting the new plan year.

If the contribution is “tentative,” the employer can wait until 30 days before the plan year's end to decide whether to make a safe harbor NEC. Employees must receive notice within a reasonable period before the beginning of the plan year of the possibility of a safe harbor contribution being made (discussed below). A supplemental (“condition”) notice may be required at least 30 days before the end of the plan year that the employer has decided to make or not make the “*tentative*” safe harbor NEC.

Definition of “Compensation” for Safe-Harbor Matching and Enhanced Contributions

One of the first practical considerations an employer encounters in making safe harbor contributions is the definition of compensation used. Safe harbor employer contributions must be based on a definition of compensation within the meaning of Treas. Reg. § 1.401(k)-6, which refers, in turn, to the definition of compensation under IRC § 414(s), but without the ability to exclude all compensation more than a specified dollar amount [Treas. Reg. § 1.401(k)-3(b)(2)].

To use the safe harbor, a plan must use a specific definition of compensation. If a plan uses a definition of compensation outside of this specified “safe harbor” definition of compensation, then the plan loses its safe harbor status.

Safe-Harbor Contribution Requirement: ACP Test

To satisfy the safe harbor ACP test concerning matching contributions, a plan must satisfy the ADP test safe harbor and limit matching contributions in accordance with IRC § 401(m)(11) and

Treas. Reg. § 1-401(m)-3(d). The ACP test is satisfied if any of the safe harbor ADP contributions described above are made, including the safe harbor NEC. If the plan wants to take advantage of the ACP safe harbor, there are additional requirements for all the employer matching contributions made to the plan. These additional requirements are automatically met if the plan uses only the safe harbor basic matching formula described in "*Safe Harbor BASIC matching contribution*" above. The "*additional*" matching contribution does not have to be 100% vested or have withdrawal restrictions, but it must be tracked as a separate contribution source.

It is, however, possible for an employer to provide additional matching contributions, i.e., a more generous matching contribution formula, and to continue to be treated as satisfying the ACP test if, under the plan:

- Matching contributions are not made concerning elective contributions or employee contributions that in aggregate exceed 6 percent of employee's compensation [Treas. Reg. § 1.401(k)-3-d(3)(i)];
- The rate of matching contribution does not increase as the rate of employee contributions or elective contributions increases [Treas. Reg. § 1.401(k)-3-d(2)]; and
- For employee contribution or elective deferral, the matching contribution with respect to a highly compensated employee (HCE) may not be greater than the matching contribution with respect to a non-highly compensated employee (NHCE) [Treas. Reg. § 1.401(k)-3-d(4)].

A plan does not fail to satisfy this last requirement merely because it provides that matching contributions will be made separately with respect to each payroll period, or with respect to all payroll periods ending with or within each month or quarter of a plan year, so long as the matching contributions for any quarter are contributed to the plan by the last day of the following quarter.

In applying the fourth limitation, matching contributions for a highly compensated employee (HCE) under all plans of the employer will be considered. However, non-simultaneous participation in more than one plan during a year, or the period used to determine compensation under each plan is limited to periods of actual participation in the plan, will not result in failure to satisfy the safe harbor matching contribution requirements [Treas. Reg. § 1.401(k)-3-d(5)].

Effect of Additional Matching, NEC, or After-Tax Employee Contributions

The basic purpose of a Safe Harbor 401(k)(12) plan is to enable the plan sponsor (employer) and its plan administrator to avoid the nondiscrimination testing associated with the employees' salary deferral contributions and the employer's matching contributions. As discussed above, a 401(k)(12) Safe Harbor plan must satisfy the safe harbor contribution requirements for purposes of the ADP and ACP tests. What is the effect on the contribution safe harbor for the ADP and ACP tests if the employer makes matching or NECs more than the safe harbor amounts or if the employer allows employees to make after-tax contributions?

General Rule. Additional contributions above and beyond the safe harbor contributions are treated similarly to contributions to a non-safe harbor plan. In practical terms, that means the additional contributions allocated to employees must be tested for coverage under IRC § 410(b) and for nondiscrimination under IRC § 401(a)(4). It also means that the additional contributions are not subject to the vesting and withdrawal requirements that apply to safe harbor contributions.

Additional Non-Elective Contributions (NECs)

As mentioned above, employer contributions more than the NEC safe harbor contribution limits are subject to the general nondiscrimination requirements of IRC § 401(a)(4). In meeting these requirements, the safe harbor NEC made to the plan may be considered. NECs used to satisfy the design-based safe harbor can be used to satisfy other qualified retirement plan nondiscrimination rules as well [Treas. Reg. § 1.401(k)-3(h)(2)]. However, these contributions cannot be considered in determining whether a plan meets the permitted disparity rules of IRC § 401(l) [IRC § 401(k)(12)(E)(ii); Treas. Reg. §1.401(k)-3(h)(2)].

After-Tax Employee Contributions

The designed-based safe harbors provide relief from ACP testing only for matching contributions and not after-tax employee contributions. After-tax employee contributions continue to be subject to ACP testing [IRS Notice 98-52]. Moreover, employer matching and NECs used to satisfy the safe harbor requirements cannot be considered in applying that ACP test, except to the extent they exceed the amounts required to satisfy the safe harbor requirements. For this reason, a plan intended as a 401(k)(12) Safe Harbor plan will not likely include a provision for after-tax employee contributions.

Effect of Additional Contributions on the IRC § 416 Top-Heavy Requirement

The top-heavy rules do not apply to a 401(k)(12) Safe Harbor plan that only provides for safe harbor contributions [IRC § 416(g)(4)(H)]. The mere inclusion in a plan of a provision that provides for additional contributions at the employer's discretion will also not cause the plan to be subject to the top-heavy rules [Rev. Rule. 2004-13]. However, any additional contribution that is made will cause the plan to be subject to the top-heavy rules. If a 401(k)(12) Safe Harbor plan falls outside of the top-heavy exemption, safe harbor NECs may be counted under IRC § 416 toward the minimum contribution requirement for top-heavy plans [IRS Notice 98-52].

Withdrawal, Vesting, and Other Restrictions

A 401(k)(12) Safe Harbor plan must provide that all safe harbor employer contributions, including safe harbor matching contributions, are fully vested and non-forfeitable [IRC § 401(k)(12)(E)(i)]. In addition to vesting limitations, safe-harbor plans may not condition contributions on certain requirements. A plan may not require that an employee be employed on the last day of the plan year to receive a safe harbor matching or NEC. It may not condition the match or NEC upon completing a certain number of hours of service, e.g., 1,000 hours of service in the plan year [Treas. Reg. § 1.401(k)-3(c) (7, Ex. 7]). In addition, a safe-harbor plan must impose the same withdrawal restrictions that apply to elective deferrals under a 401(k) plan to employer safe harbor contributions [IRC § 401(k)(12)(E)(i)].

A 401(k)(12) Safe Harbor plan does not require that the CODA include an automatic contribution arrangement. That is, in contrast to the QACA safe harbor found in IRC § 401(k)(13) (discussed below), a 401(k)(12) Safe Harbor plan may require affirmative elections to defer. However, nothing found in a 401(k)(12) Safe Harbor plan precludes a plan from including an automatic contribution arrangement.

Notice Requirement

The second requirement necessary to satisfy the ADP test safe harbor is the notice requirement, which is satisfied if each eligible employee for the plan year is given written notice of the employee's rights and obligations under the plan, and the notice satisfies the content requirement and the timing requirement [Treas. Reg. § 1.401(k)-3(d)]. The notice must be in writing, or such other form as may be approved by the Commissioner.

The content requirement requires that the notice be sufficiently accurate and comprehensive to inform the employee of the employee's rights and obligations under the plan and written in a manner calculated to be understood by the average employee eligible to participate in the plan.

The notice must accurately describe:

- The safe harbor matching contribution or safe harbor NEC formula used under the plan (including a description of the levels of safe harbor matching contributions, if any, available under the plan).
- Any other contributions under the plan or matching contributions to another plan on account of elective contributions or employee contributions under the plan (including the potential for discretionary matching contributions) and the conditions under which such contributions are made.
- The plan to which safe harbor contributions will be made (if different than the plan containing the 401(k) plan).
- The type and amount of compensation that may be deferred under the plan.
- How to make cash or deferred elections, including any administrative requirements that apply to such elections.
- The periods available under the plan for making cash or deferred elections.
- Withdrawal and vesting provisions applicable to contributions under the plan; and
- Information that makes it easy to obtain additional information about the plan (including an additional copy of the summary plan description-SPD) such as telephone numbers, addresses, and, if applicable, electronic addresses of individuals or offices from whom employees can obtain such plan information [Treas. Reg. § 1.401(k)-3(d)(3)(11)].

The timing requirement requires that the plan sponsor must provide notice within a reasonable period before each year. This requirement is deemed to be satisfied if the notice is given to each eligible employee at least 30 days and not more than 90 days before the beginning of each plan year. In the case of newly hired employees, the notice must be provided within the ninety (90) day period ending with the day the employee becomes eligible [Treas. Reg. § 1.401(k)-3(d)(3)(ii)]. However, the general rule is that the notice must be provided within a reasonable period before the beginning of the plan year (or, in the year, the employee becomes eligible, within a reasonable period before the employee becomes eligible), determined based on all the facts and circumstances.

Special notice must be provided if the employer decides to suspend its contributions mid-year. The required notice may be provided in writing or electronic form, provided that the general IRS requirements for paperless delivery of notices in Treas. Reg. § 1.401(a)-21 is satisfied. given (and the employee can make a deferral election) before the employee's first payday.

Plan Year Requirements

As a rule, a plan will not satisfy the 401(k)(12) Safe Harbor plan design unless plan provisions that satisfy the applicable rules are adopted before the first day of the plan year and remain in effect for the entire twelve (12)-month plan year [Treas. Reg. § 1.401(k)-3(e)(1)]. The regulations go on to provide that, except as provided with respect to a permissible reduction or suspension of safe harbor contributions in accordance with Treas. Regs. § 1.401(k)-3(g), a plan which includes provisions that satisfy the rules of a 401(k)(12) Safe Harbor plan will not satisfy the requirements of Treas. Reg. § 1.401(k)-1(b) [the coverage and nondiscrimination requirements applicable to the CODA] if it is amended to change such provisions for that plan year [Treas. Reg. § 1.401(k)-3(e)(2)]:

- *Initial Plan Year*. The regulations provide that a newly established plan (other than a successor plan) may have a plan year that is less than twelve (12) months long but at least three (3) months long. A newly established employer may establish its plan as soon as administratively feasible after the employer comes into existence. A CODA may be added to an existing profit-sharing, stock bonus, or pre-ERISA money purchase pension plan for the first time during that year provided that:
    - The plan is not a successor plan; and
    - CODA is made effective no later than three (3) months prior to the end of the plan year [Treas. Reg. § 1.401(k)-3(e)(2)].
- *Change of Plan Year*. A plan that has a short plan year because of changing its plan year does not violate the general rule that a plan must have a twelve (12)-month plan year, provided that:
    - The plan satisfied the plan year requirements for the immediately preceding plan year; and
    - The plan satisfies the plan year requirements for the immediately following plan year [Treas. Reg. § 1.401(k)-3(e)(3)];
- *Final Plan Year*. A plan that terminates during a plan year, with the result that the final plan year is less than twelve (12) months in length, does not fail to satisfy the plan's general rule.

Permitted Suspension or Reduction of Safe-Harbor Contributions

If a plan utilizes matching contributions to satisfy the safe harbor contribution requirement, the plan may be amended during the plan year to reduce or suspend those safe harbor matching contributions on participants' future elective contributions provided certain conditions are met:

- In the case of plan years beginning on or after January 1, 2015, the employer either:
    - is operating at an economic loss as described in IRC § 412(c)(2)(A) for the plan year; or
    - includes in the annual notice to participants a statement that the plan may be amended during the plan year to reduce or suspend safe harbor NECs and that the reduction or suspension will not apply until at least thirty (30) days after all eligible employees are provided notice of the reduction or suspension.
- All eligible employees are provided a supplemental notice that explains:
    - the consequences of the amendment that reduces or suspends future safe harbor contributions; and
    - the procedures for changing cash or deferred elections and (if applicable) employee after-tax contribution elections; and (C) the effective date of the amendment.
- The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of the date the amendment is adopted or thirty (30) days after eligible employees are provided the supplemental notice.
- Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections.
- The plan is amended to provide that the ADP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in Treas. Reg. § 1.401(k)-2(a)(2)(ii); and
- The plan satisfies all the requirements of Treas. Reg. § 1.401(k)-3 [the safe harbor regulations] with respect to amounts deferred through the effective date of the amendment [Treas. Reg. § 1.401(k)-3(g)(1)(i)].

If a plan utilizes NECs to satisfy the safe harbor contribution requirement, then for amendments adopted after May 18, 2009, the plan may be amended during the plan year to reduce or suspend those safe harbor NECs provided certain conditions are met:

- The employer either:
    - is operating at an economic loss, as described in IRC § 412(c)(2)(A) for the plan year; or
    - includes in the annual notice to participants a statement that the plan may be amended during the plan year to reduce or suspend safe harbor NECs and that the reduction or suspension will not apply until at least thirty (30) days after all eligible employees are provided notice of the reduction or suspension.
- All eligible employees are provided a supplemental notice that explains:
    - the consequences of the amendment that reduces or suspends future safe harbor contributions.
    - the procedures for changing cash or deferred elections and (if applicable) employee after-tax contribution elections; and
    - the effective date of the amendment.
- The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of the date the amendment is adopted or thirty (30) days after eligible employees are provided the supplemental notice.

- Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections.
- The plan is amended to provide that the ADP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in Treas. Reg. § 1.401(k)-2(a)(2)(ii); and
- The plan satisfies all the requirements of Treas. Reg. § 1.401(k)-3 [the safe harbor regulations] with respect to amounts deferred through the effective date of the amendment [Treas. Reg. § 1.401(k)-3(g)(1)(ii)].

Automatic Contribution Arrangement (ACA) in a 401(k)(12) Safe Harbor Plan

There are certain automatic contribution arrangements (ACAs) that have permeated 401(k) plan design in recent years and include:

- Automatic Contribution Arrangements (ACA).
- Eligible Automatic Contribution Arrangements (EACA); and
- Qualified Automatic Contribution Arrangements (QACA).

It is significant to note that a QACA, found in a 401(k)(13) Safe Harbor plan, can be utilized as an alternative safe-harbor arrangement to a 401(k)(12) Safe Harbor plan. The 401(k)(12) Safe Harbor plan does not require that the CODA include an ACA. That is, in contrast to the QACA 401(k)(13) Safe Harbor plan, a 401(k)(12) Safe Harbor plan may require affirmative elections to defer. However, nothing found in a 401(k)(12) Safe Harbor plan precludes a plan from including an ACA.

Next, we will examine the second safe harbor plan design: the 401(k)(13) Safe Harbor plan.

401(k)(13) Safe Harbor Plan

The Pension Protection Act (PPA) of 2006 (Public Law 109-280), Section 902, added IRC §§§ 401(k)(13), 401(m)(12) and 414(w), which relieves employers who automatically enroll employees into 401(k) plans with a *qualified automatic contribution arrangement* (QACA) from certain "*non-discrimination*" rules that would otherwise apply.

In 2009, the IRS promulgated final regulations addressing automatic enrollment, "*Automatic Contribution Arrangements*, 74 Fed. Reg. 8,200 February 24, 2009 (to be codified at 26 C.F.R. pts. 1 and 54). A QACA allows an employer to automatically enroll employees in the plan and establish a minimum contribution level (discussed below). The objective of automatic enrollment is to encourage employees to increase their retirement savings by eliminating the need to make an affirmative election to participate in the plan with a default percentage contributed. Instead, they must opt out of participating or for a lower contribution. As the GAO reported in 2009, existing studies have shown that automatically enrolling employees in 401(k) plans can substantially increase participation rates (GAO-10-31).

A plan that includes a QACA must include safe-harbor non-elective contributions or matching contributions and meet certain other requirements. If it does, it will satisfy both the ADP and ACP tests. A QACA can also include an eligible automatic contribution arrangement (EACA) discussed below.

QACA Contributions

To encourage more employers to adopt automatic enrollment, the new law establishes 401(k) "S*afe-Harbor*" plans to include employer contributions, computed in a manner similar to those of a traditional Safe Harbor plan. Under IRC § 401(k)(13)(D)(i), the employer must make either minimum non-elective contributions (NECs) to all employees covered in the plan or make matching contributions.

QACA Minimum Non-elective Contributions

If a participant fails to make an election to defer compensation into the plan, the QACA must provide that no less than 3 percent of the participant's compensation must be deferred into the plan during the plan year in which the employee becomes a plan participant and the following plan year. After that plan year, the QACA must provide that the deferral percentage will increase by at least one percentage point each plan year thereafter until the participant's rate of deferral equals 6 percent of compensation [Treas. Reg. § 1.401(k)-3(j)(2)]. Employees will be fully vested in any employer contribution after two years of service.

The percentage automatically withheld must apply uniformly to all employees covered by the plan and must not exceed 10 percent of salary.

QACA Matching Contribution

The employer can provide QACA matching contributions for NHCEs must be 100 percent of the first 1 percent of compensation plus 50 percent of the next 50 percent of compensation. This produces a 3.5 percent match for an employee who contributes at least 6 percent of compensation. This is slightly less than the 4 percent match discussed above for a traditional safe harbor plan.

The type of safe harbor contribution selected must be described in the annual notice to eligible participants.

Notice Requirements

As with a traditional Safe Harbor plan, each year, a written notice of the employees' rights and obligations under the plan must be provided to the participants to whom the QACA applies. The plan may provide the notice electronically if it complies with the rules in Treas. Reg. § 1.401(a)-21. The notice must be sufficiently accurate and comprehensive to inform employees of their rights and obligations under the plan and be written in a way that is calculated to be understood by the average eligible employee.

In addition to the information required for a traditional Safe Harbor plan, the notice for a QACA must explain the following:

- Investment provisions describing the plan methods of investing the trust or custodial funds, including funding options, the availability of loans, and self-directed investments.
- Administrative provisions such as how responsibilities are allocated among fiduciaries, the resignation or replacement of fiduciaries, claims procedures, recordkeeping requirements; and
- CODAs.

The notice timing requirement will be satisfied if the notice is provided at least 30 days (and not more than 90 days) before the beginning of each plan year or in the case of a new employee, not more than 90 days before the employee is eligible to participate. The plan must provide the notice early enough that the employee has reasonable time to make the elections on whether to have a different amount or percentage contributed or no contribution made and how any contributions made are to be invested. Under Treas. Reg. § 1.401(k)-3(k)(4)(iii), the default election cannot become effective sooner than the earlier of the pay date for the second payroll period beginning after the date the notice is provided and the first pay date that is at least 30 days after the notice is provided.

> ***For Example:*** An employer pays its employees on the first and fifteenth of every month. On July 1, the first day of the pay period ending on July 15th, it provides the required notice concerning the QACA and how to change the default elections. The default election cannot become effective until August 15.

Safe Harbor Contributions Not Eligible for Hardship Distribution

Safe-harbor contributions are not eligible for a hardship withdrawal. This is because safe harbor contributions must satisfy the distribution restrictions of IRC § 401(k). Still, hardship distributions under that Code section and the corresponding regulations are limited to contributions pursuant to a cash or deferred election to a 401(k) plan or pursuant to a salary reduction agreement to a 403(b) plan. Safe harbor contributions are not elective contributions to a 401(k) or 403(b) plan and so are not eligible for hardship withdrawal [IRC § 401(k)(12)(E) (i); IRC § 401(k)(13(D)(iii)(II)].

No Exception from Safe Harbor Matching Contributions for Catch-Up Contributions

If a plan uses safe harbor matching contributions to satisfy the ADP safe harbor requirements and permits age-50 catch-up contributions, the safe harbor matching contributions must be applied to the age-50 catch-up contributions to the extent the safe harbor matching contributions would otherwise apply to elective deferrals under the plan. The preamble to the 401(k) regulations issued in 2004 made clear that there is no exception with respect to those catch-up contributions.

> ***For Example*:** A participant could contribute the maximum dollar amount ($23,000 for 2024) before receiving the plan's maximum match as limited by the compensation limit ($345,000 for 2024). If the plan matched elective deferrals dollar for dollar up to 8% of compensation, the compensation limit would cap matching contributions at $23,000 (6.7% of $345,000), and $3,500 of catch-up contributions would need to be matched.

A safe harbor plan document must specify which safe harbor is used and which safe harbor contributions are used to satisfy the safe harbor requirements, as well as any optional provisions applicable to the selected safe harbor. The plan document cannot provide that ADP or ACP testing will be used if the ADP or ACP safe harbor requirements are not satisfied [Treas. Reg. § 1.401(k)-1(e)(7) and Treas. Reg. § 1.401(m)-1(c)(2)].

Traditional vs. QACA Safe Harbor

The 401(k) plan is relieved of complying with the ADP and ACP tests with both safe harbors. The major difference between the two safe-harbors is that the QACA safe-harbor imposes minimum contribution percentages (see Table 5.1). A traditional Safe Harbor plan can have an automatic contribution arrangement that does not meet the QACA minimum percentages and is not subject to uniformity. However, the employer contributions under a traditional Safe Harbor plan must immediately be fully vested, while a QACA Safe Harbor plan can use a vesting schedule. The QACA Safe Harbor also requires a slightly lower employer match requirement. If an employee contributes 5 percent, the traditional Safe Harbor plan results in a 4 percent employer match, while a QACA Safe Harbor produces a 3.5 percent match.

Qualified Default Investment Alternatives

If an employee becomes a participant through a QACA or EACA, elective deferrals and contributions may be made before the individual has chosen how the funds should be invested. If the plan fiduciary invests the funds in a Qualified Default Investment Alternative (QDIA), the participant is considered to have exercised control over the investment of the account assets, and the fiduciary is not liable for their performance.

Eligible Automatic Contribution Arrangements (EACA)

An Eligible Automatic Contribution Arrangement (ECAC) can be part of a safe-harbor 401(k) plan or a QACA. It can be applied to all employees or only to employees who become eligible to participate in the plan after the ECACs effective date.

Table 5.1
Traditional Safe Harbor vs. QACA Safe-Harbor Comparison

Basic Design Requirements	Traditional 401(k)(12) Safe Harbor	QACA 401(k)(13) Safe Harbor
Safe Harbor Matching Contributions	Match each plan year 100% of first 3% of safe harbor compensation deferred by each eligible NHCE, plus 5% of next 2% of safe harbor compensation deferred by the NHCE (4% of compensation total).	Match each plan year 100% of first 1% of safe harbor compensation deferred by each eligible NHCE, plus 50% of next 5% of safe harbor compensation deferred by the NHCE.
Or	**Or**	**Or**
Safe Harbor NEC	Provide each plan year a non-matching NEC contribution of at least 3% of safe harbor compensation to each eligible NHCE	Provide each plan year a non-matching NEC of at least 3% of safe-harbor compensation to each eligible NHCE.
Vesting of Safe Harbor Employer Contribution	Immediate 100% vesting	100% vesting after two years of service
Limitations on Matching Contributions	Matching contributions cannot be made with respect to elective deferrals (including Roth contributions) or employee non-Roth after-tax contributions that exceed 6% of an employee's safe harbor compensation. **And** Discretionary matching contributions cannot exceed 4% of a safe harbor compensation safe harbor compensation	Matching contributions cannot be made with respect to elective deferrals (including Roth contributions) or employee non-Roth after-tax contributions that exceed 6% of an employee's safe harbor compensation. **And** Discretionary matching contributions cannot exceed 4% of safe-harbor compensation safe harbor compensation

Source: The American Society of Pension Professionals & Actuaries
https://www.asppa.org/news/traditional-safe-harbor-401k-plan-vs-qaca-—-how-choose

Timeline for Making Safe Harbor 401(k) Plan Contributions

Employer contributions to a retirement plan can be made anywhere from the first day of the plan year through the due date of the company's income tax return for that year. With respect to safe harbor contributions, timing options are as outlined below:

- Matching contributions may be funded under one of the following options:

  - *Each payroll period*. Under this option, only that pay period's compensation and contribution are taken into consideration for determining the match to be allocated at that time.
  - *Monthly*. All pay periods in a month are taken into consideration for determining the match to be allocated that month.
  - *Quarterly*. All pay periods in a quarter are taken into consideration for determining the match to be allocated that quarter; and
  - *Plan Year*. All pay periods during the year are considered for determining the match to be allocated that year.
- Non-elective contributions (NECs) may be funded during the year but must always be reviewed at the end of the year to confirm that each participant receives 3% of the pay.

Deadline to Start a Safe Harbor 401(k) Plan

Plans must send out Safe Harbor notices by September 1, 2025, to start a new Safe Harbor plan for 2025. New Safe Harbor plans must allow employees to save into the 401(k) for at least three months in the plan's first year. This means that the plan must be effective as of October 1, 2025. Since employees need to have 30 days' notice — the plan must send notices no later than September 1st—the effective date of the plan.

SIMPLE 401(k) Plans

Under IRC §§ 401(k)(11)(A) and 401(m)(10), a plan sponsor (employer) can establish a SIMPLE 401(k) that can be treated as meeting the ADP tests of IRC § 401(k)(3)(A)(ii) and the ACP test of IRC § 401(m)(2). By limiting employer contributions to only the matching contributions or the non-elective contributions, the SIMPLE 401(k) plan also satisfies the top-heavy rules. But the plan sponsor is required to make employer contributions that are fully 100% immediately vested.

SIMPLE 401(k) plans closely follow the requirements for SIMPLE IRA plans described in IRC § 408(p). Still, SIMPLE IRA plans are far more popular with employers because the IRA plans are less burdensome to set up and maintain; for example, Form 5500 is not required for SIMPLE IRA plans.

SIMPLE 401(k) Eligible Employers

Any employer with 100 or fewer employees with at least $5,000 of compensation in the preceding calendar year is eligible to set up a SIMPLE 401(k) plan. Eligible employers include:

- Self-employed individuals.
- Corporations.
- Partnerships.
- Tax-exempt entities (Except Government employers); and
- Indian Tribal governments.

An eligible employer who establishes a SIMPLE 401(k) plan cannot maintain any other plan for eligible employees to participate in the SIMPLE 401(k) plan and cannot receive any contributions or benefit accruals under any other plans of the employer. By contrast, provided certain requirements are met, an employer who establishes a traditional 401(k) plan may choose to establish a SEP IRA, profit-sharing, or other defined contribution plan, maintain both plans concurrently and allow eligible employees to participate in both plans.

SIMPLE 401(k) Contributions

Below are the 2025 contribution limits for a SIMPLE 401(k) plans which are similar to the contribution limits for a SIMPLE IRA. The pan allows:

- Employee Elective Deferral Contributions.
- Catch-up Contributions; and
- Employer Matching Contributions
- Employer Non-Elective Contributions

Employee Elective Deferral Contributions

The 2025-dollar limitation on elective contributions is $16,500 (up from $16,000 in 2024). In addition, the SECURE 2.0 Act of 2022, Section 117, provides an increase to the annual deferral limit (and the catch-up contribution, discussed below) at age 50 by 10 percent, as compared to the limit that would otherwise apply ($16,500), in the case of an employer with no more than 25 employees. For 2025, the amount will be $17,600 ($16,500 = $1,650).

Note: An employer with 26 to 100 employees would be permitted to provide higher deferral limits, but only if the employer either provides a 4 percent matching contribution or a 3 percent employer contribution.

Catch-Up Contributions

There is also a provision for catch-up contributions for participants who have reached ages 50 – 59 or age 64 and older of $3,500. The SECURE 2.0 Act of 2022, Section 109, provides an enhanced contribution for those participants ages 60, 61, 62, and 63 of $5,250 in 2025 [IRC § 414(v)(2)].

In addition, Section 117 of the SECURE 2.0 Act 0f 2022 also increases the annual catch-up contribution at age 50 by 10 percent, to $3,850 as compared to the $3,500 limit that would otherwise apply, in the case of an employer with no more than 25 employees. An employer with 26 to 100 employees would be permitted to provide higher deferral limits, but only if the employer either provides a 4 percent matching contribution or a 3 percent employer contribution.

Employer Matching Contributions

Under the employer matching contribution, the employer must generally match employee deferrals on a dollar-for-dollar basis of up to 3% of the employee's compensation for the calendar year. An employer's matching percentage cannot be greater than 3% of an employee's compensation. However, in two out of every five years, the employer has the option of electing a matching percentage as low as 1% of each eligible employee's compensation. In determining whether the limit was reduced to below 3%, years in which an employer (or a predecessor employer) did not maintain a SIMPLE IRA plan and years in which the employer had such a plan but chose to make a non-elective contribution (discussed below) are treated as a year for which the limit was 3% (IRS Notice 98-4, D-5). For purposes of the matching contribution, compensation for 2025 is not limited to $350,000 by IRC § 401(a)(17). Therefore, an employee who earns $517K and elects to contribute $16,500 will receive a full match of $16,500 for a total contribution of $33,000. Also, matching contributions must be based on an employee's entire calendar-year compensation, regardless of when the employee starts or stops deferrals during the year.

Employer Non-Elective Contribution

Alternatively employers can choose the non-elective contribution method, which requires contributing a fixed 2% of each eligible employee's compensation, regardless of whether the employee makes any elective deferrals to the plan. The non-elective contribution is particularly advantageous for employees who might not otherwise participate in the plan, as it ensures they still receive employer provided retirement savings.

IRC § 408(p)(2)(A)(iv) establishes the maximum limit on additional nonelective contributions that an employer can make to an employee's SIMPLE 401(k) plan. For 2025, this limit has been increased from $5,000 to $5,100 to account for inflation adjustments. This provision is critical in scenarios where the employer opts to make nonelective contributions instead of matching employee deferrals. Under this limitation, employers who choose the nonelective contribution route are required to contribute a fixed percentage of an employee's compensation, generally 2%, regardless of whether the employee makes elective deferrals. The increase from $5,000 to $5,100 means that the 2% nonelective contribution applies only up to a compensation cap of $255,000 (calculated as $5,100 ÷ 2%), ensuring that higher-income employees do not receive disproportionately large contributions. This adjustment aligns with the goal of preserving the plan's intended benefit structure, which is to encourage consistent contributions to retirement savings while adhering to reasonable limits on employer expenditures.

This modest increase helps maintain the value of nonelective contributions in real terms, ensuring that employees continue to receive meaningful support toward their retirement savings, even as wages and inflation rise. Employers offering SIMPLE retirement accounts or SIMPLE 401(k) plans should be mindful of this updated limit when planning their contributions to ensure compliance with IRS regulations.

Note: As discussed above, Section 117 increases the annual deferral limit and the catch-up contribution at age 50 by 10 percent, in the case of an employer with no more than 25 employees. An employer with 26 to 100 employees would be permitted to provide higher deferral limits, but only if the employer either provides a 4 percent matching contribution or a 3 percent employer contribution.

SIMPLE 401(k) plans are subject to the same "*annual additions*" limits of IRC § 415(c). Additions to a participant's account cannot exceed the lesser of $70,000 or 100% of compensation (maximum for 2025). Also, the compensation limit applies to both plans, which means the employer cannot consider compensation in excess of $350,000 for 2025 for plan purposes.

Deadline to Establish SIMPLE 401(k)

A SIMPLE 401(k) must be established between January 1 and October 1. An exception applies to businesses that come into existence after October 1. The plan can be established for these businesses as soon as administratively feasible.

Annual Notice Requirements

There are special election and notice requirements for SIMPLE 401(k) plans:

- For an employee's initial year of participation, they must be permitted to make a cash or deferred election under the plan during a 60-day period that includes either the day the employee becomes eligible or the day before; and
- For each subsequent year, the employee must be permitted to make or modify their cash or deferred election during the 60-day period immediately preceding such calendar year.

An eligible employee must be permitted to terminate their cash or deferred election at any time.

The employer must notify each eligible employee within a reasonable time prior to each 60-day election period that they can make or modify a cash or deferred election and whether the employer will be making matching or non-elective contributions for the year.

Table 5.2 illustrates a comparison of total contributions between a traditional 401(k) plan and a SIMPLE 401(k) plan in 2025.

Table 5.2
Comparison of Total Contribution Limits: Traditional 401(k) vs. SIMPLE 401(k)

Contribution Type	Traditional 401(k)	SIMPLE 401(k)
Elective Deferrals	$16,5000	$16,500
Catch-up (Ages 50-59 or 64+)	$7,500	$3,500
Catch-up (Ages 60-63)	$11,250	$5,250
Total Contributions (under 50)	$70,000 (combined employee and employer contributions)	Employee deferral plus employer match/non-elective contribution
Total Contribution (Age 50+)	$77,500 (combined	Employee deferral plus catch-up and employer contributions
Total Contribution (Ages 60 -63)	$81,250 (combined)	Employee deferral plus catch-up and employer contributions

Note: The total contribution limits for traditional 401(k) plans include both employee and employer contributions, with a maximum of $70,000 for individuals under 50 and $77,500 for those aged 50 and above. For participants aged 60 to 63, the limit increases to $81,250. SIMPLE 401(k) plans have different structures, and total contributions depend on elective deferrals, catch-up contributions, and employer matching or non-elective contributions.

Note: Employees are 100% immediately vested in all contributions. Loans are permitted. In-service withdrawals are permitted on account of hardships.

Individual (Solo) 401(k) Plan

The Individual 401(k) is a self-employed retirement plan that is sometimes referred to as an "Individual (k)," "Solo 401k", "Single (k)," and "Self Employed 401k". The Individual 401(k) came about with the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA). This tax law became effective beginning January 1, 2002, and provides significant advantages to small business owners whose only employee is the owner and the owner’s spouse.

What makes the Individual 401(k) unique is that greater contributions may be made at identical income levels compared to other self-employed retirement plans, therefore maximizing retirement contributions and valuable tax deductions (discussed below).

Employer Eligibility

The Individual 401(k) is for owner-only businesses or owner and spouse businesses. The business can be:

- Incorporated (or unincorporated)
- Sole proprietors
- Partnerships
- S corporations

- C corporations; and
- Limited Liability Corporations.

A business that employs part-time W-2 employees may exclude them from plan participation. Independent contractors (IRS Form 1099 employees) employed by the business are excluded from the plan. They would not disqualify the employer from setting up an Individual 401k. Generally, under federal law, the following types of employees are permitted to be excluded:

- Employees under age 21.
- Employees with less than one year of service.
- W-2 employees who work less than 1000 hours per year.
- Certain union employees; and
- Certain nonresident alien employees.

Plan Benefits

The Individual 401(k) plan has several benefits for small business owners and the self–employed:

- Higher Contribution Limits
- Tax-Deductible Contributions
- Tax-Deferred Growth
- Contribution Flexibility
- Access to Tax-Free Loans
- Cost-Effective Administration; and
- Retirement Plan Consolidation.

Compared to a Traditional 401(k), the Individual 401(k) plan is easy, flexible, and inexpensive to maintain because the administration is minimal, and complex nondiscrimination tests are not required. Fees vary depending on the level of administrative services provided by the Individual 401(k) administrator. If an Individual 401(k) is greater than $250,000, IRS Form 5500 needs to be filed. The administrator may charge a fee for its completion, or the individual could complete the form themselves.

Another important feature of the Individual 401(k) plan is the opportunity for small business owners to consolidate retirement assets into one account. This includes Traditional IRAs, SEP IRA Plans, 401(k) Plans, Money Purchase Plans, SIMPLE IRAs, Profit Sharing Plans, Defined Benefit Plans, 403(b) Plans, and IRA Rollovers.

Consolidating retirement accounts is particularly important if the individual small business owner would like to use the loan provision (discussed below). Other advantages of rolling over and consolidating their retirement plans into their Individual 401(k) are improved financial organization and ease of monitoring the retirement portfolio.

Contributions

Individual 401(k) retirement plans may provide significant tax savings because, in general, the small business owner may deduct 100% of contributions made into an Individual 401(k) from their taxable income. Incorporated businesses can generally deduct the salary deferral contribution from W-2 earnings and the profit-sharing contribution as a business expense. Unincorporated businesses such as sole proprietors can generally deduct contributions made to an Individual 401(k) from personal income (discussed below).

Individual 401(k) contribution limits are $70,000 in 2025 ($77,500 if age 50-59 and 64 and older or $81,250 aged 60-63). The annual Individual 401(k) contribution consists of two parts:

- A salary deferral contribution; and
- A profit-sharing contribution.

The total allowable contribution adds these two parts together to get to the maximum Individual 401(k) contribution limit.

Note: Individual 401(k) salary deferral contributions can be made as Roth 401(k) (after tax) or traditional 401(k) (pre-tax).

Calculation for an S or C corporation or an LLC taxed as a corporation:

- *Salary Deferral Contribution*: In 2025, 100% of W-2 earnings up to the maximum of $23,500 or $31,000 ($7,500 catch up contribution) if age 50-59 or 64 and older; for those participants aged 60, 61, 62, or 63, the maximum of $23,500 or $34,750 ($11,250 catch-up contributions), can be contributed to an Individual 401(k); and
- *Profit-Sharing Contribution:* A profit-sharing contribution of up to 25% of W-2 earnings can be contributed to an Individual 401(k).

Individual 401(k) contribution calculation for a sole proprietorship, partnership, or an LLC taxed as a sole proprietorship:

- *Salary Deferral Contribution:* Although the term salary deferral is used, these businesses do not provide a W-2 salary to the business owner. The salary deferral contribution is based on net adjusted business profit for businesses of this type. Net adjusted business profit is calculated by taking gross self-employment income, subtracting business expenses, and then subtracting 1/2 of the self-employment tax. In 2025, 100% of net adjusted business profits income up to the maximum of $23,500 or $31,000 if age 50-59 or 64 an older, or $$34,750 if aged 60, 61, 62, or 63 can be contributed in salary deferrals into an Individual 401(k); and
- *Profit-Sharing Contribution*: A profit-sharing contribution can be made up to 20% of net adjusted businesses profits. Net adjusted business profit is calculated by taking gross self-employment income, subtracting business expenses, and then subtracting 1/2 of the self-employment tax.

Each year the funding of an Individual 401(k) retirement plan is completely discretionary. The individual can increase or decrease your salary deferral and/or profit-sharing contributions depending on the profitability of your business.

Loans

Like a traditional 401(k), an Individual 401(k) loan is permitted at any time using the accumulated balance of the 401(k) as collateral for the loan. Individual loans are permitted up to ½ of the total balance of the 401(k) up to a maximum of $50,000. An individual 401(k) loan is received tax-free and penalty-free. There are no penalties or taxes due, provided loan payments are paid on time.

Generally, Individual 401(k) loans have a 5-year maximum repayment term. Individual 401(k) loans used to purchase a primary residence may extend the loan repayment term up to 10-15 years. Loans must be repaid according to the terms of the loan amortization schedule, which is provided when a loan is initiated. Failure to repay the loan according to these terms may result in a loan default causing taxes as well as IRS penalties.

Loan payments are made monthly or quarterly. Loan payments of principal and interest are repaid into the individual's own Individual 401(k). Because of this, an Individual 401(k) loan may be a favorable option compared to other loans where interest is paid to the bank or lending institution.

The proceeds from an Individual 401(k) loan can be used for any purpose, and there are no income or credit qualifications to receive the loan. The ease of an Individual 401(k) loan is attractive because start-up businesses and self-employed business owners often struggle to qualify for a self-employed loan through banks and lending institutions.

Note: Loans are not permitted with traditional IRAs or Roth IRAs, SEP IRAs, or Keogh (Money Purchase/Profit Sharing Plans).

IRS requires that the employer notify each employee of the availability of the feature when they become a participant and each year thereafter. The employee has a reasonable period of time to elect out of the automatic enrollment feature.

According to Vanguard's, "*How America Saves Report 2024"*, in 2023, 81% of Vanguard DC plans permitted participants to borrow from their plan, and 91% of active participants had access to a loan feature. Thirteen percent of participants had a loan outstanding at year-end 2023. On average, the outstanding loan account balance was 9% of the participant's account balance, excluding the loan, and the average participant had borrowed about $10,700.

Outstanding loans are typically excluded from measures of plan and participant assets because these assets have, in effect, been withdrawn from the plan and are not currently available as a retirement resource.

Loans are sometimes criticized as a form of revolving credit for younger, lower-income workers. While that may be partly true, loan use by age follows a hump-shaped profile, with use highest among participants in their prime working years. Among workers ages 45 to 54, 18% had a loan outstanding in 2023. Men and women used loans at similar rates.

Among Vanguard plans, the fraction of participants taking loans from their DC plans has generally declined since 2014. In addition, for reasons not well understood, there appears to be a pronounced seasonality to taking loans, with borrowing typically peaking in the summer months. Throughout 2023, overall loan initiations increased modestly from 2022 but remained below the pre-pandemic rate.

Chapter 5
Review Questions

1. Which of the following statements about Safe Harbor 401(k) plans is FALSE?

( ) A. Provides for employer contributions that are fully vested when made.
( ) B. Eliminates the nondiscrimination and top-heavy tests ordinarily applied under a traditional 401(k) plan.
( ) C. There are requirements pertaining to the number of employees in the organization
( ) D. Ideal for businesses with highly compensated employees (HCEs) whose contributions would be limited in a traditional 401(k) plan.

2. Under the 401(k)(12) Safe Harbor plan basic match formula, what is the maximum matching contribution required for an employee to meet the safe harbor requirement?

( ) A. 10% of compensation
( ) B. 6% of compensation
( ) C. 3.5% of compensation
( ) D. 4% of compensation

3. Which of the following enacted by Congress added IRC § 401(k)(13) Safe Harbor plans?

( ) A. The Pension Protection Act (PPA) of 2006
( ) B. The Small Business Job Protection Act (SBJA) of 1996
( ) C. The Deficit Reduction Act (DRA) of 2005
( ) D. The Economic Growth Tax Relief Reconciliation Act (EGTRRA) of 2001

4. Evaluate the employer match percentage under a Qualified Automatic Contribution Arrangement (QACA) Safe Harbor plan. Given that an employee contributes 6 percent of their salary, what percentage match will the employer provide?

( ) A. 1%
( ) B. 3.5%
( ) C. 4%
( ) D. 6%

5. Apply your understanding of regulatory requirements to determine the asset threshold for filing Form 5500 for an individual 401(k) plan. At what amount of plan assets must Form 5500 be filed?

( ) A. $250,000
( ) B. $100,000
( ) C. $500,000
( ) D. $150,000

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CHAPTER 6

COMBINATION PLANS

Overview

Many large firms are converting their DB plans into hybrid DB plans to cap their pension liabilities. We also see several small- and midsize firms are starting to rely on these plans, which, when used in combination with a 401(k) plan, can help participants cut their current tax bill and sock away quite a bit of money for retirement. These "*combination plans*" were authorized after Congress passed the Pension Protection Act of 2006, specifically Section 903, which created IRC Section 414(x) in the Internal Revenue Code.

This chapter will examine the benefits of "*Eligible Combined Plans*." It will begin with a history and background of the legislative changes that enacted IRC § 414(x). Then discuss its legal structure, minimum benefits, vesting, and eligibility requirements.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Describe the Background of the DB(k) Plan
- Identify Who Can Benefit from Setting Up a DB(k) plan.
- Recognize the Structure of the DB(k) Plan
- Identify the Eligibility Requirements under IRC § 414(x), Its Minimum Benefits, Vesting, and Eligibility Requirements
- Determine the Minimum Benefits and Vesting Requirements
- Outline the Considerations for Adopting an Eligible Combination Plan

Background

Section 903 of the Pension Protection Act of 2006 allows an employer, beginning in 2010, to adopt an "*Eligible Combined Plan*," consisting of a DB plan and a DC plan, more than likely a 401(k) profit-sharing plan held in a single trust, using one plan document, one summary plan description, one Form 5500, and one audit (if required). The idea behind the Combination Plan was simple. By combining a DB plan and a DC plan, a small employer (at least 2 but less than 500 employees) could reduce the two separate plans' costs and administration requirements. In addition, the Combination Plan would enable the small employer to offer the guaranteed income of a pension and the opportunity for the workers to save in a DC plan (401(k) plan).

Eligible Combined Plan

Under IRC § 414(x)(2)(A) of the Code, an "*eligible combined plan*" is a plan:

- That is maintained by a small employer (defined below) at the time the plan is established.
- That consists of a DB plan and an applicable DC plan.
- The assets of which are held in a single trust forming part of the plan and are clearly identified and allocated to the DB plan and the applicable DC plan to the extent necessary for the separate application of the Code; and
- That meets the benefit, contribution, vesting, and non-discrimination requirements under IRC § 414(x).

Eligible Small Employers

Under IRC § 414(x)(2)(A), an eligible "*small employer*" is generally an employer (considering the rules of IRC § 414(b), (c), (m), and (o) that employed an average of at least 2 but not more than 500 employees on each business day during the preceding calendar year and who employs at least 2 employees on the first day of the plan year.

In the case of an employer that was not in existence throughout the preceding calendar year, the determination of whether the employer is a small employer is based on the average number of employees it is reasonably expected the employer will employ on business days in the current calendar year.

IRC § 414(x) (7) defines an "*applicable defined contribution plan*" as a DC plan that includes a qualified cash or deferred arrangement.

Eligibility Requirements for Combined Plans

IRC § 414(x)(1) provides that the Code's requirements are applied to a DB plan or applicable DC plan that is part of an eligible combined plan in the same manner as if each such plan were not a part of the eligible combined plan. Further, in the case of the termination of both the DB plan and the applicable DC plan forming an eligible combined plan, the DB plan and the applicable DC plan must be terminated separately by the plan administrator. Under IRC § 414(x)(6)(A), the rules of IRC § 414(k), which determine the requirements applicable to DB pension plans with separate participant accounts, do not apply to eligible combined plans.

Minimum Benefits and Vesting under DB Plan

Under IRC § 414(x)(2)(B), the DB plan that forms part of the eligible combined plan must provide each participant with a minimum employer-provided accrued benefit. The minimum benefit must be an annual retirement benefit that is not less than the applicable percentage of the participant's final average pay. For this purpose, the applicable percentage is the lesser of:

- 1 percent multiplied by the participant's years of service with the employer; or

- 20 percent.

Final average pay is determined using consecutive years (not exceeding five) during which the participant had the greatest aggregate compensation from the employer.

As an alternative to the minimum benefits mentioned above, the DB component of the eligible combined plan may be a Cash Balance Plan, under which the accrued benefit is calculated as the balance of a hypothetical account or an accumulated percentage of the participant's average compensation, and which meets the applicable interest credit requirements of IRC § 411(b)(5)(B)(i) (as added by the PPA of 2006). The plan would be treated as meeting the benefit requirements if each participant received a pay credit for the year, which is not less than a specified percentage of compensation, based on the participant's age (see Table 6.1). For participants aged 30 or less at the beginning of the year, the percentage is 2. The applicable percentage increases to 4 for participants older than 30 but younger than 40; 6 for participants older than 40 but younger than 50; and 8 for participants aged 50 or older.

Table 6.1
Minimum Benefit Rules

Participant's Age as of Beginning of Plan Year	Percentage
30 or less	2
Over 30 but less than 40	4
40 or over but less than 50	6
50 or over	8

For purposes of the minimum benefit rules, years of service are determined under the rules of IRC § 411(a)(4), (5), and (6), except that the plan may not disregard any year of service merely because a participant makes, or fails to make, any elective contributions under the qualified cash or deferred arrangement that is included in the applicable DC plan that forms part of the eligible combined plan.

Under IRC § 414(x)(2)(D)(i), a participant must be fully vested in their employer-provided accrued benefit under the DB plan after the completion of three (3) years of service.

Minimum Contributions and Vesting under DC Plans

Under IRC § 414(x)(2)(C), the applicable DC plan that forms part of the eligible combined plan must meet certain contribution requirements. In particular, the qualified cash or deferred arrangement included in such plan must constitute an automatic contribution arrangement, pursuant to which each eligible employee is treated as having elected to make an elective contribution of 4 percent of compensation. However, an eligible employee may elect not to make such contributions or elect contributions at a different enrollment rate.

In addition, the employer must be required to make matching contributions on behalf of each employee eligible to participate in the qualified cash or deferred arrangement. To satisfy the basic matching contribution requirement in IRC § 414(x)(2)(C)(i)(II), matching contributions must be made in an amount equal to 50 percent of the elective contributions of the employee to the extent such elective contributions do not exceed 4 percent of compensation. Alternatively, the plan may provide for a different rate of matching contribution, provided that the rate of matching contribution does not increase as the participant's rate of elective contribution increases. The aggregate amount of matching contributions at each rate of elective contribution is no less than the aggregate amount of matching contributions provided under the basic matching contribution requirement. In no case may the rate of matching contribution for any elective contribution of a highly compensated employee at any rate of elective contribution be higher than the rate of matching contribution for an NHCE.

The applicable DC plan can also provide for non-elective employer contributions (NECs), but non-elective contributions are not considered in determining whether the matching contribution requirements are met.

Under IRC § 414(x)(2)(D)(ii)(l), all participants must be fully vested in any matching contributions provided under the applicable DC plan, including any matching contributions exceeding required matching contributions. In addition, under IRC § 414(x)(2)(D)(ii) (ll), a participant must be fully vested in any non-elective contributions under the applicable DC plan after completion of three (3) years of service.

Under IRC § 414(x)(2)(E), all contributions and benefits under the DB plan and applicable DC plan forming part of the eligible combined plan, and all rights and features under each such plan must be provided uniformly to all participants.

Under IRC § 414(x)(2)(F), the minimum benefit and contribution requirements applicable to the DB plan and applicable DC plan must be met without application of the permitted disparity rules under IRC § 401(l). In addition, the DB plan and applicable DC plan must meet the nondiscrimination requirements under IRC § 401(a)(4) and the minimum coverage requirements under IRC § 410(b) without application of the permitted disparity rules and without being combined with any other plan.

Nondiscrimination and Top-Heavy Requirements

Under IRC § 414(x)(3), a qualified cash or deferred arrangement that is included in the applicable DC plan that forms part of an eligible combined plan and that meets the minimum contribution requirements described above is treated as meeting the actual deferral percentage (ADP) test under IRC § 401(k) on a safe harbor basis. In addition, in applying the safe harbor contribution percentage test for matching contributions under IRC § 401(m)(11), the minimum contribution requirements described above, and the notice requirements described below are substituted for the otherwise applicable minimum contribution and notice requirements.

Under IRC § 414(x)(4), a DB plan and applicable DC plan forming part of an eligible combined plan for any plan year are treated as meeting the top-heavy requirements under IRC § 416.

Automatic Contribution and Notice Requirements

Under IRC § 414(x)(5), the qualified cash or deferred arrangement that is included in an eligible combined plan is treated as an automatic contribution arrangement (ACA) if it meets certain notice and election requirements and provides that each employee eligible to participate in the arrangement is treated as having elected to make elective contributions in an amount equal to four (4) percent of the employee's compensation unless the employee specifically elects not to have such contributions made or to have such contributions made at a different rate. Each employee eligible to participate in the qualified cash or deferred arrangement must receive a notice explaining the employee's right to elect not to have elective contributions made on the employee's behalf or to have the contributions made at a different rate. Each eligible employee must also have a reasonable period after receiving the notice and before the first elective contribution is made to make an election. In addition, within a reasonable period before any year, each eligible employee must be given notice of the employee's rights and obligations under the arrangement. The notice must be sufficiently accurate and comprehensive to apprise the employee of the employee’s rights and obligations and must be written in a manner calculated to be understood by the average eligible employee.

Considerations for Adopting a Combination Plan

Under IRC § 414(x), benefits may be required to vest over a shorter period than they would otherwise be required to under the plan's terms. Likewise, the contributions required may or may not be greater than the current contribution requirements depending on many factors, including the plan’s current top-heavy status, DB plan formulas, actual employee turnover, etc. While there are many things to consider when adopting any type of retirement plan, the major considerations include:

- *Required Funding.* Given the volatility of the stock market and the inflexible funding requirements mandated by the PPA of 2006, by utilizing IRC § 414(x), an employer (plan sponsor) gives up the flexibility of discretionary matching contributions found in the 401(k) world and the DB plan contribution must be funded no matter what the magnitude.
- *Cash Flow*. Consistent and positive cash flow is a must for this type of plan.
- *Company Size.* Small, owner-dominated companies that have both types of retirement plans are the most likely candidates; and
- *Impact of Current Testing.* The more the plans are already affected by the top-heavy and non-discrimination rules, the more preferable this arrangement becomes.

Table 6.2 identifies some high-level considerations and comments on whether an eligible combination plan under IRC §414(x) plan merits consideration:

Table 6.2
IRC § 414(x) Requirements

Employer Type	Current Defined Benefit Plan	Consistent and Positive Company Cash Flow	Refunds in 401(k) Plan	Already Top Heavy	IRC § 414(x) Worthy of Consideration
Small, 25 Employees	Yes	Yes	Yes	Yes	Yes–this type of arrangement may be less expensive than a safe harbor defined contribution plan (for the DC plan).
Medium, 250 Employees	Yes	Yes	Yes	Yes	Maybe–this is an efficiency issue, providing the minimum benefits may be much more expensive than making the refunds.
Large, 500 Employees	Yes	Yes	Yes	Yes	No–if the employee base is growing then this option may not be available for long: 500 employees is the limit.
Any (with 500 or fewer employees)	No	Yes	Yes	Yes	Maybe–careful consideration is necessary: adding a DB plan is not a benefit that allows flexibility in funding.
Any (with 500 or fewer employees)	Yes/No	No	Yes	Yes	Maybe–again, careful consideration is necessary; adding a DB plan is not a benefit that allows flexibility in funding; if the goal is to reduce the current level of benefits provided in the DB plan, this kind of plan might be useful

For many small business owners who want to control the costs of their retirement plan, while further increasing their own allocations, the eligible combination plan may be their choice. Table 6.3 illustrates the unparalleled flexibility of the Cash Balance and 401(k) Combination Plan arrangement.

Table 6.3
Cash Balance Plan and 401(k) Combination Plan[1]

Census Data			Safe Harbor and 401(k) Profit Sharing Plan[2]				Cash Balance Plan		
Position	**Age**	**Annual Pay**	**Salary Deferral**	**3% SHNEC**	**Cross-Tested PS**	**Total % of Pay**	**Cost Allocation**	**% of Pay**	**Combined Total**
Owner A	55	$350,000	$31,000	$0	$10,500	3%	$189,000	54%	$230,500
Owner B	50	$350,000	$31,000	$0	$10,500	3%	$189,000	54%	$230,500
EE 1	50	$75,000	$0	$2,250	$6,000	8%	$1,500	2%	$9,750
EE2	55	$50,000	$0	$1,500	$4,000	8%	$1,000	2%	$6,500
EE 3	35	$40,000	$0	$1,200	$3,200	8%	$800	2%	$5,200
EE 4	30	$35,000	$0	$1,050	$2,800	8%	$700	2%	$4,550
EE 5	25	$30,000	$0	$900	$2,400	8%	$600	2%	$3,900
		Owners	$62,000	$ 0	$21,000		$378,000		$461,000
		EEs	$0	$6,900	$18,400		$ 4,600		$ 29,900
		Totals	$62,000	$6,900	$39,400		$382,600		$490,900
									94% To Owners

[1]Assumes a benefit based on 10% of average monthly compensation multiplied by a maximum of ten years of participation, and a Target Normal Cost calculated using mandated segment rates. [2] 3% Safe Harbor Non-Elective employer contribution is allocated to all eligible participants plus a 5% regular employer Profit Sharing allocation to non-owner participants. Complying with Safe Harbor provisions allows the owners to make maximum salary deferrals without failing required non-discrimination testing. [3] Profit Sharing, Safe Harbor, Salary Deferral and Cash Balance allocations are converted to monthly benefits at age 65 (Normal Retirement Age) and aggregated to pass non-discrimination testing.

In this design, the 401(k)-plan portion uses a 3% Safe Harbor non-elective contribution (SHNEC) for all non-owners to allow the owners to make maximum salary deferrals plus catch-up contributions without fear of failing the ADP Test for nondiscrimination of deferrals. The 3% SHNEC also helps to satisfy complex dual plan Top Heavy Minimum and Gateway Test requirements. The non-owners receive the bulk of their benefits ($18,400) in the Safe Harbor 401(k)/Profit-sharing plan, while the owners receive the bulk of their benefits ($189,000) in the Cash Balance Plan (54% of pay). The profit sharing allocations are converted to benefit accruals at age 65. They are cross tested in aggregation with the cash balance plan benefits to demonstrate that combined employer contributions are nondiscriminatory. Although assumed to be zero, additional voluntary salary deferrals by non-owners will not impact the testing of this arrangement.

By adding the cash balance plan, the contributions for target employees rose to $378,000 compared with just $62,000 in the 401(k)/profit-sharing plan alone. This defined benefit and defined contribution plan combination made it possible for the two owners to contribute an additional combined amount of $461,000.

Bottom Line: Percentage for the owners was 94%. The cost of covering the non-target employees was $29,900 or 13% of non-target employee payroll ($230,000). This increased $11,500 over the contributions made to the 401(k)/profit-sharing plan alone. The tax savings on the additional contribution for the owners would more than offset the additional contribution cost for the rest of the employees.

IRS Revenue Ruling 2012-4: DC to DB Rollovers

Employers who sponsor both a 401(k) or other DC plan and a DB plan (combination plans) may be able to offer participants a lifetime income benefit that is already largely in place. Such employers can permit terminating employees covered under both plans to roll all or a portion of their DC benefits to the pension plan to receive a greater life annuity benefit from the pension plan. This approach may be beneficial for retirees and other terminating employees while still helping to minimize the employer's administrative burdens.

Although some employers have offered such rollovers, many others were reluctant to follow suit in the absence of formal guidance on how such rollovers work in practice. Now that the Treasury Department and Internal Revenue Service (IRS) have issued guidance with IRS Rev. Ruling 2012-4, clarifying how this annuity conversion can be accomplished under the rules for qualified plans (discussed below), there is a renewed interest in DC to DB rollovers.

Let's review some of the advantages and disadvantages of these rollovers from the employers' and employees' perspectives.

For employer's, there are several advantages of offering a DC to DB rollover:

- *Distinguishing the Employer's DC Plan from the Competition.* Until this feature becomes commonplace, this option can be communicated as a positive feature of the employer's program, setting it apart from other DC plans in the marketplace. It also is a feature that employers without a DB plan, frozen or otherwise, cannot replicate.
- *Using the DC Plan to Aid Retention.* Offering this option only for employees who retire after certain age/service criteria is achieved may encourage mid-career employees to stay until the attainment of the rollover criteria.
- *Opportunity to Generate Investment Gains.* For purposes of the conversion to lifetime income, the lifetime income stream created from the rollover will be valued using actuarial assumptions based on interest rates on corporate bonds. However, unless the plan's assets are invested only in fixed-income investments, the DB plan's long-time horizon may allow it to invest in other investments and thus possibly earn a greater return than the fixed-income rate used in the conversion; and
- *Marginal Improvement in Funded Status.* To the extent that a plan is less than 100 percent funded, rollovers will increase its funded status. This occurs because the additional liabilities attributable to the rollover are essentially 100 percent funded at the time of rollover and, therefore, drive the total plan's funded status a bit closer to 100 percent.

Employees may want to make a DC to DB plan rollover for the following reasons:

- *Obtain Longevity Protection at Below Insurance Market Costs.* Provides longevity protection without expense and profit loads found in commercial annuities, the conversion rates used by the plan will typically be less than prevailing rates in the individual annuity marketplace. This is the primary advantage of such rollovers for employees, and.
- *Avoid Section 415 Maximum Benefit Limit.* That limit does not apply to the rollover, provided the annuity is calculated using IRC §417 (e) assumptions.

The primary disadvantages of rolling money from a DC to a DB plan are:

- *Increased Financial Exposure to the Employer*. Employees may not want to have too much of their net worth in their employer's DB plan, especially if there are concerns about the financial solvency of the employer and if the DB plan is underfunded.
- *Use of Unisex Annuity Rates.* The DB plan would need to use unisex rates for these conversions. Unless a 100 percent female table is used, the unisex table will provide a subsidy to the female participant and penalize the male participant. From the male participant's point of view, this financial disadvantage may outweigh the financial advantage of not having to pay for insurance company expenses and profit loads; and
- *Lack of a Cash-Value Feature.* This can pose a problem for employees who face unforeseen large expenses. Of course, this can be mitigated to some extent by rolling over only a portion of the DC account balance.

Employers who are thinking about offering a DC to DB rollover option should be aware that there are still some ambiguities about the design, as noted below:

- *Pension Benefit Guaranty Corporation (PBGC) Protection.* The PBGC has not yet provided guidance on how its benefit guarantees will apply to additional lifetime payment amounts derived from a rollover contribution. In addition, in some cases, the rollover amount could cause the total benefit payable from the DB plan to exceed the maximum PBGC guarantee. Without PBGC protection, there is a possibility that participants could lose all or a portion of the rollover benefit should the plan terminate with insufficient assets;
- *How to Handle After-Tax Contributions.* Transfers of after-tax money will likely require special tax treatment; additional IRS guidance is needed; and
- *Potential Administrative Issues.* It is unclear whether the non-discrimination rules allow the employer to require a minimum transfer amount to avoid the administrative costs of small annuities. For example, to avoid *de minimis* payments, the usual cash-out rule should apply, allowing employers only to pay annuity amounts that have a present value (combined with the regular DB benefit) of $5,000 or more.

Chapter 6
Review Questions

1. Which Act by Congress permits employers with 500 or fewer employees the authority to establish a combination plan under IRC Section 414(x)?

   ( ) A. Employee Retirement Income Security Act of 1974
   ( ) B. Deficit Reduction Act of 2005
   ( ) C. Pension Protection Act of 2006
   ( ) D. Economic Growth Tax Relief Reconciliation Act of 2001

2. Which of the following statements about an eligible combination plan under IRC § 414(x) is FALSE?

   ( ) A. The plan must meet specified benefit, contribution, vesting, and nondiscrimination requirements.
   ( ) B. Must file only a Single Form 5500
   ( ) C. Must file only one plan document
   ( ) D. Must file two separate plan documents

3. Determine when a participant must be fully vested in their employer-provided accrued benefit under the DB plan after completing how many years of service?

   ( ) A. 3 years
   ( ) B. 5 years
   ( ) C. 6 years
   ( ) D. No service requirement

4. Under IRC § 414(x)(2)(B), the DB plan must provide each participant with a minimum benefit that is the lesser of 1 percent multiplied by the participant's years of service with the employer; or what percent

   ( ) A. 10%
   ( ) B. 20%
   ( ) C. 50%
   ( ) D. 60%

Under IRC § 414(x)(4), how are the DB (Defined Benefit) and DC (Defined Contribution) plans treated in relation to the top-heavy requirements under IRC § 416?

( ) A. They must be tested separately to meet the top-heavy requirements.
( ) B. They are automatically considered non-top-heavy without any further testing.
( ) C. They are treated as a single plan for the purpose of meeting the top-heavy requirements.
( ) D. They are exempt from all top-heavy requirements.

CHAPTER 7

DESIGNATED ROTH ACCOUNTS (DRACs)

Overview

In this chapter, we will explore the intricacies of Designated Roth Accounts (DRACs) within the framework of 401(k) plans. Introduced as part of the Economic Growth and Tax Relief Reconciliation Act of 2001, DRACs provide a unique tax-advantaged retirement savings option. This chapter will delve into the historical background of DRACs, highlighting their development and significance in retirement planning.

We will compare traditional 401(k) plans with Roth 401(k) plans, focusing on key differences such as tax treatment of contributions and distributions, required minimum distributions (RMDs), and the flexibility offered by each plan type. Understanding these differences is crucial for financial professionals to effectively advise clients on the most suitable retirement savings strategies.

Furthermore, the chapter will cover the tax rules applicable to DRACs, including in-plan conversions, rollovers to Individual Retirement Accounts (IRAs), and the implications of the SECURE 2.0 Act of 2022 on distributions. These rules are essential for navigating the complexities of DRACs and ensuring compliance while maximizing the tax benefits for clients.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Recall the differences between a traditional 401(k) and a DRAC 401(k).
- Explain the background of the Designated Roth Account (DRAC).
- Apply the rules for DRAC Rollovers and distributions.
- Analyze the rules for DRAC In-plan Conversions.
- Evaluate the benefits and drawbacks of a DRAC 401(k); and
- Formulate a plan for implementing DRAC 401(k) within an organization.

By mastering these objectives, financial professionals will be equipped with the knowledge and skills necessary to guide clients in making informed decisions about their retirement savings, leveraging the benefits of Designated Roth Accounts within 401(k) plans.

Background

Beginning in 2006, a provision in the *Economic Growth Tax Relief and Reconciliation Act of 2001* (EGTRRA), Section 617(f), allowed employers who had a 401(k) plan to set up a DRAC. If an employer amended their 401(k) plan documents to permit DRAC contributions, participants would be able to elect to allocate part or all of their elective deferrals ($23,500 in 2025) into a DRAC within their 401(k) plans. A DRAC combines many of the benefits of the Roth IRA and the traditional 401(k) (See Table 7.1).

Table 7.1
DRAC vs. Traditional 401(k) Plan (2024)

	DRAC	Traditional 401(k)
Contributions Are	Post -Tax	Pre-Tax
Can be Started By	Employer only	Employer only
Matching Funds Are	Pre-Taxed in a Traditional 401K	Pre-Taxed in a Traditional 401K
Maximum Annual Individual Contribution (2024)	$23,500	$23,500
Catch-up Contribution (2024)	$7,500/$11,250	$7,500/$11,250
Can Roll-Over to	Roth IRA or new employer's 401K	Traditional IRA, a new employer's Traditional 401K, or a Roth IRA (pay taxes)
Pay Taxes At	Time of Contribution	Withdrawal in Retirement
Can Begin Withdrawing Earnings Without Penalty	At age 59 ½	At age 59 ½
Taxes in Account	No taxes on dividends, capital gains, or interest	No taxes on dividends, capital gains, or interest

Under EGTRRA of 2001, DRAC plans were available for tax years beginning in 2006. But like all other provisions contained in the Act, the DRAC contributions were to sunset and not be permissible after December 31, 2010. All of that changed with the enactment of the Pension Protection Act (PPA) of 2006, which gave permanence to the DRAC.

Vanguard's, *How Americans Save 2024* reported that at year-end 2023, the Roth feature was offered by 82% of Vanguard plans and had been adopted by 17% of participants in plans offering the feature, up from 12% in 2019. Those who used this feature tended to be younger or higher-income participants.

DRAC Qualification Requirements

To meet the qualifications requirements, a 401(k) plan must do the following:

- Establish separate DRAC accounts for the contributions of each employee and any earnings properly allocable to the DRAC; and
- Maintain separate recordkeeping for each DRAC [IRC § 402A (b)(2)].

DRAC Contributions

By contributing to a DRAC, participants elect to trade the tax deductions available in the current year in exchange for tax-free benefits in retirement. Specifically, individuals contribute to a DRAC on an after-tax basis. Upon retirement, these contributions, and the earnings on them can be withdrawn tax-free if certain requirements are met [IRC § 402A(b)(1)].

The maximum deferral amount permitted by law may be allocated between the traditional and DRAC inside a 401(k) [IRC § 402(a)(c)(2)]. As mentioned above, the maximum contribution limit for 2025 is $23,500 (subject to limitations by the actual deferral percentage (ADP) and actual contribution percentage (ACP) discussed in Chapter 4) and indexed for inflation thereafter, plus catch-up contributions of $7,500 for workers aged 50-59 or 64 and older and workers aged 60-63 contributions of $34,750. Therefore, the total amount a business owner or employee aged 50-59 or 64 could contribute to their regular and Roth accounts inside of a 401(k) plan is $31,0000 or those aged 60,61, 62 and 63 $34,750 in 2025.

Note: Section 604, of the SECURE 2.0 Act of 2022, allows plan participants to designate employer matching and nonelective contributions for Roth treatment.

Whether DRAC contributions are better than before-tax contributions depend on two factors:

- The tax rate today; and
- The tax rate in retirement.

If tax rates are higher in retirement, the DRAC contribution is more beneficial. Conversely, if tax rates are lower in retirement, before-tax contributions will yield more take-home income. Consider the following simplified example illustrated in Table 7.2, comparing how retirement income differs when $5,000 is contributed to a DRAC, a before-tax account, and an after-tax account for 30 years at a 7% rate of return.

In contrast to Roth IRA, there is no income ceiling above which an employee cannot make DRAC contributions [IRC § 402A]. There is no age limit above which the employee cannot contribute to a DRAC. An employee can contribute to a DRAC even if they are also a participant in other retirement plans offered by the same or another employer.

Table 7.2
Comparison of Retirement Income

	DRAC	Before-Tax	After-Tax
Contribution	$5,000	$5,000	$5,000
Balance After 30 Years	$38,061	$38,061	$38,061
Tax Amount (25% Tax Rate)	$ 0	$9,515	$8,265*
Ending Balance	**$38,061**	**$28,546**	**$29,796**

*For purposes of simplicity, this example assumes the 25% tax is paid on the investment earnings, which equal the ending balance ($38,061) minus the initial contribution of $5,000. The tax situation could be much more complicated.

The DRAC offers several benefits to participants. Among them are:

- No income phase-outs on contributions to the plan.
- Continue ability to make DRAC contributions (if other conditions are met);
- Creation of a hedge against future tax increases; and
- Exemption from the required minimum distribution rules.

DRAC In-Plan Conversions

On September 27, 2010, President Obama signed the *Small Business Job Protection Act (SBJPA) of 2010*. The Act, under Sections 2111 and 2112, now permitted 401(k), 403(b), and governmental 457(b) employers (plan sponsors) to amend their plans to permit vested account balances that can be distributed as an eligible rollover distribution to be converted to DRAC amounts within the plan (DRAC In-Plan Conversions). The converted amounts will be treated as distributions and taxable in the year of conversion. The in-plan DRAC conversion provision was included in the Act because it was expected to raise more than $5.5 billion over a 10-year period from participants who perform in-plan rollovers to DRAC programs. The implementation of this feature is discretionary.

Prior to the enactment of SBJPA, a participant could take a distribution of retirement plan assets (to the extent permitted under law and by the plan) and convert the assets outside the plan by rolling over the distribution to a Roth IRA. The prior law put plan sponsors in somewhat of a dilemma because if they wanted to allow participants to maximize the amount of money they could rollover to a Roth IRA, the plan had to expand its in-service distribution features. However, if the plan expanded its in-service distribution features, those features would need to be offered to a non-discriminatory cross-section of participants–and some of the participants might use a distribution for a purpose other than Roth conversions. This concern about "*leakage*" from the retirement system caused many plan sponsors to refrain from expanding their in-service distribution options.

SBJPA fixed the "*leakage*" problem. Specifically, the Act stated that a plan could restrict its expanded in-service distribution options solely to DRAC conversions. In other words, a plan can be amended to permit expanded in-service distributions *solely* to make in-plan DRAC conversions. Now, if the plan permits, a participant or beneficiary eligible to take an in-service distribution may elect to convert plan assets into DRAC amounts and keep the assets in the plan. As a result, plan sponsors considering amending in-service distribution rules to permit participants to roll over accounts to Roth IRAs to take advantage of 2010 tax rules can now amend their plans to liberalize in-service distribution rules solely for converting plan assets into DRAC assets inside the plan.

Requirements for In-Plan DRAC Conversions

A plan may (but is not required to) permit in-plan DRAC conversions only if the plan is a 401(k) or 403(b) plan that has a DRAC elective deferral arrangement. So, for example, a plan that is only a profit-sharing plan would not be eligible to offer in-plan DRAC conversions.

If a plan permits DRAC conversions, a participant can only convert distributable amounts under the plan's terms (as amended) and qualify as eligible rollover distributions. Under the Internal Revenue Code (IRC), the maximum extent to which in-service distributions are permissible depends on the type of contribution:

- Participant 401(k) deferrals are generally distributable only upon the participant’s severance from employment, death, disability, or attainment of age 59½.
- Employer matching and profit-sharing contributions generally can be distributed while a participant is actively employed if the employer contributions have accumulated for a fixed number of years, upon attaining a stated age, or upon any other stated event. Internal Revenue Service (IRS) rulings have clarified that the “*fixed number of years*” generally must be at least two (2) years, but that a plan can permit a full distribution of all employer contributions after a participant has been in the plan for a period of at least five (5) years. These “*two-year/five-year*” rules are commonly accepted as the most liberal rules a plan can permit for in-service distribution of employer matching and profit-sharing contributions; and
- After-tax and rollover contributions are generally freely distributable at any time.

Plan sponsors may amend their plans to permit in-plan Roth conversions for some or all of these types of contributions.

Benefits to Participants

The ability to convert plan assets into DRAC assets may be popular with plan participants because they can choose to convert plan assets into DRAC assets and later take a tax-free distribution, provided the participant meets the requirements for a “*qualified distribution*” (discussed below). Participants who are unsure about future tax rates or their future tax bracket can diversify by converting some retirement plan assets into DRAC assets and maintaining other assets as traditional pre-tax assets.

Converted amounts are not subject to the 10 percent early distribution tax under IRC § 72 (t) (generally applicable to distributions to participants underage 59½ that are not rolled over to an IRA).

New Law Expands “In-Plan” DRAC Conversions

On January 2, 2013, President Obama signed into law the *American Taxpayer Relief Act of 2012* (ATRA) (the "*fiscal cliff*" bill). The new law, Section 902 of the Act, permits 401(k) plans (as well as 403(b) and governmental 457 (b) plan sponsors to amend their plans to permit any amount under the 401(k) plan to be converted to a DRAC amount within the plan, even if the amount is not otherwise distributable.

Participants will now be able to do in-plan DRAC conversions from any non-DRAC vested account without requiring that the amount converted be eligible for distribution and rollover from the plan.

As was discussed above, pre-Act, only amounts eligible for distribution and for rollover, such as in-service withdrawals of elective contributions after age 59½, in-service withdrawals of employer contributions after a stated age and/or stated period of time, and distributions due to disability, severance of employment, or retirement were eligible for conversion.

A conversion will not be treated as having violated IRC § 401(k)(2)(B)(i), § 403(b)(7)(A)(ii), or § 457(d)(1)(A) (pertaining to limitations on distributions). However, what remains the same (not inclusive): An in-plan DRAC conversion feature is discretionary; employers are not required to amend their plans to allow for conversions.

To allow in-plan DRAC conversions, a 401(k), 403(b), or governmental 457(b) plan must:

- Permit ongoing DRAC contributions; and
- Allow conversions.

Participants who make a DRAC conversion are subject to ordinary income tax on the amount converted but are not subject to the 10% early distribution tax.

DRAC conversions are not subject to mandatory or optional withholding. However, since the conversion amount is subject to ordinary income tax, the participant should consider increasing their withholding or making estimated tax payments outside the plan to avoid any underpayment penalties. If the plan is subject to spousal consent requirements, no spousal consent is required for a conversion.

While the availability of the DRAC deferral feature has increased relatively quickly, DRAC in-plan conversions are less common–but gaining momentum.

DRAC Rollovers

IRS permits DRAC-to-Roth IRA rollovers to be accomplished by either direct rollover (trustee-to-trustee transfer) or indirect (60-day rollover). Rollover from a DRAC to a Roth IRA is permitted even if the participant is not eligible to make annual contributions to a Roth IRA or convert their Traditional IRA to a Roth IRA. This means that a participant can establish a Roth IRA purely to receive a rollover of their DRAC, even if their income is too high to allow them to contribute to a Roth IRA:

- *Direct Rollover* (trustee-to-trustee transfer)–the entire plan balance can go to an employer Roth plan or an individual Roth IRA; or
- *Indirect Rollover* (60-day rollover)–only taxable amounts can be rolled over to another Roth employer plan, or the entire plan balance can go to an individual Roth IRA. The rollover must be completed within 60 days.

If the employee does a partial indirect (60-day) rollover of a non-qualified distribution to his individual Roth IRA, the amount rolled into the Roth IRA is deemed to come first from taxable amounts distributed from the DRAC. The employee is rolling the taxable earnings portion into the Roth IRA first. The balance of the distribution comes from the tax-free part (see Table 7.3).

Table 7.3.
Allowable Rollovers from Roth 401(k)

Direct Rollover (trustee-to-trustee transfer)	All or any part of the plan balance can go to another Roth 401(k), or Roth 403(b), if the receiving plan allows, or to a Roth IRA
Rollover to Employee (Indirect 60-day rollover)	All or any part of the balance can be rolled into a Roth IRA. Only taxable amounts (earnings) can be rolled over to another Roth 401(k) or Roth 403(b) if the receiving plan allows

Qualified DRAC Distributions

The tax rules for distributions from DRACs differ significantly from traditional 401(k) accounts and Roth IRAs. No income tax applies to "*qualified distributions*" from DRACs. No income tax applies to qualified distributions from a DRAC since taxes were paid at the time of the original contributions.

If a distribution is a qualified distribution, the entire distribution from the DRAC (contributions and earnings) is tax-free. Two conditions (both, not either/or) must be satisfied to qualify for tax-free status:

- The DRAC participant must satisfy the "*five-year rule*;" and
- There must be a "*qualified purpose"* for the distribution.

The Five-Year Holding Period Rule

The *five-year holding period rule* is satisfied at the end of the 5-year period during which the participant's deferral is first deposited to the DRAC. This means that any deferral contributed within the calendar year 2011, even if the first contribution date was December 31, 2011, is considered qualified as of January 1, 2016.

DRACs have their own 5-year holding rules, unlike individual Roth IRAs, where there is only one 5-year period that starts with establishing the owner's first Roth IRA. DRACs have a separate 5-year holding period for each employer's DRAC. If your client works for two different employers and participates in a DRAC at each company, they will have two separate 5-year periods, one for each DRAC.

Also, the 5-year holding period is never carried over to an individual Roth IRA. The DRAC funds will be governed by the 5-year rule applicable to the Roth IRA. If the Roth IRA has already satisfied the 5-year period, then the employer funds are deemed to have also met the 5- year period, even if they were only in the DRAC for a year. This is just one more reason for many of your clients to establish a Roth IRA.

Qualified Purpose Rule

A distribution from a DRAC satisfies the qualified purpose rule only if the distribution is attributable to:

- The participant's attainment of age 59 ½.
- The participant's disability; or
- The participant's death.

There are no exceptions to the above rules, such as the exception for first-time homebuyers that applies to Roth IRAs.

Nonqualified DRAC Distributions

If your client does not meet the requirements of a *qualified distribution* discussed above, and they take a distribution from a DRAC without rolling it to another DRAC, it will be considered a *nonqualified distribution*.

A *nonqualified distribution* from a DRAC must report taxable income in proportion to the account earnings. For example, if 80% of the funds in the DRAC are from contributions and another 20% are from earnings, the distribution will be 20% taxable even if the amount withdrawn is less than the contribution amount. In addition, the nonqualified distribution that is not rolled over to a Roth IRA or another DRAC may be subject to the 10% early distribution tax penalty under IRC § 72(t)(1).

Note: This rule looks only at the DRAC from which the distribution is distributed. IRAs rules say you can use the pro-rata from all IRAs, but those rules don't apply here.

Advisors Beware: Roth IRA Documents Must Be Amended

On May 31, 2007, IRS released Announcement 2007-55 to remind Roth IRA sponsors that Roth IRA documents will need to be amended to allow for the acceptance of rollover contributions from

Roth 401(k) or Roth 403(b) accounts. All advisors working with clients who are thinking of rolling over Roth 401(k) balances to Roth IRA accounts should first be sure that the Roth IRA document allows for this type of rollover. A Roth IRA that has already accepted rollover contributions from a Roth 401(k) must have been amended by December 31, 2007 (Rev. Proc. 2002-10).

Rollover of After-Tax Contributions

Traditional after-tax contributions have generally fallen out of favor, as the DRAC option has typically offered employees greater benefits. However, in 2014, the IRS simplified an employee's ability to roll over traditional after-tax contributions from a 401(k) plan directly into a Roth IRA upon the termination of employment (IRS Notice 2014-54). This simplification eliminated the multistep process of first receiving a distribution of the after-tax contributions and then rolling over those funds into a Roth IRA, which required the employee to have sufficient funds to cover the 20% withholding taken from the initial distribution. Rolling over after-tax contributions into a Roth IRA allows the employee to eliminate taxes on future earnings on the rolled-over amounts.

While the pre-tax and DRAC after-tax contribution options typically provide employees with greater benefits and flexibility, the recent IRS changes have made traditional after-tax contributions a potentially more attractive option than in years past. This option could be a valuable third option for retirement savings for some employees.

The SECURE Act of 2019

Section 401

The provision provides that an inherited ROTH IRA by non-eligible designated beneficiaries will be required to draw down their entire inherited interest within ten years.

An eligible designated beneficiary (EDB) is any designated beneficiary who is:

- The surviving spouse.
- A child under the age of majority.
- Disabled or chronically ill; or
- Any other person who is not more than 10 years younger than the participant/IRA owner.

In the case of a child who has not attained the age of majority, the ten-year rule would apply as the child attains the age of majority.

SECURE 2.0 Act of 2022

Section 126

Special rules for certain distributions from long-term qualified tuition programs to Roth IRAs. Section 126 amends the Internal Revenue Code to allow for tax and penalty free rollovers from 529 accounts to Roth IRAs, under certain conditions. Beneficiaries of 529 college savings accounts would be permitted to rollover up to $35,000 over the course of their lifetime from any 529 account in their name to their Roth IRA. These rollovers are also subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years. Must be a direct, trustee-to-trustee transfer to a Roth IRA account maintained for the benefit of the 529 plan beneficiary. Rollover limited to $6,000 contribution limit per year. Families and students have concerns about leftover funds being trapped in 529 accounts unless they take a non-qualified withdrawal and assume a penalty. This has led to hesitating, delaying, or declining to fund 529s to levels needed to pay for the rising costs of education. Section 126 eliminates this concern by providing families and students with the option to avoid the penalty, resulting in families putting more into their 529 account. Families who sacrifice and save in 529 accounts should not be punished with tax and penalty years later if the beneficiary has found an alternative way to pay for their education. They should be able to retain their savings and begin their retirement account on a positive note. Section 126 is effective with respect to distributions after December 31, 2023.

Section 325

Roth plan distribution rules. Under current law, required minimum distributions are not required to begin prior to the death of the owner of a Roth IRA. However, pre-death distributions are required in the case of the owner of a Roth designated account in an employer retirement plan (e.g., 401(k) plan). Section 325 eliminates the pre-death distribution requirement for Roth accounts in employer plans, effective for taxable years beginning after December 31, 2023. Section 325 does not apply to distributions which are required with respect to years beginning before January 1, 2024, but are permitted to be paid on or after such a date.

Section 604

Optional treatment of employer matching or nonelective contributions as Roth contributions. Under current law, plan sponsors are not permitted to provide employer matching contributions in their 401(k), 403(b), and governmental 457(b) plans on a Roth basis. Matching contributions must be on a pre-tax basis only. Section 604 allows defined contribution plans to provide participants with the option of receiving matching contributions on a Roth basis, effective on the date of enactment of this Act.

Section 603

Elective deferrals are generally limited to regular contribution limit. Under current law, catch-up contributions to a qualified retirement plan can be made on a pre-tax or Roth basis (if permitted by the plan sponsor). Section 603 provides all catch-up contributions to qualified retirement plans that are subject to Roth tax treatment, effective for taxable years beginning after December 31, 2023. An exception is provided for employees with compensation of $145,000 or less (indexed).

Note: The Internal Revenue Service (IRS) released guidance on Section 603 to grant a delay of up to two years. Calling it an administrative transition period, the guidance text states that "the first two taxable years beginning after December 31, 2023, will be regarded as an administrative transition period with respect to the requirement under section 414(v)(7)(A) of the Code that catch-up contributions made on behalf of certain eligible participants be designated as Roth contributions." It also addressed the technical error that would have eliminated all catch-up contributions beginning in 2024. Under the notice, catch-up contributions can continue to be made after 2023.

Chapter 7
Review Questions

1. Which of the following Acts made the DRAC a permanent feature in a 401(k) plan?

( ) A. The American Taxpayers Relief Act of 2012
( ) B. The Economic Growth Tax Relief Reconciliation Act of 2001
( ) C. The Pension Protection Act of 2006
( ) D. The Small Business Job Protection Act of 2006

2. For the tax year 2025, what is the maximum amount allowed for a participant ages 50-59 and 64 and older can contribute to their DRAC?

( ) A. $31,000
( ) B. $16,500
( ) C. $70,000
( ) D. $77,500

3. Which of the following statements about a DRAC in-plan conversion is FALSE?

( ) A. Participants who make a DRAC conversion are subject to ordinary income tax on the amount converted but are not subject to the 10% early distribution tax.
( ) B. DRAC conversions are not subject to mandatory or optional withholding.
( ) C. DRAC conversions are now mandatory for all plans
( ) D. DRAC participants will now be able to do DRAC in-plan conversions from any non-DRAC vested account.

4. Distributed earnings from a DRAC will be exempt from taxes if they are part of what type of distribution?

( ) A. Required minimum distribution
( ) B. Qualified distribution
( ) C. Nonqualified distribution
( ) D. SOSEPP distribution

5. Which of the following statements about the DRAC 5-Year Holding Period is FALSE?

( ) A. DRACs have their own 5-Year Holding Period
( ) B. DRACs have a separate 5-Year Holding Period for each employer's DRAC
( ) C. DRAC funds rolled over to a Roth IRA will be governed by the 5-Year holding period applicable to the Roth IRA
( ) D. DRACs 5-Year Holding Period is carried forward to a Roth IRA

CHAPTER 8

401(k) PLAN DISTRIBUTIONS

Overview

As was discussed in Chapter 2, one of the most appealing features of 401(k) plans (and other qualified retirement plans and IRAs) is that they are tax-favored. Income and growth from assets in the accounts can accumulate on a tax-deferred basis. They are not taxed until distributed to the employee (plan participant). Congress intends to make qualified retirement plans long-term investments. As a result, a plan participant will face significant tax consequences for taking early distributions from their qualified retirement plans.

This chapter will examine the rules and tax penalties pertaining to distributions to the participant prior to termination of employment. It will also examine the specific rules pertaining to required minimum distributions, hardship withdrawals, in-service distributions, loans, and qualified domestic relations order (QDRO).

Learning Objectives

Upon completion of this chapter, you will be able to:

- Explain the rules and triggering events for distributions from a qualified retirement plan.
- Recall the tax penalty for early distributions under IRC § 72(t)(1) and how to avoid the penalty using the exceptions under IRC § 72(t)(2).
- Identify the required beginning date (RBD) for qualified retirement plans.
- List the required minimum distribution (RMD) rules under IRC § 401(a)(9).
- Apply required minimum distributions (RMDs) during the participant's lifetime prior to reaching their RBD and after reaching their (RBD).
- Explain the Final RMD rules released by the IRS.
- List the distribution rules pre-and post-retirement for hardships, policy loans, and in-service distributions; and
- Describe the rules for loans, hardships, and in-service distributions.
- Clarify the rules and procedures for Spousal Consent and Qualified Domestic Relations Orders (QDROs); and
- Distinguish the rules and benefits of Net Unrealized Appreciation (NUA).

Distribution Plan Requirements

A qualified 401(k) plan must provide the amounts attributable to elective contributions (such as qualified non-elective contributions (QNECs) and qualified matching contributions (QMACs) that are treated as elective contributions) may not be distributed to a participant or beneficiary before the occurrence of one of the following events (known as triggering dates):

- The participant's severance from employment, retirement, death, or disability [IRC § 401(k)(2) ((B)(i)(I)].
- The termination of the plan without the establishment of a successor defined contribution plan (other than an employee stock ownership plan or a SEP IRA) [IRC § 401(k)(10)(A)];
- The participant's attainment of age 59 ½ if the CODA is part of a profit-sharing or stock bonus plan [IRC § 401(k)(2) ((B)(i)(III)]; or
- The participant's hardship if the CODA is part of a profit-sharing or stock bonus plan [IRC § 401(k)(2) ((B)(i)(IV)].

If the amounts attributable to elective contributions (including QNECs and QMACs treated as elective contributions) are required by an employer to be transferred to another qualified retirement plan of any employer, the distribution restrictions continue to apply to the transferred amounts. Thus, such other plans will not be qualified if the transferred amounts are distributed before the occurrence of one of the events specified above. However, the distribution restrictions do not apply to rollovers and elective transfers by employees.

The distribution restrictions continue to apply to the sale of a corporate subsidiary to an unrelated entity (as opposed to the sale of an entire business to a different employer) with respect to an employee who continues employment with such subsidiary at the same desk. This rule doesn't apply to an employee who works at the same desk as a new employer.

Hardship distributions are exceptions to the traditional qualified plan distribution rules. They are explained in detail later in this chapter.

In contrast to the rule for elective contributions, employer non-elective contributions may be distributed after a fixed number of years, the attainment of a stated age, or upon the occurrence of an event such as a layoff or illness.

Distributions Prior to Age 59½

To discourage 401(k) plan participants from taking distributions from their qualified retirement plans (and IRAs), Congress enacted a special 10% addition to tax under IRC § 72(t)(1), often incorrectly referred to as a penalty.

The 10% "additional tax" is not intended to be a punishment for wrongdoing but merely a disincentive for early distribution (to encourage saving not only for but until retirement).

Under IRC § IRC § 4974(c), the term "*qualified retirement plan*" means:

- A plan described in IRC § 401(a) which includes a trust exempt from tax under section 501(a).
- An annuity plan described in IRC § 403(a).
- An annuity contract described in IRC § 403(b).
- An Individual Retirement (IRA) described in IRC § 408(a); or
- An Individual Retirement Annuity described in IRC § 408(b).

Such term includes any plan, contract, account, or annuity which, at any time, has been determined by the Secretary to be such a plan, contract, account, or annuity.

IRC § 72(t)(1) Tax Penalty

So, if a plan participant receives any amount from an above qualified retirement plan, the taxpayer's tax for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount, which is includable in gross income.

This tax (excise) penalty applies to participants who take distributions "*too early*" from their qualified retirement plans, generally before age 59½. However, the 10% distribution doesn't apply to some or all of the distribution (see Exceptions below).

IRC § 72(t)(2) Exceptions

Under IRC § 72(t)(2), the IRS allows certain exceptions to avoid the IRC § 72(t)(1) 10% addition to tax (excise) penalty. They differ for qualified retirement plans and IRAs. Most exceptions are based on hardship and/or special use exemptions. Below are the exceptions for qualified retirement plans:

- *Attainment of age 59½.* Under IRC § 72 (t)(2)(A)(i), distributions made on or after the date on which the participant (employee) attains age 59½.
- *Death.* Under IRC § 72 (t)(2)(A)(ii), distributions upon death of the participant, assets can be distributed to a beneficiary or the estate without incurring the 10% excise tax on early distributions. However, the plan distribution may be subject to federal estate taxes and or state estate or inheritance taxes.
- *Disability.* Under IRC § 72 (t)(2)(A)(iii), the 10% addition to tax does not apply to an individual who is disabled within the meaning of IRC § 72 (m)(7). IRC § 72 (m)(7) defines disability. For purposes of this section, an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."
- *Separation from Service.* Under IRC § 72(t)(A)(v), an employee who separates from service during or after the year the employee reaches age 55. The Pension Protection Act (PPA) of 2006 added IRC § 72(t)(10), which provides that in case of a distribution to a *qualified public safety employee* from a governmental defined benefit plan, IRC § 72(t)(2)(A)(v) is applied by substituting age 50 for age 55. Thus, the 10% additional tax on early distributions under IRC § 72(t)(1) does not apply to a distribution from a

governmental defined benefit plan made to a qualified public safety employee who separates from service after attainment of age 50. For the purposes of IRC § 72(t)(10), the term "*qualified public safety employee*" means an employee of a state or of a political subdivision of a state (such as a county or city) whose principal duties include services requiring specialized training in the area of police protection, firefighting services, or emergency medical services for any area within the jurisdiction of the state, or the political subdivision of the state. This 10 percent additional tax exception applies to distributions made after August 17, 2006. The Protecting Americans from Tax Hikes (PATH) Act of 2015 expands the provision to include U.S. Capitol Police officers, Supreme Court Police officers, and diplomatic security special agents. H.R. 2146, the Defending Public Safety Employees Retirement Act, which was enacted on June 29, 2015, previously expanded the provision to cover federal law enforcement officials but inadvertently omitted the other categories of public safety officers.

- *Series of Substantial Equal Periodic Payments.* Under IRC § 72(t)(2)(A)(iv), the exception rule exists for the distribution of plan assets that are part of a *series of substantial equal periodic payments* (SOSEPP), paid not less frequently than annually, for the participant's lifetime (or life expectancy) or the joint lives (or joint life expectancies) of the participant and a designated beneficiary (discussed below). Distributions from a qualified retirement plan other than an IRA or individual retirement annuity qualify for this exception **<u>only</u>** if they begin after the participant (employee) separates from the employer's service (see above Separation of Service).
- *Medical Expenses.* Under IRC § 72(t)(2)(B) distributions made to a participant, to the extent such distributions do not exceed the amount allowable as a deduction under IRC § 213 to the participant for amounts paid during the taxable year for medical care (>10% of AGI and 7.5% of AGI for taxpayer who had attained age 65 before the end of the tax year and phased out in 2017).
- *Qualified Domestic Relations Order.* Under IRC 72(t)(2)(C), exempts early distributions from the 10% additional tax if those withdrawals are made as a result of a qualified domestic relations order (QDRO) as defined under IRC § 414(p)(1). A QDRO is a judgment related to providing child support, alimony, or marital property rights to a spouse, former spouse, child, or other dependent of a participant. It is made pursuant to a state domestic relations order. A QDRO also qualifies an alternate payee to receive the amount of benefits under the plan. An alternate payee is defined as any spouse, former spouse, child, or other dependent of a participant who has the right to receive all, or a portion of, the benefits payable under a plan of such participant.
- *Special Automatic Enrollment.* Under IRC § 414(w)(1)(B, if a participant has made contributions under special automatic enrollment rules that are withdrawn pursuant to their request within 90 days of enrollment.
- *Distributions to Military Reservists.* The penalty does not apply to a distribution of elective deferrals from a 401(k) plan (includes IRA, or 403(b) plans) to a qualifying military reservist. At the time of the distribution, the military reservist must be on active duty for more than 179 days, and the distribution is taken between the date of active-duty call-up and the end of the actie-duty period [IRC § 72(t)(2)(G)]. The provison also allows the prior early distributions to be rolled back (repaid) to an IRA within two years of the end of the active service. For example, a distribution taken by a qualifying reservist whose active-duty ended on July 12, 2024. Can be rolled back to an IRA up until July 12, 2026.

- *IRS Levy*. Section 3436 of the IRS Restructuring Act added IRC § 72(t)(2(A)(vii), which provides that the additional 10-percent tax does not apply to a distribution from a qualified retirement plan, including an IRA, that is made on account of a levy under IRC § 6331 on the qualified retirement plan. However, ordinary income taxes still apply; and
- *The 2016 Disaster Relief Act*. The Tax Cut and Jobs Act of 2017, Section 11028, titled "*Relief For 2016 Disaster Areas*," allows an individual to distribute up to $100,000 of "*qualified 2016 disaster distributions*" whose principal place of abode at any time during the calendar year 2016 was in a 2016 disaster area, and who has sustained an economic loss by reason of the events that gave rise to the Presidential disaster declaration. Income attributable to a qualified 2016 disaster distribution (up to $100,000) can be included in income ratably over three years. The qualified 2016 disaster distribution can be recontributed to an eligible retirement plan (includes an IRA) within three years. **Note: Victims of certain disasters.** When a destructive hurricane or similar disaster strikes a large area or population, Congress sometimes reacts by enacting various forms of disaster relief, often including token bits of tax relief, one form of which is suspending application of the 10% tax for "qualified disaster distributions." This is one topic where the IRS website (www.irs.gov) is the best place to start looking because individual legislation may be harder to locate. Search the IRS site for the name of your disaster and see IRS Form 8915A ("Qualified Disaster Retirement Plan Distributions and Repayments") and *IRS Publication 976* ("Disaster Relief").
- *Qualified Birth or Adoption Distribution*. The SECURE Act of 2019, *The Setting Every Community Up for Retirement Enhancement* (Section 113), added an exception to the 10% penalty, it provides qualified retirement plan participants (and IRA participants) to withdraw up to $5,000 following the birth or adoption of a child without paying the usual 10% early withdrawal penalty. A married couple will each be able to withdraw $5,000 from their account, penalty-free. Participants will have one year from the date their child is born or the adoption is finalized to withdraw the funds from their retirement account without paying the 10% penalty. The participant can pay back the borrowed amount into their retirement account at a later date. Recontributed amounts will be treated as a rollover and not included in taxable income. If the participant is adopting, penalty-free withdrawals will generally be allowed under the SECURE Act if the adoptee is younger than 18 years old or was physically or mentally incapable of self-support. However, the penalty will still apply if the participant adopts their spouse's child.

The following exceptions are not allowed for qualified plans, 403(b) and 457(b) plans

- Health Insurance Premiums
- Higher Education Expenses
- First Time Homebuyer

SECURE 2.0 Act of 2022 Additional Changes to IRC § 72(t)(2)

The SECURE 2.0 Act has amended current exemptions and has added the following provisions that will assist taxpayers in avoiding the 10% addition to tax penalty under IRC § 72(t)(2).

Section 308 Distribution to Firefighters

Distribution to firefighters. Section 308 extends the age 50 rule to private sector firefighters, who merit the same treatment for distributions. Section 308 is effective for distributions made after the date of enactment of this Act.

Section 311 Qualified Birth or Adoption

Repayment of qualified birth or adoption distribution (QBAD) limited to 3 years. Section 311 amends the QBAD provision to restrict the recontribution period to 3 years. Section 311 is effective to distributions made after the date of the enactment of this Act (December 29, 2022) and retroactively to the 3-year period beginning on the day after the date on which such distribution was received.

Section 314 Domestic Abuse

Penalty-free withdrawal from retirement plans for individual cases of domestic abuse. A domestic abuse survivor may need to access his or her money in their retirement account for various reasons, such as escaping an unsafe situation. Section 314 allows retirement plans to permit participants that self-certify that they experienced domestic abuse to withdraw a small amount of money (the lesser of $10,000, indexed for inflation, or 50 percent of the participant's account). For 2025 the amount is increased to $10,300. A distribution made under Section 314 is not subject to the 10 percent tax on early distributions. Additionally, a participant can repay the withdrawn money from the retirement plan over 3 years and will be refunded for income taxes on money that is repaid. Exception limited to the lessor of $10,000 or 50% of the account value. Self-certification process Section 314 is effective for distributions made after December 31, 2023.

Section 323 SOSEPP

Clarification of substantially equal periodic payment rules. Section 323 provides that the exception continues to apply in the case of a rollover of the account, an exchange or an annuity providing the payments, or an annuity that satisfies the required minimum distribution rules. Section 323 is effective for transfers, rollovers, exchanges after December 31, 2023, and effective for annuity distributions on or after the date of enactment of this Act (December 29, 2022).

Section 326 Terminal Illness

Exception to penalty on early distributions from qualified plans for individuals with a terminal illness. Under current law, an additional 10 percent tax applies to early distributions from tax-preferred retirement accounts. Section 326 provides an exception to the tax in the case of a distribution to a terminally ill individual and would be effective for distributions made after the date of enactment of this Act (December 29, 2022).

Section 330, Exemption from early withdrawal penalty for certain State and local government corrections employees. Section 330 extends the public safety officer exception to the 10 percent early distribution tax to corrections officers who are employees of state and local governments, effective for distributions made after the date of enactment of this Act (December 29, 2022).

Section 329 Public Safety Officers

Modification of eligible age for exemption from early withdrawal penalty. The 10 percent additional tax on early distributions from tax preferred retirement savings plans does not apply to distribution from a governmental plan to a public safety officer who is at least age 50. Section 329 extends the exception to public safety officers with at least 25 years of service with the employer sponsoring the plan and is effective for distributions made after the date of enactment of this Act (December 29, 2022).

Section 331 Qualified Disaster Distribution

Special rules for use of retirement funds in connection with qualified federally declared disasters. Section 331 provides permanent rules relating to the use of retirement funds in the case of a federally declared disaster. The permanent rules allow up to $22,000 to be distributed from employer retirement plans or IRAs for affected individuals. Such distributions are not subject to the 10 percent additional tax and are considered as gross income over 3 years. Distributions can be repaid to a tax preferred retirement account. Additionally, amounts distributed prior to the disaster to purchase a home can be recontributed, and an employer is permitted to provide for a larger amount to be borrowed from a plan by affected individuals and for additional time for repayment of plan loans owed by affected individuals. Section 331 is effective for disasters occurring on or after January 26, 2021.

Section 334 Qualified Long-Term Care Distributions

Long-term care contracts purchased with retirement plan distributions. Section 334 permits retirement plans to distribute up to $2,600 per year for the payment of premiums for certain specified long term care insurance contracts. Distributions from plans to pay such premiums are exempt from the additional 10 percent tax on early distributions. Only a policy that provides for high quality coverage is eligible for early distribution and waiver of the 10 percent tax. Section 334 is effective 3 years after the date of enactment of this Act (December 29, 2025).

Section 127 Emergency Savings Accounts

Section 127 permits employers to offer short-term emergency savings accounts (“ESAs”) to non-Highly Compensated Employees. ESAs must be funded with Roth contributions. Contributions are treated as elective deferrals for matching purposes and capped at $2,500 - unless the employer specifies a lower amount. Participants must be allowed to take at least one withdrawal per month and the first four withdrawals per year cannot be subject to fees.

Next, we will examine the most often used exception to the 10% tax penalty, the Series of Substantial Equal Periodic Payments (SOSEPP).

Series of Substantial Equal Periodic Payments

Under IRC § 72(t)(2)(A)(iv), the additional tax does not apply to distributions that are:

- Part of a *series of substantially equal periodic payments* (not less frequently than annually) (SOSEPP); and
- Made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary.

Calculating the SOSEPP Payment

Under IRS Notice 89-25 and Revenue Ruling 2002-62, payments are substantially equal periodic payments under IRC § 72(t)(2)(A)(iv) if they are made in accordance with the following calculation methods:

- *Required Minimum Distribution (Life Expectancy) method*. Under the "*required minimum distribution method*," the annual payment for each year is determined by dividing the account balance for that year by the factor from the chosen life expectancy table for that year. Under this method, the account balance, the factor from the chosen life expectancy table, and the resulting annual payments are re-determined for each year;
- *Amortization method:* Under the "*amortization method*," the annual payment for each year is determined by amortizing the account balance, in level amounts, over a specified number of years determined using the chosen life expectancy table and the chosen interest rate. Under this method, the account balance, the number from the chosen life expectancy table, and the resulting annual payment are determined once for the first distribution year, and the annual payment is the same amount in each succeeding year; and
- *Annuitization method.* Under the "*annuitization method*," the annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the taxpayer's age and continuing for the life of the taxpayer (or the joint lives of the individual and beneficiary). Under this method, the account balance, the annuity factor, the chosen interest rate, and the resulting annual payment are determined once for the first distribution year, and the annual payment is the same amount in each succeeding year.

Modification of SOSEPP

IRC § 72(t)(4) mandates that the participant cannot modify SOSEPP payments until the later of five (5) years after the date of the first payment or the date the participant attains age 59½. Once this ending date has passed, payments may be freely taken from the plan without the 10% addition to tax (or the series may be suspended completely). If the series of substantially equal periodic payments is modified before this period expires, all payments in the series lose the shelter of the exemption, and the penalty applies, retroactively and with interest, to all pre-age 59½ distributions. The only codified exception to this rule is that if the series is modified "by reason of death or disability," there is no penalty.

However, due to the declining market of 2000-2002, many participants experienced a substantial decline in their retirement account balances. The problem was that many participants who saw their account balances drop were forced to continue taking out the same number of payments. As a result, they were faced with the potential of running out (or nearly running out) of funds before their payment (modification) period expired. They were dealing with the possibility of having little or no money left for future retirement years. There was also a question of whether, if they ran out of funds before their payment schedule expired, they would have to pay a penalty for modifying their payments (because the payments ceased). Increasing pressure was being placed on the Internal Revenue Service to provide relief, or, at the very least, guidance to deal with these situations.

Revenue Ruling 2002-62

Relief did come to those taking SOSEPPs, whose portfolios were devastated by market conditions in 2001 when the IRS passed Revenue Ruling 2002-62. Under this Revenue Ruling, the IRS made it clear that IF funds in a participant's account plan or an IRA were exhausted (because they are following an acceptable method of a series of substantially equal periodic payments), they would not be subject to a 10% addition to tax under IRC § 72(t)(1) because of not receiving series of substantially equal periodic payments. The resulting cessation of payments will not be treated as a modification of the series of payments.

> ***For Example:*** Paul at age 51, Paul began taking out $100,000 a year from his IRA using the amortization method. Under IRC § 72(t)(4), Paul must continue taking such payments until age 59½. By age 57, taking such payments has completely depleted his IRA. As a result, the payment schedule stops. Under the Revenue Ruling 2002-62, Paul will not face the penalty or interest for modifying such payments.

One time change allowed: More importantly, this IRS Revenue Ruling 2002-62 allowed the participants to make a one-time change to the method they currently were using to calculate payments. A participant who began distributions in a year using either the amortization method or the annuitization method may in–any subsequent year–switch to the required minimum distribution method to determine the payment for the year of the switch and all subsequent years. Doing so will not be considered a modification subjecting them to retroactive taxes. Once such a change is made, the required minimum distribution method must be followed in all subsequent years. Any subsequent change will be a modification (AND THEREFORE A TAXABLE EVENT) for purposes of IRC § 72(t)(4). Because the required minimum distribution method produces the lowest payment amount, participants will be able to keep more funds in their IRAs.

Therefore, because the required minimum distribution method produces a much lower payment, a participant needs to be certain that switching to this method will still provide enough funds on which to live. If the switch is made and the participant later decides they need more money from their IRA, taking an extra distribution will be considered a modification and trigger the retroactive tax and interest.

Effective Dates: For a series of periodic payments that began on or after January 1, 2003, this Ruling replaces the guidance in Q&A-12 of Notice 89-25. For a series of periodic payments that begins in 2002, this Ruling may be used. If a series of periodic payments began in a year before 2003 (and satisfied IRC § 72(t)(2)(A)(iv)), the method of calculating the payments could be changed at any time to the required minimum distribution method, including the use of a different life expectancy table.

Interest rates: An important part of the Ruling is the ceiling on interest rates. IRS Rev. Ruling 2002-62 switched from the concept of a "*reasonable interest rate"* to a ceiling rate that is not more than 120 percent of the federal "*mid-term assumed federal rate"* (AFR). This rate is a specific reference rate for three to nine-year fixed-term investments instead of an average rate for a variety of investments (stocks, bonds, etc.) used to calculate a "reasonable interest rate" under the old rule. The fixed rate would ordinarily be much lower than the expected rate of return on these other investments. This change aimed to reduce the maximum payments that can be taken (see Table 8.1). The interest rate that may be used is any interest rate that is not more than 120 percent of the federal mid-term rate for either of the two months immediately preceding the month in which the distribution begins.

Table 8.1
120% Mid-Term Applicable Federal Rates (AFR), Table 1

Month	Year	Annual	Semi Annual	Quarterly	Monthly
December	2024	5.03%	4.97%	4.52%	4.51%
November	2024	4.45%	4.40%	4.38%	4.36%
October	2024	4.45%	4.40%	4.38%	4.36%
September	2024	4.84%	4.78%	4.75%	4.73%
August	2024	5.22%	5.15%	5.12%	5.10%
July	2024	5.40%	5.33%	5.29%	5.23%
June	2024	5.61%	5,53%	5.49%	5.47%
May	2024	5.31%	5.24%	5.21%	5.18%
April	2024	5.17%	5.10%	5.07%	5.05%
March	2024	4.97%	4.91%	4.88%	4.86%
Feruary	2024	4.79%	4.73%	4.70%	4.68%
January	2024	5.25%	5.18%	5.15%	5.12%

Source: https://apps.irs.gov/app/picklist/list/federalRates.html

Life expectancy tables: The Ruling also changed the life expectancy tables that taxpayers used in determining their payments. Instead of choosing among Table UP 1984, 90 CM and Treas. Reg. §1.401(a)(9)-9 (all of which include both single and joint life factors), participants must now choose one of the following three life expectancy tables to determine distributions:

- *Single Life Expectancy Table* (Treas. Reg. § 1.401(a)(9)-9, Q&A-1). This is a non-sex-based life expectancy table. This table does not use a beneficiary's age to calculate the account owner's life expectancy. This table can be used by all account owners regardless of marital status or selected beneficiary. Choosing single life expectancy will produce the highest distribution of the three available life expectancy tables (see Table 8.2);

- *Uniform Lifetime Table.* This is a non-sex-based table developed by the IRS to simplify minimum distribution requirements. The uniform lifetime table estimates joint survivorship but does not use a beneficiary's age to determine the resulting life expectancy. This table can be used by all account owners regardless of marital status or selected beneficiary (see Table 8.3); and
- Joint and Last Survivor Table (Treas. Reg. § 1.401(a)(9)-9, Q&A-3). This is also a non-sex-based life expectancy table for determining joint survivorship using the account owner's oldest named beneficiary (see Table 8.4).

The number used for a distribution year is the number shown from the table for the employee's (or IRA participant's) age on his or her birthday in that year. This is known as the "*applicable divisor period"* (ADP).

Calculating the Three Methods

Assumptions:

- IRA account balance: $500,000
- Age of participant in distribution year: 50
- Age of Beneficiary (Spouse): 45
- Using Rate of 5.03%

Table 8.2
72(t) Annual Payments
Single Life Table (age 50/45) $500,000 (Using a rate of 5.03%):
Date: 12/10/2024

34.2 Years	Single Life Expectancy
$14,620 [$1,218/mo.]	Minimum Distribution Method
$30,922 [$2,577/mo.]	Amortization Method
$30,516 [$2,543/mo.]	Annuitization Method

Account Balances and Distributions

Your Age Beneficiary Age	Single Life Expectancy	Distribution Year/Month	Balance
50	34.2	$30,922/$2,577	$494,228
51	33.2	$30,922/$2,577	$488,165
52	32.2	$30,922/$2,577	$482,797
53	31.2	$30,922/$2,577	$475,109
54	30.2	$30,922/$2,577	$468,085
55	29.2	$30,922/$2,577	$460,707
56	28.2	$30,922/$2,577	$452,958
57	27.2	$30,922/$2,577	$444,820
58	26.2	$30,922/$2,577	$436,272
59	25.2	$30,922/$2,577	$427,294
60	24.2	$30,922/$2,577	$417,864

Source: http://www.bankrate.com/calculators/retirement/72-t-distribution-calculator.aspx

Table 8.3
72(t) Annual Payments
Uniform Lifetime Table (Age 50/45) $500,000 (Using a rate of 5.03%)
Date: 12/10/2024

46.5 Years	Applicable Life Expectancy / Uniform Lifetime Table
$10,753 [$896/mo.]	Life Expectancy Method
$28,009 [$2,334/mo.]	Amortization Method
$30,516 [$2,543/mo.]	Annuitization Method

Account Balances and Distribution

Your Age	Uniform Lifetime	Distribution Year/Month	Ending Balance
50	46.5	$30,516/$2,543	$494,634
51	45.5	$30,516/$2,543	$488,998
52	44.5	$30,516/$2,543	$483,078
53	43.5	$30,516/$2,543	$476,861
54	42.5	$30,516/$2,543	$470,331
55	41.5	$30,516/$2,543	$463,472
56	40.5	$30,516/$2,543	$456,269
57	39.5	$30,516/$2,543	$448,703
58	38.5	$30,516/$2,543	$440,756
59	37.5	$30,516/$2,543	$432,410
60	36.5	$30,516/$2,543	$423,644

Source: http://www.bankrate.com/calculators/retirement/72-t-distribution-calculator.aspx

Table 8.4
Joint Life Table (Age 50/45) $500,000 (Using a rate of 5.03%):
Date: 12/10/2024
72(t) Annual Payments

43.2 Years	Joint Life Expectancy
$11,574 [$965/mo.]	Minimum Distribution Method
$28,580 [$2,382/mo.]	Amortization Method
$30,516 [$2,543/mo.]	Annuitization Method

Account Balances and Distribution

Your Age/ Beneficiary Age	Joint Life Expectancy	Distribution Year/Month	Ending Balance
50/45	43.2	$30,516/$2,543	$494,634
51/46	42.2	30,516/$2,543	$488,998
52/47	41.2	30,516/$2,543	$483,078
53/48	40.2	30,516/$2,543	$476,861
54/49	39.2	30,516/$2,543	$470,331
55/50	38.2	30,516/$2,543	$463,472
56/51	37.2	30,516/$2,543	$456,269
57/52	36.5	30,516/$2,543	$448,703
58/53	35.2	30,516/$2,543	$440,756
59/54	34.2	30,516/$2,543	$432,410
60/55	33.2	30,516/$2,543	$423,644

Source: http://www.bankrate.com/calculators/retirement/72-t-distribution-calculator.aspx

IRS Notice 2022-6

Notice 2022-6 states that it replaces Rev. Rul. 2002-62 for any series of payments commencing on or after January 1, 2023, and that it "may be used for a series of payments commencing in 2022." Importantly, it also states that for SOSEPP distributions beginning prior to 2023 using the RMD method, the new Single Life Table or Joint and Last Survivor Table provided in the Regulations, or the Uniform Lifetime Table for younger ages, provided in the Notice, may be used for payments in the series without the use of the new tables being considered a modification that would subject the payment to penalty as described above.

This means that an individual taking distributions under an RMD SOSEPP that commenced prior to 2022 may continue to use the old tables, i.e., the tables that were used when the RMD-method SOSEPP began. Certain other aspects of this transition rule are unclear, such as: whether a switch to the new tables must be made in 2022-2023 or could be made in any later year; and whether a person whose SOSEPP started prior to 2022 but then switches to the RMD method after 2022, has the option, upon making that switch, to use either set of tables. Further IRS clarification will be needed for these and similar fine points.

Net Unrealized Appreciation of Employer Stock

According to Fidelity, more than 15 million people own about $400 billion of company stock in Fidelity administered workplace retirement plans alone. Remember that is only Fidelity's figures. How many more employees have company stock inside their qualified retirement plans?

At some point in time, all those employees who hold employer stock inside their qualified retirement plan will have to decide on how to distribute those assets. The question is: Are you aware of a little-known tax break that could save your client a bundle on taxes if they can qualify? It's called Net Unrealized Appreciation (NUA)

What Is Net Unrealized Appreciation (NUA)?

Under IRC § 402 (e)(4), it provides special favorable tax treatment of the lump sum distribution of "*employer securities*" from a qualified retirement plan. When available, NUA, presents an opportunity to reverse the typical tradeoff of the tax deferral that can be taken now, that typically comes with losing out on the favorable tax treatment on qualified dividends and long-term capital gains in the future, for contributions made to a 401(k), IRA, or similar (non-Roth) retirement account.

In effect, NUA, allows an individual to trade back the ordinary income tax rates (that would normally apply to plan assets when distributed) for long-term capital gains on a portion of their retirement savings that consist of the appreciation of employer securities within a plan, in exchange for giving up the tax-deferred "wrapper" provided by the retirement account and paying ordinary income tax on the employer securities purchased, at the time of purchase.

Simply put, NUA is the appreciation of an employer's stock that occurs while those shares are held inside of a retirement plan that is sponsored by that employer. Obviously, the growth of employer shares in a retirement account can lead to significant NUA over the course of an employee's work history. Accordingly, advisors with clients who have NUA can provide valuable tax planning services.

Taxation of an NUA Transaction

Although the ability to trade ordinary income tax rates for long-term capital gains rates for long-term capital gains on NUA is an enticing proposition it's not always a slam dunk that it would appear to be on the surface. That's because, in addition to giving up the tax-deferred "wrapper" provided by the retirement account, when an individual engages in an NUA transaction (i.e., when a complete distribution of plan funds is made, in which the employer stock is moved in-kind to a taxable account), they must pay ordinary income tax on the cost of the employer's company shares (what would be the cost basis of the shares if they had been purchased in a taxable account) for which NUA is used

The NUA (i.e., the growth on the shares of employer stock), unlike the cost of the employer company's shares themselves, is not taxable until the shares are sold in a taxable account. Only at that time, when the shares are sold, does the NUA become taxable at long-term capital gains rates.

NUA Transaction Rules

Individuals who wish to engage in an NUA transaction (by completely disbursing retirement plan funds and moving any employer stock in-kind to a taxable account) may only do so at certain times, and they must follow certain rules precisely, as even a "simple" slip up can turn a potentially tax-saving NUA transaction into a tax-accelerating (and tax-increasing) disaster instead.
,
Specifically, there are four key NUA rules which must be followed to properly execute an NUA transaction. They are:

- Distribution made after one of the "*triggering events*":
    - Separation from service from the company whose plan holds the stock (except in the case of self-employed workers).
    - Reaching age 59½.
    - Total disability (for self-employed workers only); and
    - Death.
- Distribute their entire vested balance (lump-sum) in their plan within one tax year (though not all distributions have to be taken at the same time).
- Distribute all assets from all qualified requirement plans held with the employer, even if it's only company stock; and
- Distribute company stock as actual shares. Cannot convert employer stock to cash before the distribution.

Factors To Consider

As the advisor, you should consider the following factors to decide whether your client should rollover all their assets into an IRA or transfer company stock separately into a taxable account:

- *Tax rates.* The larger the difference between the ordinary income tax rate and the long-term capital gains tax rate, the greater the potential tax savings of electing NUA tax treatment of company stock.
- *Absolute NUA.* The larger the dollar value of the stock's appreciation, the more the NUA rules can save on taxes;
- *Percentage of NUA.* An NUA that is a higher percentage of total market value creates greater potential tax savings because more of the proceeds will be taxed at the lower capital gains rate and less will be taxed at income tax rates; and
- *Time horizon to distribution.* The longer your client plans to keep their assets invested in an IRA, the greater the potential benefit of that account's tax-deferred growth. A shorter time frame makes the NUA election more attractive.

Let's review an example of the NUA comparison with an IRA rollover.

> ***For Example:*** Tom, who is single and in the 37% tax bracket, decides to retire at age 50. He holds $100,000 worth of company stock with a cost basis of $20,000, resulting in net unrealized appreciation of $80,000. He wants immediate access to the cash. Tom decides to distribute the assets into a taxable account and elect NUA tax treatment. He pays income tax and a 10% early withdrawal penalty on just his $20,000 cost basis—a total of $9,400. Tom then immediately sells his company stock and pays 23.8% capital gains tax on the stock's $80,000 NUA. In all, he pays taxes and penalties of $28,440, leaving him with $71,560.
>
> Tom's other option is to have rolled over his company stock into an IRA, then sold the shares and withdrew the cash. With this option, Tom would pay income tax and penalties on the entire $100,000, for a total of $37,000 in income tax and $10,000 in early-withdrawal penalties. As a result, Tom would end up with just $53,000.

Note: In the above example, the results will differ depending on your client's holding period and percentage of NUA, but in this scenario, NUA tax treatment is clearly a better choice for Tom. As you can see, the decision of whether to take NUA treatment can be complicated. Certain situations may trigger restrictions on the NUA strategy. Before you just rollover funds to IRAs, an NUA comparison should be calculated if your client holds company stock.

Required Minimum Distributions

As discussed above, Congress intended the 401(k) plan to be used by the participant in retirement and not as wealth-transfer vehicles. To prevent the accumulation and transfer of wealth in and from qualified retirement plans (and IRAs), the Internal Revenue Service (IRS) enacted IRC § 401(a)(9), which *requires minimum distributions* (RMDs) to be taken from qualified retirement plans (and IRAs).

SECURE Act of 2019

The SECURE Act (Section 114) amended IRC § 401(a)(9)(C)(i)(I) by striking "age 70½" and inserting "age 72, the age for required mandatory distributions from IRAs (and qualified retirement plans). Thus, an individual turning 72 on February 2, 2020, can take their first RMD until as late as April 1, 2021. However, if the first RMD is not taken in the year an individual turns 72 but is instead taken the following year (by April 1), a second RMD will also still need to be distributed that year (the year the individual turns 73) by the end of the year. But either way, the first age-72 RMD will always be calculated using the age 72 life expectancy factor.

SECURE Act 2.0 Act of 2022

SECURE 2.0, Section 107, changes the age component of the required beginning date definition to age 73 for those who attain age 72 after December 31, 2022, and age 73 before January 1, 2033. SECURE 2.0 further increases the age to age 75 for those who attain age 74 after December 31, 2032 (see Table 8,5).

Required Beginning Date (RBD)

The fundamental rule for the distribution of IRAs (and retirement plans) benefits provides that the entire interest of each employee (plan participant) must be distributed to such employee (participant) not later than the required beginning date (RBD) [IRC § 401(a)(9)(A)].

For an IRA [IRC § 408(a)(6)], the term "*required beginning date*" (RBD) means April 1 of the calendar year following the calendar year in which the individual attains age 73 in 2023. However, in the case of a qualified retirement plan, the term "*required beginning date*" (RBD) is April 1 of the calendar year following the later of:

- The calendar year in which the employee attains age 73; or
- The calendar year in which the employee retires.

The rules for extending the required beginning date for employees' qualified retirement plans do not apply to employees who are 5% or more owners of the company sponsoring the plan. For such persons, the term "*required beginning date*" means April 1 of the calendar year following the later of:

- The calendar year in which the employee attains age 73; or
- The calendar year in which the employee retires.

"*Five percent ownership*" means ownership of more than 5 percent of the capital or profits of the employer [IRC § 416(i)(1)(B)(i)(II)] or, if the employer is a corporation, more than 5% of the outstanding stock of the corporation or stock possessing more than 5% of the total combined voting power of the corporation [IRC § 416(i)(1)(B)(i)(I)].

Note: A plan is permitted to provide that the RBD for all employees is April 1 of the calendar year following the calendar year in which the employee attains age 73 regardless of whether the employee is a five percent owner. Make sure you review your client's Summary Plan of Description (SPD) to define the required beginning date (RBD).

Table 8.5
New Age requirements for RMDs

Age 70 ½	For Births on June 30. 1949 or earlier	fAnyone born on June 30, 1949, or earlier should have already started lifetime RMDs and is bound by the original age 70 ½ RMD rule
Age 72	For Births on July 1, 1949, through and including December 31, 1950.	Anyone born on July 1, 1949, though and including December 31, 1950, should have already started lifetime RMDs and is bound by original SECURE RMD age change to 72. Nothing changes with SECURE 2.0. Continue with their existing RMD schedule.
Age 73	For Births on January 1, 1951, through and including December 31, 1959	Anyone born on January 1, 1951, through and including December 31, 1959, will use age 73 as their IRA RMD age. Note: We need a year to adjust to the new age, and in 2023 is that adjustment year. People boron in 1951 will all turn 72 this year. NO RMD is required for these folks in

		2023 because the rule is now age 73 until next year. Accordingly, no one will have their very first IRA RMD in 2023, because this year we are transitioning to the new age.
Age 75	For Births on January 1, 1960, or later	Doesn't begin for another 10 years (January 1, 2033)

Calculating Required Minimum Distribution

The RMD is generally computed for each participant based upon life expectancy. The idea is that distributions are spread ratably over a period projected to coincide with the participant's remaining lifetime (or the IRA participant's joint lives and a designated beneficiary). Thus, the minimum payment is calculated based upon a number of years of life expectancy, determined from IRS actuarial tables. The value of the retirement plan assets, as of the beginning of each calendar year, beginning with the year in which the RBD is attained, is divided by the applicable life expectancy to determine the minimum distribution for that year. The 1987 regulations required Tables V and VI in Reg. §1.72-9 to determine the life expectancy divisor. Under the Regs., only the Uniform Lifetime Table is used prior to the participant's death, except in cases where the designated beneficiary (DB) is a spouse more than ten years younger than the participant. In that case, the applicable distribution period (ADP) will be determined using the Uniform Life Table or the joint life expectancies of the participant and the spouse using the participant and the spouse's birthdays in the distribution calendar year [Treas. Reg. 1.408(a)(9)-5, A-4(b)]. The RMD is recalculated each year, based upon the account's value as of the last day of the previous calendar year, divided by the applicable life expectancy factor (LEF).

Once the amount is determined, it may be distributed at any time during the calendar year, in a single payment or any number of partial payments. Regarding the determination of the account value balance, it should be noted that even if the RMD for a given year is not made until December 31, the account value used in calculating the RMD amount is the value as of December 31, the previous calendar year. It is important to note that, although the concept of spreading out minimum payments based upon life expectancy would theoretically produce roughly equal amounts each year until the account is exhausted at death, annual distributions can vary widely from year to year since they are based upon continually changing current market values of the remaining asset pool.

New RMD Tables

On November 6, 2020, the IRS issued final regulations containing new life expectancy tables to be used for determining Required Minimum Distributions ("RMDs"). These new tables are effective for RMDs beginning on January 1, 2022. The old tables will still apply for 2021. No RMDs were required for 2020 due to the Coronavirus Aid, Relief, and Economic Security (CARES) Act. After reviewing improvements in mortality since RMD life expectancy tables were last updated in 2002, the IRS provided for an overall moderate reduction of RMDs utilizing these newly updated tables.

The changes to the life expectancy tables are intended to allow for the retention of greater amounts in affected retirement plans (generally IRA's and Company plans), defer taxes a little longer and hopefully provide more retirement income to participants to account for generally longer life spans. The effective date for the new tables was delayed from 2021 to 2022 in the final regulations, so account custodians and plan administrators would have enough time to update their computer systems that calculate the RMDs.

The three tables used to determine RMDs are:

- Single Life Table;
- Uniform Lifetime Table; and
- Joint and Last Survivor Table

Non-eligible designated beneficiaries that inherit an account after January 1, 2020 (the effective date of the SECURE Act), no longer use the three tables listed above and are now instead subject to the new *10 year rule*, whereby the funds are now required to be withdrawn by the end of the 10^{th} year following the year within which the account holder dies.

The revised tables will also affect individuals receiving Substantially Equal Periodic Payments (SEPPs) from IRAs or company retirement plans to avoid the 10% penalty on pre-age 59 ½ distributions. The IRS Life Expectancy Tables are also utilized to calculate the SEPP payment amounts, and the updated tables will cause a reduction of the amount permitted to be withdrawn without penalty.

Single Life Table

After the Secure Act, the Single Life Table will be used by a newly defined class of beneficiaries called Eligible Designated Beneficiaries (EDB). Eligible designated beneficiaries (EDBs) are defined as:

- Spouses.
- Disabled or chronically ill individuals.
- Minor children of the account owner/participant; or
- Someone who is no more than 10 years younger than the account owner/participant.

Table 8.6 illustrates the Single Life Table.

Table 8.6
The New Single Life Table

Age	LEF	Age	LEF	Age	LEF
70	18.8	87	7.1	104	2.2
71	18.0	88	6.6	105	2.1
72	17.2	89	6.1	106	2.1
73	16.4	90	5.7	107	2.1
74	15.6	91	5.3	108	2.0
75	14.8	92	4.9	109	2.0
76	14.1	93	4.6	110	2.0
77	13.3	94	4.3	111	2.0
78	12.6	95	4.0	112	2.0
79	11.9	96	3.7	113	1.9
80	11.2	97	3.4	114	1.9
81	10.5	98	3.2	115	1.8
82	9.9	99	3.0	116	1.8
83	9.3	100	2.8	117	1.6
84	8.7	101	2.6	118	1.4
85	8.1	102	2.5	119	1.1
86	7.6	103	2.3	120	+1.0

Source: Federal Register; https://www.federalregister.gov/documents/2020/11/12/2020-24723/updated-life-expectancy-and-distribution-period-tables-used-for-purposes-of-determining-minimum

Accounts inherited from an account owner/participants' passing before the SECURE Act went into effect on January 1, 2020, will continue to utilize the *Single Life Table* for distribution calculations and will also be affected by these updates to the tables. Finally, account owners/participants who died before January 1, 2020, and who failed to name a living beneficiary and who died *after* their Required Beginning Date, will also use the Single Life Table.

> ***For Example:*** A 75-year-old surviving spouse who is a sole beneficiary applying the Single Life Table under the former tables would use a life expectancy of 13.4 years to calculate RMDs and now under the new Single Life Table will use a life expectancy of 14.8 years for years beginning in 2022. In this example, if the beneficiary of the account owner had a $900,000 account balance on December 31, 2020, utilizing what will be former Single Life Tables, the RMD for 2021 would be $67,164. If the RMD for a 75-year-old with a $900,000 dollar account balance on December 31st, 2021, was calculated for 2022 under the newly updated Single Life Table, the RMD would be $60,811, a reduction of $6,353 or approximately 9.5%.

Uniform Lifetime Table

The Uniform Lifetime Table is the table most used by plan owners. It is used to determine lifetime RMDs to most plan participants over the age of 72; including when a spousal beneficiary is a sole designated beneficiary but who is not over 10 years younger than the account owner or when the spouse is not the sole designated beneficiary. The *Uniform Lifetime Table* is also used to calculate distributions required for an individual who has inherited a tax deferred retirement account from their spouse and has selected to transfer the account into their own name (see Table 8.7).

Table 8.7
The New Uniform Lifetime Table

Age	LEF	% of Account	Age	LEF	% of Account	Age	LEF	% of Account
70	29.1	3.44%	87	14.4	6.95%	104	4.9	20.41%
71	28.2	3.55%	88	13.7	7.76%	105	4.6	21.74%
72	27.4	3.65%	89	12.9	8.20%	106	4.3	23.26%
73	26.5	3.78%	90	12.2	8.73%	107	4.1	24.40%
74	25.5	3.93%	91	11.5	9.26%	108	3.9	25.65%
75	23.7	4.07%	92	10.8	9.51%	109	3.7	27.03%
76	22.9	4.22%	93	10.1	10.53%	110	3.5	28.58%
77	22.0	4.37%	94	9.5	11.24%	111	3.4	29.42%
78	20.0	4.55%	95	8.9	11.91%	112	3.3	30.31%
79	21.1	4.74%	96	8.4	12.83%	113	3.1	32.26%
80	20.0	4.96%	97	7.8	13.70%	114	3.0	33.34%
81	19.4	5.16%	98	7.3	14.71%	115	2.9	34.49%
82	18.5	5.41%	99	6.8	15.63%	116	2.8	35.72%
83	17.7	5.65%	100	6.4	16.67%	117	2.7	37.04%
84	16.8	5.96%	101	6.0	17.86%	118	2.5	40.00%
85	16.0	6.25%	102	5.6	19.24%	119	2.3	43.48%
86	15.2	6.58%	103	5.2	20.41%	120	2.0+	50.0%

Source: Federal Register; https://www.federalregister.gov/documents/2020/11/12/2020-24723/updated-life-expectancy-and-distribution-period-tables-used-for-purposes-of-determining-minimum

For Example: A 72-year-old IRA owner applying the Uniform Lifetime Table under the former tables would use a life expectancy of 25.6 years to calculate an RMD for calculation years up to 2021. Under the new Uniform Life Table (see Table 8.7 above), the IRA owner would use a life expectancy of 27.4 years for RMD calculations starting in 2022. In this example, if the account owner had a $1 million account balance on December 31, 2023, utilizing the former tables, the RMD for 2024 would be $39,063. If the RMD for a 72-year-old with a $1 million account balance on December 31, 2023, was required for 2024, using the newly updated tables the RMD would be $36,496, a reduction of approximately $2,567 or 6.6%.

Joint and Last Survivor Table

The Joint and Last Survivor Table is only used to determine RMDs to plan participants over the age of 73 when a spouse is a sole designated beneficiary and who is more than 10 years younger than the account owner (see Table 8.8).

Table 8.8
IRS Joint Life and Last Survivor Expectancy Table

		70	71	72	73	74	75	76	77	78
Your spouse's beneficiary age	**65**	26.9	25.7	25,4	25.1	24.9	24.6	24.4	24.3	24.1
	64	26.6	26.3	26.0	25.8	25.5	25.3	25.2	25.0	24.8
	63	27.2	26.9	26.7	26.5	26.2	26.1	25.9	25.7	25.6
	62	27.9	27.6	27.4	27.2	27.0	26.8	26.6	26.5	26.4
	61	28.5	28.3	28.1	27.9	27.7	27.5	27.4	27.3	27.1
	60	29.25	29.0	28.8	28.6	28.4	28.3	28.3	28.2	28.0

Note: This is a partial table. For the complete table, please refer to IRS Publication 590-B.
Source: Federal Register; https://www.federalregister.gov/documents/2020/11/12/2020-24723/updated-life-expectancy-and-distribution-period-tables-used-for-purposes-of-determining-minimum

For Example: Sheila is an IRA owner, and her husband, Tom, is the sole beneficiary on her account. On December 31 of last year, Sheila's ending account balance was $262,000. Sheila turns 76 this year, and Tom turns 60. To calculate her RMD for this year, Sheila divides $262,000 by the life expectancy factor of 28.2 years. Her distribution amount is $9,290.78.

Reminders: RMDs reflect the amount *required t*o be distributed. Owners and beneficiaries can always withdraw more than the required amount. Under the CARES Act provisions which Congress enacted in response to the COVID 19 Pandemic, no RMDs were required for 2020. RMDs returned in 2021, absent a change in the law, and will utilize the old IRS Life Expectancy Tables. However, for individuals just reaching their new RBD of age 72 in 2020, RMDs need not be made until December 31, 2021, due to the delayed RBD under the CARES Act. In 2022, RMDs will be calculated utilizing the updated tables and provisions from the SECURE Act. SECURE Act provisions include extended RBD for distributions to age 72 (previously age 70 ½) and the requirement that non-eligible designated beneficiaries comply with the 10-year distribution rule for all account assets.

Determination of Marital Status

The regulations clarify that the IRA participant's marital status is determined on January 1 each year for lifetime distributions. Divorce or death after that date is disregarded until the following year. Further, a change in beneficiary due to the spouse's death is not recognized until the following year.

Penalties for Failure to Take the Proper RMDs

Under IRC § 4974(a), once the participant reaches their RBD, RMDs are required to commence, if none are made, or if they total less than the required minimum in any year, a penalty excise tax is imposed. If a participant does not take the proper RMD, they will need to complete IRS Form 5329 and attach a letter of explanation to their tax return for that year. Until a couple of years ago, you were also required to send in a check for the penalty amount. This is no longer required. If the IRS decides not to grant a waiver, they'll send a bill.

New Rule for Reduced RMD Penalty

Prior to the SECURE 2.0 Act of 2022, the tax penalty was computed as 50% of the amount by which the RMD exceeds the amount actually distributed. This was the highest tax penalty in the Internal Revenue Code.

The SECURE 2.0 Act of 2022, Section 302, introduced a significant change to the penalty by reducing it from 50% to 25% of the amount that was requried to be distributred but was not. In addtion, the penalty can be further reduced to 10% if the account holder corrects the shortfall in a timely manner.

To receive relief and reduce the penalty from 25% to 10%, the following steps must be taken:

- Correction of RMD Shortfall:
    - The account holder must take the missed RMD by the end of the second year following the year in which the RMD should have been taken.
- Filing Form 5329:
    - The account holder must file IRS Form 5329, "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts."
    - On the form, the account holder should indicate that they have corrected the missed RMD.
    - The form should be filed with their federal income tax return for the year in which the shortfall is corrected.
- Reasonable Cause:
    - Although not always required, providing a reasonable cause for the missed RMD can be beneficial. This can be included in a statement attached to Form 5329 explaining the circumstances that led to the failure to take the RMD and the steps taken to rectify it.

The SECURE 2.0 Act of 2022 reduces the penalty to 25% in all cases. In addition, the penalty drops down to 10% if you take the necessary RMD by the end of the second year following the year it was due. So, for example, if you fail to take an RMD due in 2024, the penalty is knocked down to 10% if the participant withdraws the necessary funds by December 31, 2026. These penalty-reduction provisions applied beginning back in 2023.

Designated Beneficiary Rules

As a general rule, a "*designated beneficiary"*(DB) is an individual who is designated as a beneficiary under the plan, either by the terms of the plan or if the plan so provides, by the affirmative election of the participant [IRC § 401(a)(9)(E); Treas. Reg. 1.401(a)(9)-4, Q&A-1].

Note: The SECURE Act has not changed the definition of the designated beneficiary (DB).

Only an individual may be a designated beneficiary for purposes of the distribution rules. A legal "person" that is not an individual, such as the "estate" of the participant or a charitable organization, may not be a designated beneficiary. If a person other than an individual is designated as a beneficiary of a participant's 401(k) (or IRA), the participant will be treated as not having a designated beneficiary [Treas. Reg. 1.401(a)(9)-4, Q&A 3].

A designated beneficiary need not be specified by name in the beneficiary form or by the participant to be a designated beneficiary. The individual who is to be the beneficiary is identifiable under the beneficiary form as of the date the beneficiary is determined. The members of a class of beneficiaries capable of expansion or contraction will be treated as identifiable if possible, as of the date the beneficiary is determined, to identify the class member with the shortest life expectancy (the eldest). However, as discussed above, the fact that a participant's interest in a qualified retirement plan (and/or IRA) passes to a certain individual under a will or otherwise under applicable state law does not make that individual a designated beneficiary unless the individual is properly designated as a beneficiary under the plan [Treas. Reg. 1.401(a)(9)-4, Q&A-1].

If there are two or more beneficiaries (multiple beneficiaries), only the oldest beneficiary will be treated as a designated beneficiary for purposes of determining the applicable distribution period (ADP) unless each beneficiary is entitled to a separate share or a separate account [Treas. Reg. 1.401(a)(9)-5, Q&A-7(a)1].

If there are two or more (multiple) beneficiaries, and one of the beneficiaries is not an individual, the participant will be treated as not having any designated beneficiary unless the non-individual beneficiary is entitled to a separate share or a separate account [Treas. Reg. 1.401(a)(9)-5, Q&A-7(a)(2)].

A separate account is a portion of a participant's benefit determined by an acceptable separate accounting, including allocating investment gains and losses, contributions, and forfeitures, on a pro-rata basis reasonably and consistently between such portion and any other benefits [Treas. Reg. 1.401(a)(9)-8, Q&A-3]. The amounts of each such portion of the benefit will be separately determined to determine the amount of the required minimum distribution [Treas. Reg. 1.401(a)(9)-8, Q&A-3].

Once the separate accounts are established, the separate accounting can provide for separate investments for each separate account under which gains and losses from the investment of the account are allocated only to that account, or investment gains and losses can continue to be allocated among the separate accounts on a pro-rata basis. A separate accounting must allocate any post-death distributions to the separate account of the beneficiary receiving that distribution [Treas. Reg. 1.401(a)(9)-8, Q&A-3].

Date to Determine the Designated Beneficiary

To be a designated beneficiary, an individual must be a beneficiary as of the date of the participant's death. The participant's designated beneficiary will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the participant's death (known as the "*beneficiary finalization date*"). Accordingly, any person who was a beneficiary as of the date of the participant's death but is not a beneficiary as of September 30th of the calendar year following the calendar year of the participant's death (either because the person disclaimed entitlement to the benefit in favor of another beneficiary or because the person received the entire benefit to which the person is entitled before that date) is not taken into account in determining the participant's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the participant's death [Treas. Reg. 1.401(a)(9)-4, Q&A-4(a)].

In short, the designated beneficiary is determined as of the date of death. Between the date of death and the beneficiary designation date, the date of death beneficiary can be eliminated by disclaimer or distribution, but no new beneficiaries can be added.

Postmortem Planning

The rule that allows the designated beneficiary to be determined as late as September 30 of the calendar year following the calendar year of the participant's death creates post-mortem planning opportunities for maximizing the post-death spread period; for example, when there are multiple potential beneficiaries (e.g., a primary and a secondary beneficiary, or two or more co-beneficiaries).

Qualified Trusts as Designated Beneficiaries

Although a trust is not considered an individual, its beneficiaries may be treated as the participant's designated beneficiary in determining required minimum distributions if it is considered a "*qualified trust*." To be a qualified trust and be considered a designated beneficiary, the trust must satisfy five tests. The first four tests are as follows:

- The trust must be valid under state law;
- The trust must be irrevocable or become irrevocable at the taxpayer's death;
- The trust beneficiaries must be identifiable; and
- Certain documentation must be provided to the plan administrator (or IRA) custodian by October 31 of the year after the taxpayer's death.

If these four tests are met, the trust will generally be treated as a designated beneficiary, and the required minimum distribution will be based on the oldest trust beneficiary's life expectancy [Treas. Reg. § 1.401(a)(9)-5, A-7(a)(1). But there is, in essence, a fifth test for the trust to be a designated beneficiary because all of the trust's beneficiaries must be individuals the age of whom can be identified [Treas. Reg. § 1.401(a)(9)-4, A-5(c) and Treas. Reg. § 1.401(a)(9)-4, A-3]. Therefore, the fifth requirement is to draft the trust so that it is possible to determine the oldest beneficiary's identity and require that only individuals may be beneficiaries of the trust. This fifth test can create problems, especially with multi-beneficiary common pot trusts or multi-generation dynasty trusts.

It is difficult to draft a trust with individual and ascertainable beneficiaries because the IRS has not explained which contingent beneficiaries can be ignored. The regulations provide that if the first four tests above are met, the IRS will treat the trust's beneficiaries as the potential designated beneficiary of the retirement account. It then becomes necessary to determine three things:

- The identity of the beneficiaries of the trust;
- The identity of any beneficiaries of the trust that are not individuals; and
- The identity of the oldest beneficiary.

In making these determinations, the trust's "*contingent beneficiaries*" must be taken into account [Treas. Reg. § 1.401(a)(9)-5, A-7(b)]. The regulations provide that a person will not be considered a beneficiary for purposes of determining the beneficiary with the shortest life expectancy, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the participant's beneficiaries after that beneficiary's death. However, the preceding sentence does not apply to a person who has any right (including a contingent right) to a participant's benefit beyond being a mere potential successor to the interest of one of the participant's beneficiaries upon that beneficiary's death.

This rather unhelpful regulation guides that a "mere potential successor" beneficiary can be ignored. The regulation also specifically states that one cannot ignore contingent beneficiaries simply because the current beneficiary is entitled to all of the trust income, as is the case with a QTIP trust or QSST:

> *"…if the first beneficiary has a right to all income ... during that beneficiary's life and a second beneficiary has a right to the principal but only after the death of the first income beneficiary ...both beneficiaries must be taken into account in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries."*

Although the regulation contemplates that some beneficiaries can be ignored, it never really explains the circumstances in which they can be ignored [Treas. Reg. § 1.401(a)(9)-5, A-7(c)(1)]. Under Private Rev. Rul. 200438044 takes a date-of-death look at then-living trust beneficiaries to determine which contingent remainder beneficiaries can be ignored. Under this ruling's analysis, if a trust is to terminate upon a beneficiary's reaching a certain age, then the only remainder beneficiaries that must be counted are the individuals that would receive the trust assets upon termination, provided those individuals are alive on the taxpayer's death. They have already attained the age for termination. This ruling is not helpful to dynasty trusts or lifetime trusts with withdrawal rights. The beneficiary is never required to take outright ownership of the trust assets. It will be interesting to see if the IRS consistently applies the analysis of this ruling. Until the IRS or Congress clarifies these rules, practitioners in this area must proceed very carefully.

The SECURE ACT: The 10-Year Rule

Under the SECURE Act (Section 401), upon the death of the retirement plan participant, there is no longer a distinction between the retirement plan participant's death before RBD or death after the retirement plan participant's RBD. The SECURE Act adds a new section to IRC § 401(a)(9), IRC § 401(a)(9)(H). Section H layers new payout periods that will apply to all designated beneficiaries on top of the existing rules (discussed above): A 10-year payout replaces the life expectancy payout method for all but five categories of designated beneficiaries. Those five categories ("eligible designated beneficiaries") will be entitled to a modified version of the life expectancy payout. However, most non-spouse beneficiaries who inherit the IRA (and or defined contribution plan) would be required to withdraw down the entire inherited interest by the end of the 10th year following the year of inheritance. Like the existing 5-year rule for non-designated beneficiaries (discussed above), though, within the 10-year period, there are no distribution requirements. Thus, the designated beneficiaries (DB) will have some flexibility regarding timing distributions from the inherited account(s) for maximum tax efficiency.

Note: The SECURE applies only to "certain defined contribution plans." Defined benefit plans, including certain annuity payouts in an IRA or other defined contribution plans that were already locked in prior to the enactment of SECURE, are not affected. Title IV, IRC § 401(b)(4).

Eligible Designated Beneficiaries

Significantly, the ten-year rule would not apply to any portion payable to an "eligible designated beneficiary" (EDB) if such portion will be:

- Distributed over the beneficiary's life or a period not exceeding their life expectancy; and
- Such distributions begin within one year of the death.

An "*eligible designated beneficiary*" (EDB) is any designated beneficiary who is:

- The surviving spouse [IRC § 401(a)(9)(E)(ii)(l)]. The surviving spouse can still use the life expectancy payout. However, on their death, the exception ceases to apply, and a 10-year payout applies;
- Certain minor children of the original retirement plan participant [IRC § 401(a)(9)(E)(ii)(ll). The life expectancy payout applies to a "child of the employee who has not reached majority." However, upon reaching majority, the 10-year rule kicks in, but only until they reach the age of majority;
- Disabled Beneficiary. The life expectancy payout applies to a designated beneficiary who is disabled (as defined by IRC § 72(m)(7)). Upon their death, the 10-year payout rule kicks in;
- Chronically ill individual. The life expectancy payout applies to a designated beneficiary who is chronically ill (as defined by IRC § 7702B(c)(2)). Upon their death, the 10-year payout rule kicks in; or
- Individuals who are not more than 10 years younger than the deceased retirement plan participant (owner). The life expectancy payout applies to an individual who is not more than 10 years younger than the participant; upon their death, the 10 year payout rule kicks in.

For these Eligible Designated Beneficiaries, it's "business as usual"–the same rules that applied to them before the SECURE Act will continue to apply after the SECURE Act. They can take distributions over the beneficiary's life expectancy (spousal beneficiaries may also engage in a spousal rollover). As a result, the ’Stretch’ isn’t truly “dead,”’ but it will only live on via a small percentage of post-2019 beneficiaries.

It is important to emphasize that the Special Rule for Minor Children applies only to the “child of the retirement plan participant [or employee] who has not reached majority.” As such, minor children would appear to be ineligible for similar treatment if a retirement account was inherited from a non-parent, such as a grandparent.

In the case of a child who has not attained the age of majority, the ten-year rule would apply as of the date the child attains the age of majority. The 10-year rule also would apply upon the death of any eligible beneficiary.

If the eligible designated beneficiary (EDB) is the surviving spouse, such distributions would not be required to begin earlier than the date on which the retirement plan (owner)r would have attained age 73. Surviving spouses also have the option of converting the retirement plan funds to their own IRA.

These changes would generally apply concerning deaths after 2019. There are delayed effective dates for collectively bargained plans and for governmental plans. The new rules do not apply to a qualified annuity that is a binding contract as of the bill's date of enactment and for which payments have begun, or the owner has made an irrevocable election as to the method and amount annuity payments.

Applying the RMD Rules after the SECURE Act

The first step in determining the required minimum distributions (RMDs) after the retirement plan participant’s death is to ascertain the identity of the designated beneficiary or beneficiaries. Is the primary beneficiary one of the following?

- The surviving spouse (sole designated beneficiary);
- A non-spouse designated beneficiary;
- A trust (designated beneficiary)
- A non-designated beneficiary; or
- An eligible designated beneficiary

Surviving Spouse as Sole Designated Beneficiary

The surviving spouse of the participant is an EDB. The surviving spouse will have a choice of the following options:

- Lump Sum;
- Rollover to a spousal IRA;
- Rollover to an Inherited IRA; or
- Remain as beneficiary (if plan allows-no rollover).

Lump Sum. Spouse takes a lump sum distribution of the inherited retirement assets and pays income taxes in the year of distribution.

Rollover. The current regulations continue and clarify the rule in the original 1987 Treas. Regs. which allows the surviving spouse of a deceased retirement plan participant to elect to rollover the assets and treat assets as a spousal IRA. With this option, the surviving spouse would rollover an inherited IRA as the spouse's own IRA. Thus, the surviving spouse may even make additional contributions into the IRA and make rollover transfers from it [Treas. Reg. §1.408-8, Q&A-5]. A new payout period can be established based upon the then age of the surviving spouse. No distributions will be required until the surviving spouse has reached age 73. If the surviving spouse had reached age 73 prior to the IRA participant's death, then the required beginning date (RBD) is December 31 of the calendar year following the year in which the decedent died [Ltr. Ruls. 9704019 and 9739034]. The minimum payout would be determined from the Uniform Lifetime Table based upon the surviving spouse's age. The surviving spouse may name a beneficiary to accede to the account upon the surviving spouse's death. If the surviving spouse remarries and their new spouse is designated as beneficiary, or if the new spouse is more than 10 years younger, minimum distributions can be based upon their actual joint life expectancy, resulting in a lower minimum required distribution under the Uniform Lifetime Table.

The surviving spouse's election to treat the deceased spouse's IRA as their own may be made by affirmative action recharacterizing the IRA title. Additionally, the election is deemed to have been made if the required minimum distribution for any year is not made to the surviving spouse or if the surviving spouse contributes to the account [Treas. Reg. §1.408-8, Q&A-5(b)].

These rules make the election consistent with the underlying premise that the surviving spouse could have received a distribution of the entire deceased participant's retirement plan and rolled it over to an IRA in the surviving spouse's own name. The affirmative election can be made at any time after the retirement plan participant's death. For example, the surviving spouse is not deemed to have waived their right to make this election due to having accepted the minimum distribution from the account for the year following the year of the retirement plan participant's death. Required minimum distributions for years prior to the election will not trigger the 10 percent premature withdrawal penalty even if the surviving spouse had not attained age 59½ when they were received.

The regulations clarify that this election (whether by affirmative action or a deemed election) operates upon the following:

- Only after the distribution of what would have been the required minimum amount, if any, for the year of the retirement plan participant's death (computed as if the owner had lived for the entire year) [Treas. Reg. §1.408-8, Q&A-4]; and
- Only if the spouse is the account's sole beneficiary and has an unlimited right of withdrawal from the account, this requirement is not satisfied if the spouse's interest is held through a trust, even if the spouse is the sole beneficiary of the trust [Treas. Reg. §1.408-8,Q&A-5(a)].

If the spouse actually receives a distribution from the retirement plan, the spouse is permitted to roll that distribution over within 60 days into an IRA in the spouse's own name to the extent that the distribution is not a required minimum distribution, regardless of whether or not the spouse is the sole beneficiary of the retirement plan participant. Further, if the spouse receives the distribution before the year that the retirement plan participant would have been 72, no portion of the distribution is a required minimum distribution to determine whether it is eligible to be rolled over by the surviving spouse.

Remain As A Beneficiary. If the retirement plan participant dies prior to age 73, and the surviving spouse does not make the election to treat the inherited IRA as his or her own account, annual required minimum distributions (RMDs) need not commence until December 31 of the year in which the deceased IRA participant would have attained age 73 [IRC § 401(a)(9)(B)(iv)(I)]. This rule, delaying the RBD until December 31 of the year that the deceased IRA participant would have reached 73, in cases where the surviving spouse is the beneficiary, is also applied where the beneficiary is a trust and the surviving spouse is the sole beneficiary [Treas. Reg. §1.401(a)(9)-5, Q&A-7(c)(3)].

Once the commencement date arrives, required minimum distributions are based upon the then life expectancy of the surviving spouse. The designated beneficiary's required minimum distributions will be based on the 10-year rule upon the surviving spouse's death. If the surviving spouse dies before distributions to such spouse have begun under the previous rule, the relevant designated beneficiary (DB) for determining the distribution period is the designated beneficiary, if any, of the surviving spouse (determined as of September 30 of the calendar year following such spouse's death), and distributions will be based on the 10-year rule. If there is no designated beneficiary concerning the deceased surviving spouse, a 5-year rule applies; the entire account balance must be distributed no later than December 31 of the fifth calendar year after the year of the spouse's death [Treas. Reg. §1.401(a)(9)-3,Q&A-5].

If the surviving spouse has not died before the first required minimum distribution, and the required minimum distributions are not commenced when otherwise required, the surviving spouse is automatically deemed to have elected to have the account treated as their own IRA account, with distributions to begin at their RBD [Treas. Reg. §1.408-8,Q&A-5].

Special Rules for Surviving Spouse

Under IRC § 401(a)(9)(B)(iv), a surviving spouse does not have to start taking required minimum distributions until the end of the calendar year in which the participant would have reached age 73, if later than December 31 of the year after the participant's death.

The surviving spouse's choices also include:

- Distribute all the assets by the end of the tenth year after the year the participant died, provided the plan offers this option; otherwise, the spouse could simply roll this to an inherited IRA to have this option;
- Roll to their own traditional IRA (as a spousal rollover);
- Roll to a Roth IRA, which would be a taxable conversion (the RMD for the year of death may not be rolled over); or

- Roll the deceased participant's plan assets to the plan where the surviving spouse works, where it becomes the surviving spouse's rollover source funds, provided the recipient plan accepts rollovers. IRC § 401(a)(9) regulations specifically permit this, again, provided the plan accepts rollover contributions.

The surviving spouse could always accelerate the payments unless the plan or beneficiary form overrides any acceleration.

Note: Under SECURE 2.0 Act of 2022, Section 327, provides that a surviving spouse may elect to be treated as the deceased employee for purposes of the RMD rules, effective beginning in 2024. A surviving spouse who makes this election would begin RMDs no earlier than the date the deceased participant would have reached RMD age. Further, if a spouse beneficiary who makes this election dies before they're required to start RMDs, the RMD rules would apply as if the spouse beneficiary were the employee.

Non-Spouse Individual Designated Beneficiary

If the retirement plan participant named a non-spouse designated beneficiary as the primary beneficiary and if there is one individual beneficiary named, such beneficiary must take required minimum distributions under one of the following two methods:

- Take a lump sum distribution;
- Take full distribution by applying the requirements of the 10-year rule.

For your client who simply wishes to leave their retirement plan funds outright to various individuals (e.g., adult children) may have nothing to change. The children will have to pay taxes sooner than was previously expected, and that in turn may mean the taxes will be higher than if more spread out, but other than finding a new funding source for the taxes or converting to a Roth IRA now if the client is in a lower bracket than his beneficiaries, there is not much that can be done about this.

If your client is planning with minor children, as under existing rules, leaving retirement benefits for minor children is difficult without either accelerating the taxation of the benefits or accelerating the children's control. As an eligible designated beneficiary (EDB), the minor child would have the same life expectancy payout. Still, it would not last their entire life–only until they reach majority. At this point, the child would have to receive all benefits outright within 10 years after attaining majority, which may or may not be what the parents want. Here are some important points and questions about this EDB category:

- The EDB exception for minor children applies only to the child of the participant–not to grandchildren or any other children;
- The exception ceases to apply once the child "reaches majority (within the meaning of subparagraph [§ 401(a)(9)] (F)." (§ 401(a)(9)(F) is an otherwise unrelated provision that deals with payments made to a minor child being treated as paid to the surviving spouse.) Presumably, the child reaches majority when they attain the age of majority applicable in their state (typically 18 or 21) unless this regulatory exception (under § 401(a)(9)(F))

applies: *"... a child may be treated as having not reached the age of majority if the child has not completed a specified course of education and is under the age of 26. In addition, a child who is disabled within the meaning of section 72(m)(7) when the child reaches the age of majority may be treated as having not reached the age of majority so long as the child continues to be disabled"* Reg. § 1.401(a)(9)-6, A-15; and

- If the minor dies prior to attaining majority, the 10-year rule will kick in at that time.

A designated beneficiary who is "disabled (within the meaning of section 72(m)(7))" is an EDB § 401(a)(9)(E) ((ii)(III). IRC § 72(m)(7) provides that:

> "…*an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long continued and indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require."*

A designated beneficiary who is "a chronically ill individual (within the meaning of section 7702(B)(c)(2)" is an EDB–except that the requirements of subparagraph (A)(i) [of § 7702B(c)(2)] shall only be treated as met if there is a certification that as of such date, the period of inability described in such subparagraph with respect to the individual is an indefinite one which is reasonably expected to be lengthy in nature)" § 401(a)(9)(E)((ii)(IV).

On the death of the disabled or chronically ill individual, as with other EDBs, the life expectancy payout period terminates, and the 10-year rule kicks in.

If your client names a designated beneficiary (DB) who is less than 10 years younger, who is not a surviving spouse, minor child, disabled or chronically ill beneficiary, is entitled to an "exception from the application of the 10-year rule because they are an EDB." As with other EDBs discussed above, the exception permitting a life expectancy payout ends at the death of the EDB. Upon the EDB's death, however, IRC § 401(a)(9)(H)(iii) provides that "the exception under clause (ii) [granting life expectancy payout to the EDB] shall not apply to any beneficiary of such eligible designated beneficiary and the remainder of such portion shall be distributed within 10 years after the death of such eligible designated beneficiary."

Trust as Beneficiary (Designated Beneficiary)

The changes introduced by the SECURE Act will make it even more necessary to review any situations where trusts are named as retirement account beneficiaries. As was discussed above, in general, trusts created to serve as the beneficiary of a retirement account are drafted in such a manner as to comply with the "see-through trust" rules, which allow the trust to stretch distributions over the oldest applicable trust beneficiary.

There are two types of such trusts; conduit trusts and accumulation trusts (also referred to as discretionary trusts). The SECURE Act could unfavorably impact both types of trust.

For instance, many conduit trusts are drafted in a manner that only allows for the RMD to be disbursed from an inherited IRA to the trust each year, with a corresponding requirement for that amount to be passed directly out to the trust beneficiaries. Considering the changes made by the SECURE Act, for those beneficiaries subject to the 10-Year Rule, there is only one year where there is an RMD…the 10th year!

As a result of this change, conduit Trusts drafted with language like that referenced above might not allow the trustee to take *any* distributions of the inherited account until the 10th year after death (because prior to that 10th year, any IRA distributions would be "voluntary"). And then, in the 10th year, the *entire* balance would have to come out in one year to the trust *and* be passed entirely along to the trust beneficiaries (as a mandated RMD that under the conduit provisions "must" be passed through). The result could be what would amount to a very high tax bill, as the entire value of the retirement account is lumped into a single tax year as a distribution to the beneficiary. Not to mention the loss of any protection of such assets (after they are distributed from the trust).

Accumulation trusts may not fare much better, though, if at all. Such trusts often require that all, or a substantial portion of retirement account distributions, remain *in* the trust (and not distributed out to the trust beneficiaries). In such circumstances, amounts retained by the trust are subject to trust tax rates, which are *highly* compressed compared to individual tax rates.

For example, in 2025, trusts reach the highest federal tax bracket of 37% at just $15,651 of taxable income. Given that such trusts will have at best, 10 years to spread out distributions from inherited retirement accounts (since an accumulation trust itself would now often be subject to the 10-year rule, as a "see-through-but-likely-not-eligible designated beneficiary trust"), significant amounts of wealth could evaporate in the form of high trust taxes.

Reminder: For the most part, the changes under the SECURE Act (Section 401) will impact beneficiaries beginning in 2020. However, Congress did carve out a few exceptions to this rule, as follows:

- Plans maintained pursuant to a collective bargaining agreement have an effective date of January 1, 2022 (unless the collectively bargained agreement terminates sooner);
- Governmental plans, such as 403(b) and 457 plans sponsored by state and local governments, and the Thrift Savings Plan sponsored by the federal government (and in which Congresspersons, themselves, participate) are not impacted until January 1, 2022; and
- Annuities in which individuals have already irrevocably annuitized over life or joint life expectancy, or in which an individual has elected an irrevocable income option that will begin at a later point, are exempt entirely (and simply follow the already-binding contractual provisions of the annuitized contract).

How RMDs are Reported

RMDs are taxable as ordinary income and reported on IRD For 1099-R. They are not eligible for rollover distributions. The exclusion ratio would be applied to the extent the participant has a cost basis unless the minimum distribution is a qualified distribution from a DRAC.

Distributions to actively employed participants over age 73 and who are not 5 percent owners are no longer considered required minimum distributions. As a result, distributions to participants in this category are considered eligible rollover distribution unless they fall within another exception to that rule [IRS Notice 97-75, 1997-2 C.B.337].

IRS Notice 2024-35

On April 16, 2024, IRS released Notice 2024-35 extending temporary relief for certain required minimum distributions ("RMD") related to the SECURE Act's 10-year distribution rule through 2024. This notice follows similar relief provided by the IRS in Notice 2022-23 and Notice 2023-54 earlier periods.

The Notice also confirms that failure to make these RMD payments during the extended relief period will not jeopardize plan qualification. Please note this RMD waiver only applies to beneficiaries utilizing the 10-year rule and not the eligible designated beneficiaries utilizing the life expectancy rule.

The notice also suggested that the proposed RMD regulations will be finalized soon and that the proposed RMD regulations would apply for determining RMDs for calendar years beginning on or after January 1, 2025.

Note: The IRS says that a rollover of a 2023 distribution by someone born in 1951 won't violate the once-per-year rule if another distribution was received in the prior 12 months that was also rolled over. But it will start a new 12-month period that will prevent a distribution received in the next 12 months from being rolled over.

IRS Releases Final RMD Regulations

On July 19, 2024, the U.S. Treasury Department and IRS released final regulations (T.D. 10001) and proposed regulations (REG-103529-23) relating to required minimum distributions (RMDs) under IRC § 401 (a) (9) from qualified plans under IRC § 401 (a); IRC § 403 (b) annuity contracts, custodial accounts, and retirement income accounts; Individual Retirement Accounts (IRAs) and Annuities; and eligible Deferred Compensation plans.

- The final regulations reflect the amendments made to section 401(a)(9) by provisions of the "Setting Every Community Up for Retirement Enhancement Act of 2019" (SECURE Act), enacted on December 20, 2019, as Division O of the Further Consolidated Appropriations Act of 2019, Pub. L. No. 116-94, and by various sections of the "SECURE

2.0 Act of 2022" (SECURE 2.0 Act), enacted on December 29, 2022, as Division T of the Consolidated Appropriations Act, 2023, Pub. L. 117-328.

- The proposed regulations reflect various provisions of the SECURE 2.0 Act relating to IRC § 401(a)(9) that were reserved in the final regulations

The IRS has confirmed the requirement for Non-Eligible Designated Beneficiaries (NEDBs) to take RMDs annually (although for beneficiaries who would have been required to take RMDs in 2021–2024 but didn't, the IRS has confirmed that there will be no penalty and no requirement to make up the missed distribution, meaning the new regulation effectively starts with RMDs required to be taken in 2025).

Beyond the confirmation of the general post-death RMD rules, the 260-page Final Regulations document offers several other regulatory guidance for specific circumstances where the new rules for Eligible and Non-Eligible Designated Beneficiaries apply. These include:

- New rules for handling undistributed RMDs in the year of an account owner's death.
- A new "Hypothetical RMD" rule for surviving spouses who initially elect to use the 10-Year Rule but later choose to roll over or treat the inherited account as their own.
- Specification that when a plan participant has 100% of their plan balance in a Designated Roth account, any Non-Eligible Designated Beneficiaries are not required to take annual RMDs during the period of the 10-Year Rule.
- Clarification of the requirements for successor beneficiaries who, depending on the circumstances, may need to either begin a new 10-year period after which the account must be fully distributed or finish out the original beneficiary's 10-year period.
- New definitions of which beneficiaries of a See-Through Trust are also considered beneficiaries of the retirement account and which may be disregarded for retirement account purposes.
- A new rule providing that when a See-Through Trust is divided into separate trusts for each beneficiary upon the death of the retirement account owner, the RMD rules will be applied individually for each trust beneficiary rather than uniformly across all beneficiaries based on the beneficiary with the shortest required distribution timeline; and
- Clarification that when a retirement account (including IRAs) owns both annuity and non-annuity assets, those assets can be aggregated together for the purposes of calculating the participant's RMD and that payments from the annuity can count against the total RMD for both annuity and non-annuity assets.

Along with the new Finalized Regulations, the IRS also released a new set of Proposed Regulations dealing with some unanswered questions around the SECURE 2.0 Act passed in late 2022. Most notably, the new Proposed Regulations confirm that the RMD age for individuals born in 1959 is 73 (since a drafting error in the final legislation inadvertently set that RMD age to both 73 and 75) and fill in rules around the SECURE Act's new provision allowing surviving spouses of retirement account owners to elect to be treated as the decedent for RMD purposes – although, as the Proposed Regulations make clear, the treatment for surviving spouses won't really be identical to the decedent's since the surviving spouse must still calculate RMDs based on their own life expectancy, and none of their own beneficiaries will qualify as Eligible Designated Beneficiaries.

You can download the Final Regulations at: [Federal Register :: Required Minimum Distributions]

Hardship Withdrawals

Under IRC § 401(k)(2)(B)(i)(IV), a retirement plan may, but is not required to provide for hardship distributions. Many plans that provide for elective deferrals provide for hardship distributions. Thus, 401(k) plans may permit hardship distributions. If a 401(k) plan provides for hardship distributions, it must provide the specific criteria used to determine hardship. Thus, for example, a plan may provide that a distribution can be made only for medical or funeral expenses, but not for purchasing a principal residence or paying tuition and education expenses. In determining the existence of a need and of the amount necessary to meet the need, the plan must specify and apply nondiscriminatory and objective standards [Treas. Reg. § 1.401(k)-1(d)(3)(i)].

For a distribution from a 401(k) plan to be on account of hardship, it must be made based on the employee's immediate and heavy financial need. The amount must be necessary to satisfy the financial need. The employee's need includes the need of the employee's spouse or dependent [Treas. Reg. § 1.401(k)-1(d)(3)(i)].

Under Section 826 of the Pension Protection Act (PPA) of 2006, the employee's need also may include the need of the employee's non-spouse (including domestic partners), non- dependent beneficiary. Whether a need is immediate depends on the facts and circumstances. Certain expenses are deemed to be immediate and heavy, including:

- Certain medical expenses.
- Costs relating to the purchase of a principal residence.
- Tuition and related educational fees and expenses.
- Payments necessary to prevent eviction from, or foreclosure on, a principal residence.
- Burial or funeral expenses; and
- Certain expenses for the repair of damage to the employee's principal residence.

A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee [Treas. Reg. § 1.401(k)-1(d)(3)(iii)]. A distribution is not considered necessary to satisfy an employee's immediate and heavy financial need if the employee has other resources available to meet the need, including the assets of the employee's spouse and minor children. Whether other resources are available is determined based on facts and circumstances. Thus, for example, a vacation home owned by the employee and the employee's spouse generally is considered a resource of the employee. In contrast, property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act is not considered a resource of the employee [Treas. Reg. § 1.401(k)-1(d)(3)(iv)(B)].

A hardship distribution may not exceed the amount of the employee's need. However, the amount required to satisfy the financial need may include amounts necessary to pay any taxes or penalties that may result from the distribution [Treas. Reg. § 1.401(k)-1(d)(3)(iv)(A)]. The elective contributions available for a hardship distribution cannot be more than the employee's total elective contributions, including designated Roth contributions, as of the date of distribution reduced by the amount of previous distributions of elective contributions. This "maximum distributable amount" generally does not include earnings, qualified non-elective contributions, or qualified matching contributions unless the plan provides that certain grandfathered amounts are included. If any, other amounts under the plan, such as regular matching contributions and discretionary profit-sharing contributions, may also be distributed on account of hardship if the plan so provides [Treas. Reg. § 1.401(k)-1(d)(3)(ii)]. After an employee receives a hardship distribution of elective contributions from their 401(k) plan, generally, the employee will be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution [Treas. Reg. § 1.401(k)-1(d)(3)(iv)(E)(2)].

Hardship distributions are includible in gross income unless they consist of designated Roth contributions. In addition, they may be subject to an additional tax on early distributions of elective contributions. Unlike loans, hardship distributions are not repaid to the plan. Thus, a hardship distribution permanently reduces the employee's account balance under the plan.

Note: The Tax Cuts and Jobs Act of 2017, Section 1504 provides a provision that now allows 401(k) plans to distribute qualified non-elective contributions (QNECs), qualified matching contributions (QMACs), and investment earnings on those accounts and investment earnings on elective deferrals as amounts available for a hardship distribution.

Bipartisan Budget Act of 2018

As a result of the Bipartisan Budget Act of 2018, new rules for hardship distribution became effective as of January 1, 2019. The three primary changes to the current hardship distribution rules:

Participants will:

- Not be required to take plan loans before a hardship distribution is granted.
- No need to suspend their employee salary deferrals for six months following a hardship withdrawal; and
- Will be able to distribute other types of contributions beyond employee salary deferrals and grandfathered, pre-1989 earnings thereon as part of a hardship distribution, including qualified non-elective contributions (QNECS), qualified matching contributions (QMACs), safe harbor contributions, and earnings from all eligible sources (including past 1988 earnings on elective deferrals).

Items 1. and 2. are currently part of the IRS's requirements for a hardship distribution to meet the safe harbor definition of "necessary to satisfy an immediate and heavy financial need." [See Treasury Regulation Section 1.401(k)-1(d)(3)].
To implement the new provisions, plan sponsors will need to:

- Update their hardship distribution procedures;
- Ensure plan record keepers are making necessary administrative changes; and
- Review plan document language for necessary amendments.

Plan sponsors may incorporate softer hardship distribution rules into their plans, policies, and procedures due to these changes under the Bipartisan Budget Act of 2018.

In-Service Distributions

Under IRS Rev. Rul. 68-24, a 401(k) plan may allow participants to take *"in-service*" distributions (withdrawals) from certain contributions (discussed below) made to the plan before they leave employment. This early payout provision is known as an *in-service distribution (withdrawal) option*. Income taxes and penalties may apply to these distributions.

The *in-service distribution option* allows certain plan participants to receive some or all of their retirement assets while still employed. Furthermore, many in-service distributions are set forth in federal pension law (ERISA and PPA of 2006). In addition, the plan documents may impose additional requirements and limitations. The plan document specifies whether an in-service distribution provision is available and the conditions under which the working participant may use the in-service distribution options.

Vanguard reports in their study, "*How America Saves, 2024*" during 2023, 3% of participants took an in-service distribution, withdrawing about one-third of their account balances. All in-service distributions during 2023 amounted to 1% of aggregate plan assets.

Rules for In-Service Distributions

Different contribution types are often subject to different in-service distribution rules. The rules are driven by both legal requirements and plan document language. The availability of in-service distributions can be conditioned upon various circumstances, including the following:

- *Attainment of a Specified Age.* Under this restriction, a participant still working for their employer may be eligible to distribute some or all contribution types once they reach the designated age outlined in the plan document. The in-service distribution option tied to attaining a specified age has gained popularity with employers. For example, generally, employee salary elective deferrals, qualified non-elective contributions (QNECs), and qualified matching contributions (QMACs) are not eligible for in-service distribution until the participant attains age 59 ½. The distribution recipient must be aware that if they are not age 59 ½ or is not rolling the distribution into an IRA or other retirement plan, the amount could be subject to a 10% early distribution penalty tax;
- *Completion of a Specified Period of Service.* Under this restriction, once a participant completes a specified number of years of service with an employer, certain contribution types may be available for an in-service distribution. The following represents a review of the types of plan contributions and their respective in-service distribution rules;
- *In-Service Distributions of Employer Contributions.* Some plans allow employed participants, who otherwise would not be eligible for distributions, to take withdrawals of their employer-provided contributions. Distributions of employee salary deferrals taken while still employed are only available under a separate set of hardship rules:

    - If the plan permits, a 401(k) plan/profit-sharing plan participant may take an in-service withdrawal of employer contributions. The portion of the individual's account balance attributable to employer contributions that are eligible for an in-service withdrawal depends on the individual's time in the plan. Participants with fewer than five years of service may only access assets that have been in the plan for at least two years. This rule is sometimes referred to as the "two-year bake" rule. The two-year bake rule does not restrict participants with five or more years of service. The sponsoring employer may condition the withdrawal of employer contributions to situations of hardship, attainment of a specified age, or completion of a specified period of service.
- *In-Service Distributions of Employer Contributions Restricted to Hardship.* An employer may choose to limit in-service distributions of employer contributions to hardship situations. In-service distributions resulting from hardship are not subject to the two-year bake rule. Instead, employers will frequently limit the amount of the in-service hardship withdrawal to the lesser of:
    - The employee's vested balance in their account attributable to employer contributions; or
    - The amount of the employee's immediate and heavy financial need.

  It is important to refer to the plan language for a concise definition of what circumstances constitute a hardship under the terms of the plan. The plan will often use the same definition of hardship that applies to distributions of employee salary deferrals.

  Note: Hardship distributions are not eligible for rollover.
- *Hardship Distributions of Employee Salary Deferrals.* Typically, employee salary deferrals may not be distributed prior to severance from employment, death, disability, plan termination, attainment of age $59^{1/2}$, or hardship. Hardship distributions of employee salary deferrals are not subject to the two-year bake rule. Still, the plan must limit the amount of the distribution to the lesser of the participant's employee salary deferrals, reduced by previous hardship distributions, plus the following pre-1989 amounts: earnings on deferrals, qualified non-elective contributions (QNECs), and their earnings and qualified matching contributions (QMACs) and their earnings. It is important to review the plan language for a concise definition of what circumstances constitute a hardship under the terms of the plan. Hardship distributions of employee salary deferrals are not eligible for rollover;
- *In-Service Distributions of Rollover Contributions.* Another important source of in-service distribution dollars is rollover contributions. Rollover contributions are the amounts a plan participant has moved into their current employer's plan from a prior plan or IRA. Many plans permit in-service distributions of rollover contribution amounts at any time; and
- *In-Service Distribution of After-Tax Account.* If the plan document permits, it may be possible for a participant to request a distribution of 401(k) plan after-tax contributions while still working; the tax consequences typically depend on whether the individual rolls over the amount or whether the distribution comes from pre-1987 or post-1986 after-tax amounts. Pre-1987 after-tax contributions can potentially be recovered without associated earnings if the record keeper has tracked these dollars. Post-1986 after-tax contributions and earnings in the account are subject to special "basis recovery rules," requiring the participant to treat recovered amounts as a *pro-rata* share of after-tax contributions and earnings.

> **Note:** Based on the distribution treatment of pre-1987 after-tax contributions and/or the overall ratio of after-tax contributions to earnings, plan participants should consider whether to rollover an after-tax distribution to a Traditional IRA or make a rollover conversion to a Roth IRA or a mixture of both options.

Be aware that the required minimum distributions (RMDs) from a qualified retirement plan or IRA cannot be rolled over [IRC § 402(c)(4)(B)]. The trap is that the first-year distribution received in any year for which a distribution is required is considered part of the RMD for that year and cannot be rolled over. Another trap of this rule is that the participant's first Distribution Year is not when the required beginning date (RBD) occurs; it is the year before the RBD. Thus the first Distribution Year is the year the participant reaches age 70½ (or retires as the case may be), even though the first RMD does not have to be taken until April 1 of the following year. Any distribution received on or after January 1 of the first Distribution Year will be considered part of the RMD for that year (until the entire RMD has been distributed) and thus cannot be rolled over [Reg. 1.402(c)-2, A-7(a)].

401(k) Plan Loans

A 401(k) plan is permitted but is not required to offer loans to participants. The loan must charge a reasonable rate of interest and be adequately secured. A loan from a 401(k) (as well as any tax-qualified pension) plan is treated for federal income tax purposes as a taxable plan distribution under IRC § 72(p)] and are taxable in whole or in part under IRC § 72(e). [Treas. Reg. § 1.72(p)(1), Q&A 3].

The maximum amount a participant may borrow from their plan is 50% of their vested account balance or $50,000, whichever is less [IRC § 72(p)(2)(A)(i)]. An exception to this limit is if 50% of the vested account balance is less than $10,000: in such case, the participant may borrow up to $10,000 [IRC § 72(p)(2)(A)(ii)]. Plans are not required to include this exception.

> ***Example 1:*** Bill’s vested account balance is $80,000. Bill may take a loan up to $40,000, which is the lesser of 50% of his vested account balance and $50,000.

> ***Example 2.*** Sue has a vested account balance of $120,000. Sue may take a loan up to $50,000, which is the lesser of 50% of her vested account balance of $120,000 ($60,000) or $50,000.

Generally, the employee must repay a plan loan within five years and must make payments at least quarterly [IRC § 72(p)(2)(B)(i)]. The law provides an exception to the 5-year requirement if the employee uses the loan to purchase a primary residence [IRC § 72(p)(2)(A)(ii)].

Loans exceeding the maximum amount or not following the required repayment schedule are considered "*deemed distributions*.” If the loan repayments are not made at least quarterly, the remaining balance is treated as a distribution that is subject to income tax. In addition, if the participant is under age 59 ½, the deemed distribution would be subject to a 10% early withdrawal penalty [IRC § 72(t)1)]. If the employee continues to participate in the plan after the deemed distribution occurs, they must make loan repayments. These amounts are treated as basis and will not be taxable when later distributed by the plan. If the employee (participant) terminates employment, the plan may require the employee to repay the loan completely prior to termination. The employee can avoid the immediate income tax consequences if they can come up with the loan's outstanding balance within 60 days and rolls over this amount to an IRA or eligible retirement plan.

If the employee is in the armed forces, the employer may suspend the loan repayments during the employee's period of active duty and then extend the loan repayment period by this period. If during a leave of absence from their employer, an employee's salary is reduced to the point when the salary is insufficient to repay the loan, the employer may suspend repayment for up to a year. Unlike the exception for active members of the armed forces, the loan repayment period is not extended, and the employee may be required to increase the scheduled payment amounts to pay off the loan in the originally scheduled period.

The participant should receive information describing the availability of and terms for obtaining a loan. Some information that may be provided to a participant is as follows:

- Loans are/are not permitted.
- Minimum dollar amount required to obtain a loan.
- Maximum number of loans permitted by the plan.
- Maximum dollar amount permitted.
- Term of repayment (number of years);
- Interest rate information.
- Security for the loan.
- How repayment may be made (for instance, payroll deduction); and
- Spousal consent requirements.

The participant's spouse must give written consent to any loan secured by the employee's account balance (see Spousal Consent Rules below). This rule does not apply if the total account balance serving as security for the loan does not exceed $5,000. If consent is required, it must be given a specified number of days before the date the loan is made. [Treas. Reg. § 1.401(a)-20, Q&A 24(a)(1)].

Vanguard reports in their study, "*How America Saves, 2024"*, loans are widely offered by employee contributory DC plans. In 2023, 81% of Vanguard's DC plans permitted participants to borrow from their plan, and 91% of active participants had access to loan features. Thirteen percent of participants had a loan outstanding at year-end 2023 **(Figure 103).**[1] On average, the outstanding loan account balance was 9% of the participant's account balance, excluding the loan, and the average participant had borrowed about $10,700.

Note: The Tax Cuts and Jobs Act provided a provision Section 13613 that allows those workers who leave their current employer with an outstanding loan from their workplace retirement plan not to be taxed on the loan amount if they contribute the loan balance to an IRA by the date their individual tax return is due. Prior, individuals only had 60 days to make that rollover before they would be taxed on the loan amount.

Spousal Rights in 401(k) Plan Distributions

ERISA provides legal protections extended to the spouse of a 401(k) plan participant. Protection is afforded in two contexts. First, benefits are provided upon the death of a surviving spouse unless those benefits are waived by the participant with their spouse (see Spousal Consent below). Second, a spouse can be awarded all or any part of a participant's interest in a 401(k) plan upon the dissolution of marriage (see QDRO below).

Qualified Pre-Retirement Survivor Annuity

ERISA requires 401(k) plans to provide a qualified pre-retirement survivor annuity (QPSA). If a participant dies before the annuity starting date, benefits must be paid to the surviving spouse in the form of a QPSA.

A QPSA is an immediate annuity for the life of the surviving spouse purchased with not less than 50 percent and not more than 100 percent value of the participant's account balance determined as of the date of death [Treas. Reg. § 1.401-20, Q&A 20]. The percentage of the participant's account balance used to purchase the QPSA is specified in the plan document.

Qualified Joint and Survivor Annuity

If the participant survives until the annuity starting date, the participant's account balance must be used to purchase a qualified joint and survivor annuity (QJSA).

A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse. The survivor annuity amount is a plan-specified percentage that is not less than 50 percent and not more than 100 percent of the amount of the annuity that is payable during the joint lives of the participant and spouse [IRC 417(b)]. In the case of an unmarried participant, the QJSA is an annuity for the participant's life [Treas. Reg § 1.401(a)-20, Q&A 25(a)].

Note: The Pension Protection Act (PPA) of 2006 imposed new distribution requirements generally effective for distributions with annuity starting dates occurring in plans year beginning after December 31, 2007, and apply to any retirement plan subject to the QJSA rules of IRC § 417. The new PPA rules require that married participants have a minimum of two different joint and survivor annuity forms of payment available for retirement payouts:

- One required form is the QJSA form; and
- The second required form is a "qualified optional survivor annuity" (QOSA).

The QOSA form must be actuarially equivalent to a single life annuity. It must provide the participant's spouse with a continuation percentage of either 50% or 75% of the amount payable to the participant. If the continuation percentage specified in the plan's QJSA is less than 75%, then the QOSA must be a 75% joint and survivor annuity. Otherwise, the QOSA must be a 50% joint and survivor annuity.

Same-Sex Marriage Ruling Impacts Spousal Benefits

In 2015, the Supreme Court ruled in *Obergefell v. Hodges*, (in a 5-to-4 majority) that the Fourteenth Amendment requires a state to license a marriage between two people of the same sex and to recognize any such marriage that is lawfully licensed and performed out-of-state. As a result, all (remaining) state laws or constitutional amendments banning same-sex marriage are now invalid. The decision comes exactly two years (to the day) after the Supreme Court's 2013 decision in *United States v. Windsor*. The Court struck down a portion of the federal Defense of Marriage Act that previously prohibited the federal government from recognizing marriages between individuals of the same sex.

Now, as a result of the Obergefell decision, all 50 states and the District of Columbia must issue marriage licenses to same-sex spouses and must recognize any same-sex marriage that was lawfully performed in another state (or country). But what does this mean for employers sponsoring benefit plans? Unlike the Windsor decision, which required sponsors to extend spousal benefits under retirement plans to same-sex spouses and to change the tax reporting of certain employer-provided welfare benefits, the effect of the Obergefell decision will be more indirect and less immediate, as it may take time for currently unmarried same-sex couples living in states that previously banned same-sex marriage to obtain marriage licenses and marry. And, the effects will differ for retirement plans, fully insured welfare plans, and self-funded welfare plans.

Spousal Consent Requirement

The guidelines around spousal consent can vary by retirement account. Defined benefit (DB) plans always require spousal consent to change a beneficiary, and defined contribution (DC) plans require spousal consent most of the time, but not always.

In 1984, President Ronald Reagan signed The Retirement Equity Act; under the law, a pension plan is allowed to specify that spousal protection applies only after one year of marriage, but most do not do so. And the law does not apply to pension plans for state or local government employees. However, a minority of the state and local plans follow it. The law does not cover Individual Retirement Arrangements. However, a state property law might give a spouse some protected interest in some states.

To be proper, a spouse's consent must be in writing, must acknowledge the effect of a participant's waiver, and must be witnessed by a plan representative or notary public [IRC § 417(a)(2)(A)]. The consent must specify the non-spouse beneficiaries who will receive benefits upon the participant's death. In the case of a participant's waiver of a QJSA, it must also specify the optional form of benefit selected by the participant [Treas. Reg. § 1.401(a)-20, Q&As 31(a)(b)]. The spouse's consent to the waiver may be made either on a paper document or through an electronic medium that satisfies the requirements of Treas. Reg. § 1.401(a)-21(d)(6)].

In 2011, the court ruled in *Cajun Industries LLC v. Robert Kidder* et al. that despite having previously named his three children as beneficiaries of his 401(k) plan, a deceased plan participant's 401(k) balance will pass to his new wife. The court determined that a spouse's right to plan assets is immediately vested upon marriage under the terms of the participant's plan. Since no spousal waiver was obtained, the spouse's default beneficiary is even though she was not the named beneficiary.

The spouse got the 401(k), and the children, who were the intended beneficiaries, were disinherited. The court had little difficulty determining that Beth Bennet Kidder was the rightful plan beneficiary. First, the court noted the plan's language was “clear and unambiguous” that a deceased participant's vested interest would belong to their spouse unless a spousal waiver were executed. Next, the court addressed the Employee Retirement Income Security Act of 1974 issue raised by Mr. Kidder's children. In the court's view, it was clear that although ERISA allows plans to waive spousal consent requirements when a participant has been married less than a year, it does not require that they do so.

The beneficiary form is the most important document when it comes to retirement accounts. It takes precedence over prenuptial agreements, postnuptial agreements, and even contrary instructions on who should inherit plan assets contained in a client's will. But the Kidder case's decision clarifies that the beneficiary form can be trumped by spousal rights when it comes to ERISA plans.

Had Mr. Kidder rolled his 401(k) to an IRA after leaving Cajun Industries, but before his remarriage, this unfortunate incident would have been avoided. After the previous wife's (Betty) death, Mr. Kidder could have put the funds in an IRA and named his three children as beneficiaries (in the same manner as he did with his 401(k) plan). When he married his new wife (Beth), the children would have remained the beneficiaries of his account. He also could have asked his new wife to waive her 401(k) plan rights, but that did not happen. There is really no way to guarantee that Beth Kidder, or any other spouse, for that matter, would waive their spousal rights to plan assets.

Advisers should make sure that clients with assets in a 401(k) (or any ERISA for that matter) plan are aware of the special rule requiring spousal consent to name their children (or any other non-spouse) as a beneficiary of that plan.

Qualified Domestic Relations Order

Qualified domestic relations orders (QDROs) are an exception to the general rule that prohibits benefits in a 401(k) plan from being assigned or alienated under IRC § 401(a)(13). The QDRO rules came about because of the recurring controversy between state courts, which were attempting to award qualified plan benefits in divorce proceedings, and plan trustees, who were concerned that compliance with these orders would place them in a violation of the anti-assignment rules and disqualify the plan. Enacted in 1984, the QDRO rules now clarify a plan administrator’s or trustee’s obligations when an order dividing benefits is received.

Alternate Payee under QDRO

Under IRC § 414(p)(1)(A), a QDRO is a court order that creates a right for an alternate payee to receive some or all of a participant’s benefits in a 401(k) plan. The alternate payee can be:

- Spouse;
- Former spouse;
- Child; or
- Other dependent of participant.

QDRO Terms

Under IRC § 414(p)(2), a QDRO must clearly specify the following information:

- The participant's name and last known mailing address and each alternate payee awarded benefits in the order. However, if the plan administrator has independent knowledge of this information, the order cannot be rejected for failing to provide it;
- The amount or percentage of benefits to be paid to the alternate payee or how such amount or percentage is to be determined. This requirement generally prohibits a QDRO from using plan benefits as a source of payment;
- The number of payments or the period to which the order applies. This generally requires that the order specify whether payments will be paid as a lump sum, as an annuity, in installments, and so forth; and
- The plan to which the order applies.

A QDRO cannot contain any provision that requires a plan to provide any type or form of benefit or any option not otherwise provided under the plan. For example, a QDRO cannot require that a segregated, self-directed account be established for an alternate payee if the plan does not permit participants and beneficiaries to segregate and direct the investment of their account.

A QDRO cannot contain a provision that would require the plan to pay increased benefits. For example, a QDRO cannot award an alternate payee a dollar amount in excess of a participant's vested account balance.

Finally, under IRC § 414(p)(3), a QDRO cannot require a plan to pay to one alternate payee benefits that have already been awarded to another alternate payee in a separate QDRO.

Tax Consequences of QDRO

If the alternate payee is the spouse or former spouse of a participant, the distribution is taxed to the alternate payee. Under IRC § 402(e) (1)(A), if the alternate payee is not a spouse or former spouse, the distribution is taxed to the participant. The 10 percent additional income tax penalty that generally applies to distributions made for a participant who attains age 59 ½ does not apply to distributions made to an alternate spousal payee [IRC § 72(t)(2)(C)]. An alternate payee who is a spouse or former spouse of a participant may roll over their distribution [IRC § 402(e)(1)(B)].

Distributions under a QDRO

Distributions of all or any part of a participant's account pursuant to the provisions of a QDRO are specifically authorized. The alternate payee may receive a payment of a benefit under the plan prior to the date on which the participant is otherwise entitled to a distribution under the plan if the QDRO specifically provides for such an earlier payment. If the present value of the payment exceeds $5,000, the alternate payee must consent in writing to such distribution.

The alternate payee may receive a payment of benefits under the plan in any optional form of benefit permitted other than a joint and survivor annuity. Upon receipt of an order which appears to be a domestic relations order, the plan administrator shall promptly notify the participant and each alternate payee of the receipt of the order and provide them with a copy of the procedures established by the plan administrator for determining whether the order is a QDRO. While the determination is being made, a separate accounting shall be made with respect to any amounts payable under the order. If the plan administrator determines that the order is a QDRO within 18 months after receipt, the plan administrator shall direct the trustee to establish an account for the alternate payee, who shall direct the investment of such account. The plan administrator shall further instruct the trustee to begin making payments from the alternate payee's account pursuant to the order when required or as soon as administratively practical or as the alternate payee otherwise directs in accordance with the order. If the plan administrator determines that the order is not a QDRO, or if no determination is made within 18 months after receipt of the QDRO, then the separately accounted for amounts shall be either restored to the participant's account or distributed to the participant (if the plan otherwise permits distribution), as if the order did not exist. If the order is subsequently determined to be a QDRO, such determination shall be applied prospectively to payments made after the determination.

Withholding on Distributions

Most 401(k) plan distributions are subject to income tax withholding unless the employee elects out of withholding [IRC § 3405(a)]. Any other amount distributed is subject to 10 percent withholding unless the participant opts out of withholding [IRC 3405(b)].

IRC § 3405(c) provides a special rule requiring a 401(k) plan to withhold 20 percent of any distribution considered an eligible rollover distribution. This penalty can be avoided by doing a direct rollover of the distribution to an eligible retirement plan [IRC § 3405(c)(2)]. A participant cannot opt-out of this withholding but can have more than 20 percent withheld.

Eligible Rollover Distributions

Departing plan participants can roll over (transfer) distributions from a 401(k) plan to an Individual Retirement Account (IRA) or another employer's plan if the plan accepts such transfers. If the accrued benefit is less than $5,000 when the participant leaves an employer, the plan can make an immediate distribution without the participant's consent. Amounts of $5,000 or more may be cashed out only with the participant's written consent. For married workers, the consent of the worker’s spouse is also required.

If the distribution is more than $1,000, the plan must automatically roll over the funds into an IRA that it selects, unless the participant elects to receive a lump sum payment or roll it over into an IRA that they choose. The plan must first send a notice allowing the participant to make other arrangements. It must follow the rules regarding what type of IRA can be used (for example, it cannot combine the distribution with savings the individual has deposited directly in an IRA). Rollovers must be made to an entity qualified to offer individual retirement plans. Also, the rollover IRA must have investments designed to preserve principal. The IRA provider may not charge more in fees and expenses for such plans than it would to its other IRA customers.

If the departing employee elects to receive a lump sum payment and does not transfer the money to another qualified employer plan or an IRA, the participant will owe a 10% tax penalty if they are under age 59½ and does not meet the exceptions discussed above in IRC § 72(t).

Chapter 8
Review Questions

1. Which of the following is not a triggering event for distributions from a qualified retirement plan?

   ( ) A. The participant's severance from employment
   ( ) B. The participant's death
   ( ) C. The participant's disability
   ( ) D. The participant's attainment of age 70 ½

2. Under IRC § 72(t)(2), what is the amount of the additional tax on retirement plan distributions made before the participant attains age 59 ½?

   ( ) A. 10%
   ( ) B. 6%
   ( ) C. 25%
   ( ) D. 50%

3. Which of the following is NOT a correct statement about a 401(k)-plan loan?

   ( ) A. A loan is treated for federal income tax purposes as a taxable plan distribution
   ( ) B. The loan must charge a reasonable interest rate
   ( ) C. The plan is not required to allow participants to take a loan
   ( ) D. The maximum amount a participant may borrow is 50% of their vested account balance or $50,000, whichever is less.

4. Which of the following statements about Spousal Consent is FALSE?

   ( ) A. Defined Benefit (DB) plans always require Spousal Consent to change a beneficiary.
   ( ) B. Defined Contribution (DC) plans do not require Spousal Consent.
   ( ) C. The spouse does NOT have to consent to a waiver in writing.
   ( ) D. A spouse's consent must be in writing.

5. Distributions paid directly to the plan participant rather than being rolled over into an IRA, or another qualified retirement plan are subject to mandatory tax withholding equal to what percent of the total distribution?

   ( ) A. 10%
   ( ) B. 25%
   ( ) C. 50%
   ( ) D. 20%

CHAPTER 9

ERISA AND FIDUCIARY ROLES AND RESPONSIBILITIES

Overview

The Employee Retirement Income Security Act (ERISA) of 1974 imposes certain duties and responsibilities on the "fiduciaries" responsible for administering their retirement plan.

This chapter will examine the role of ERISA and its various Titles. It will define a fiduciary and describe their basic duties and responsibilities. In addition, the chapter will examine the various prohibited transaction rules and exemptions and how to limit plan sponsor liability, and the differences between Fidelity Insurance and Fidelity Bond. At the end of the chapter, it will examine the fiduciary definition of "*investment advice*" and review the steps taken by the DOL and the SEC to expand the fiduciary duty to protect investors in retirement plans.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Describe the background and history of ERISA.
- Explain the four Titles of ERISA.
- Define who is a fiduciary and their roles and responsibilities.
- Relate the Functional Fiduciaries, Named Fiduciaries and Non-Fiduciary Functions.
- Explain the three fiduciary rules and the Fiduciary Standard of Care.
- Evaluate the Prohibited Transaction rules and exemptions.
- Define Fiduciary Breach.
- Clarify the various levels of limiting the plan sponsors fiduciary liabilities.
- Identify the benefits and differences between Fidelity Insurance and a Fidelity Bond; and
- Explain the recent changes in the definition of Investment Advice Fiduciary.

ERISA History and Background

The Employee Retirement Income Security Act (ERISA) of 1974 (Pub. L. No. 93-406, codified in part at 29 USCS § 1002 *et seq.*) signed into law on September 2, 1974, by President Gerald Ford, is a federal law which establishes minimum standards for pension plans in private industry and provides for extensive rules on the federal income tax effects of transactions associated with employee benefit plans. Prior to this law, qualified retirement plans were largely unregulated. Employers could change, suspend, or cancel a pension program at any time. Employees had no legal rights to their benefits.

ERISA was Congress's answer to public concerns, especially regarding employees' rights to benefits. ERISA was passed to establish a set of federally regulated provisions with the primary purpose of protecting participants and beneficiaries. ERISA had the important–and still relevant function of pre-empting the patchwork of state fiduciary laws. ERISA provisions are overseen by the Department of Labor (DOL) regulations and the Internal Revenue Service.

ERISA consists of four numbered sections known as Titles. They are:

- ***Title I***: *The Protection of Employee Rights under employee Benefit Plans*. The goal of Title I of ERISA is to protect the interests of participants and their beneficiaries in employee benefit plans. This goal establishes that individuals who manage and control the plan administrator or its assets or render investment advice for a fee or other compensation must meet certain fiduciary standards of conduct. ERISA covers most private sector employee benefit plans. These plans are voluntarily established and maintained by an employer, an employee organization, or jointly by one or more such employers and an employee organization. Generally, ERISA does not cover plans established or maintained by government entities or churches for their employees or plans maintained solely to comply with workers' compensation, unemployment, or disability laws. ERISA also does not cover plans maintained outside the United States primarily for the benefit of nonresident aliens or unfunded excess benefit plans. The provisions of Title 1 of ERISA are administered by the U.S. Department of Labor and, more specifically, the Employee Benefits Security Administration (EBSA). The EBSA is responsible for administering and enforcing the fiduciary, reporting, and disclosure provisions of Title I of the ERISA. The agency is a sub-cabinet position with the establishment of Assistant Secretary and Deputy Assistant Secretary positions;
- ***Title II***: *Specific Conditions for Tax Qualification of Qualified Retirement Plans*. The Department of Labor has jurisdiction over the prohibited transaction exemption (PTEs) provisions of Title II of ERISA. However, the IRS generally administers the remainder of Title II and the standards of Title I of ERISA that address vesting, participation, nondiscrimination, and funding. For an employer-sponsored retirement plan to qualify for federal income tax deferrals and deductions, it must comply with the pension-related provisions of the Internal Revenue Code (IRC). The pension-related provisions of the IRC require plans to cover rank-and-file workers, and they include "nondiscrimination rules" that prohibit qualified plans from favoring highly compensated employees concerning eligibility or benefits. The goal of Title II was to create tax provisions that parallel and reflect the provisions of Title I. This Title includes detailed rules every qualified plan must follow to be entitled to tax-preferred treatment. For example:

    - Plans must contain maximum contribution limits:
    - Limit the maximum tax-deductible contributions for the employer and participant;
    - Be intended to be permanent;
    - Be in writing and communicated to employees;
    - Have a specified period of time when participants and beneficiaries become vested in their benefits, which are then nonforfeitable;
    - Not disproportionately favor highly compensated employees (HCEs) or discriminate against lower-paid employees; and

    - Follow uniform distribution rules for pension plans and possible excise taxes to be imposed for failure to make a required minimum distribution.
- ***Title III:*** *The Jurisdiction, Administration, and Enforcement of ERISA*. Under this title, various enforcement and regulatory responsibilities are coordinated between the Department of Labor, the Treasury Department, and the Pension Benefit Guaranty Corporation (PBGC). Title III specifies the coordination of regulatory authority between the IRS and DOL and the IRS's and DOL's authority to enforce ERISA provisions. Today, the IRS is primarily responsible for the participation, funding, and vesting rules. At the same time, the DOL is primarily responsible for the reporting, disclosure, and fiduciary standards of conduct. Additional provisions detail educational requirements for actuaries who perform certain required benefits and funding-related calculations for defined benefit plans.
- ***Title IV:*** *Pension Benefit Guaranty Corporation and Termination Insurance Programs for Defined Benefit Plans.* This title of ERISA established the Pension Benefit Guaranty Corporation (PBGC) as a government-owned corporation to protect participants' retirement income and beneficiaries in private-sector defined benefit pension plans. The PBGC does not insure defined contribution plans such as ESOPs, profit-sharing plans, 401(k), 403(b), thrift/savings plans, and stock bonus plans.

Certainly, given the shift from defined benefit to defined contribution plans, Titles I and II remain more relevant today than the provisions of Title IV.

ERISA vs. Non-ERISA Plan

It's important to distinguish between an ERISA and a non-ERISA plan. A basic definition of ERISA vs. non-ERISA includes the employer's involvement. An employer chooses the investment options in an ERISA plan, controls the deposit and timing of employee contributions, and may also provide an employer matching contribution.

In a non-ERISA plan, an employer is not involved except in compliance activities. The employee chooses the investments and controls the deposit and, following the determination of eligibility, the withdrawal of funds.

Governmental plans are exempt from ERISA coverage, while church plans and related church-organizations plans (in general funded by church contributions and revenues) are exempt from ERISA unless an affirmative election is made to be subject to ERISA.

Who Is a Fiduciary for ERISA Purposes?

Under ERISA Sec 3(21)(A), a fiduciary is anyone who has discretionary control or authority over the management or administration of an ERISA-covered plan, such as a 401(k) plan, including the plan's assets. Plan sponsors and other plan fiduciaries have specific responsibilities under ERISA (discussed below). Plan sponsors are typically the named fiduciaries, but others, such as trustees, investment advisers, or other service providers, may also be fiduciaries depending on the functions they perform for the plan.

Plan sponsors and other plan fiduciaries have specific responsibilities under ERISA. For example, ERISA stipulates that plan fiduciaries carry out their responsibilities prudently and do so solely in the interest of the plan's participants and beneficiaries. In accordance with ERISA and related Labor regulations and guidance, responsibilities of plan sponsors and other fiduciaries may include, but are not limited to:

- Selecting and monitoring any service providers to the plan.
- Reporting plan information to the federal government and participants.
- Adhering to the plan documents, including any investment policy statements.
- Identifying parties-in-interest to the plan and taking steps to monitor transactions with them.
- Selecting and monitoring investment options the plan will offer and diversifying plan investments; and
- Ensuring that the services provided to their plans are necessary and that the cost of those services is reasonable.

ERISA fiduciaries are either named in the plan document or are identified by the function they perform for the plan. Since fiduciary status may be based on a person's conduct rather than their title, it is possible to be a fiduciary without being aware of it.

These acts lead to classification as functional, deemed, or inadvertent fiduciary. Note that any persons, such as an adviser or service provider, may be a fiduciary to the plan if they are considered to have discretionary authority over the plan under certain circumstances or provide investment advice for a fee.

Functional Fiduciary

If a person acts or possesses fiduciary-like powers, the person will be deemed a functional fiduciary regardless of his title or official designation. Thus, if a person renders investment advice, as described above, for which they are compensated, they will be treated as a fiduciary.

Fiduciary classification is not an "all or nothing" concept; a person may be a fiduciary with respect to one aspect of the plan but not another. Personal liability is generally limited to the fiduciary functions that the person performs concerning the plan. Many court decisions have recognized this view.

In addition to this functional definition, ERISA also defines three specific fiduciary roles that are clearly stated in the plan document. These are called named fiduciaries.

Named Fiduciaries

Under ERISA § 402 (a), every plan must have at least one fiduciary, a person or entity, named in the written plan (or named through a process identified in the plan). This allows the participants and other interested parties to identify who is responsible for operating the plan. These named fiduciaries include:

- Plan Sponsor;
- Plan Trustee; and
- Plan Administrator.

Let's review each of these named fiduciaries in greater detail.

Plan Sponsor

The Plan Sponsor oversees all the other fiduciaries. Plan Sponsors:

- May appoint one or more fiduciaries to operate the plan;
- Monitor if fiduciaries are performing their duties as established by ERISA's prudent man standard of care and exclusive purpose rule; and
- Replace fiduciaries if they fail to fulfill their fiduciary responsibilities.

In most cases, the employer will almost always serve as the Plan Sponsor and therefore as a fiduciary, even if an expert is hired to help with fiduciary duties under the plan. In fact, ERISA Section 404 outlines that a fiduciary must act,

> *"…with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."*

This has been interpreted to mean that fiduciaries may need to hire or consult with an expert if they do not have the necessary expertise. The only case in which the employer sponsoring the plan is not a fiduciary is when the plan document has a different named fiduciary.

Plan Trustee

The Plan Trustee is responsible for everything to do with plan assets. The Trustee has the sole authority for:

- Safekeeping of plan assets;
- Prudent investment management;
- Pursuing monies owed to the trust, including monies distributed incorrectly and those not contributed on time;
- Following participant directions in accordance with plan document provisions in participant-directed plans, unless those directions conflict with ERISA;
- Prudently selecting and monitoring service providers, such as investment managers and custodians; and
- Ensuring that any expenses paid by the trust at the discretion of the Trustee are reasonable and refusing to pay from the trust any fees if payment of those fees would conflict with ERISA or the plan document.

The Trustee named in the plan document can delegate some of their duties to a service provider, but the Trustee is always responsible for whomever they hire.

Plan Administrator

The Plan Administrator is responsible for overseeing plan operations. The Plan Administrators duties are mentioned in both ERISA and DOL regulations and include:

- Providing a variety of information and documents to participants and other interested parties on request, when required by law or regulation;
- Providing participants with summary plan descriptions and summary annual reports;
- Filing the Form 5500 Annual Report and annual audit (if applicable);
- Preparing various notices (e.g., blackout, termination, suspension of accruals);
- Determining whether a domestic relations order (DRO) is qualified (QDRO) and implementing it if so;
- Compiling and providing participant fee disclosures under DOL Regulation Section 2550.404a-5; and
- Providing participant benefit statements (Section 105).

Duties of the Plan Administrator can also be found in the plan document, and the broad range of tasks include:

- Maintaining the qualified status of the plan (including the requirement to update with mandatory interim amendments and periodic restatements per IRS regulations);
- Operating the plan in accordance with its terms (a short description for a very big job, since, as mentioned, there are very many administrator "to do" items associated with operating the plan);
- Coverage, non-discrimination, and other compliance testing; and
- Properly administering loans, hardship distributions, other distributions, payroll changes affecting the plan, and other participant events.

The Plan Administrator can be a single person or a retirement plan committee. The Plan Administrator or the retirement plan committee may hire a service provider to assist with their fiduciary duties. Still, like the Trustee, they retain oversight of those hired service providers.

Non-Fiduciary Functions

Persons (settlors) performing mere ministerial functions within the guidelines established by others are not plan fiduciaries and are not subject to fiduciary duty. The settlor is the individual or entity that creates the Trust, which holds employee elective deferrals and employer contributions. They typically relate to plan design–for example, establishing a plan, determining whom the plan will cover, and designing the benefit offerings. The creation, termination, or even the amendments of a plan are also settlor functions. These decisions cannot give rise to a claim for breach of fiduciary duty. Another settlor function is deciding what class of employees to make eligible for coverage.

However, this type of decision may prompt IRS issues of coverage and discrimination, which are nonetheless not fiduciary.

The DOL regulations list the following job functions as ministerial:

- Applying rules to determine eligibility for participation in benefits;
- Calculating service and pay for benefit purposes;
- Preparing account statements or communications to employees;
- Maintaining participant's work records;
- Preparing reports required by government agencies;
- Calculating benefits;
- Explaining the plan to new participants and advising participants of their rights and options under the plan;
- Collecting contributions and applying them according to plan provisions;
- Preparing reports covering participant's benefits;
- Processing claims; and
- Making recommendations to others for decisions with respect to plan administration.

A number of non-fiduciary service providers can be hired to support fiduciaries in the carrying of ministerial functions. Non-fiduciary service providers typically include recordkeepers, third-party plan administrators (TPAs), ERISA attorneys, and independent CPA (see Table 9.1).

Plan sponsors can hire different firms to fulfill the TPA and recordkeeper functions or hire one firm that performs both jobs. Even if the service provider performs TPA and recordkeeping functions, those areas are usually separate within the larger retirement services firm.

In a participant-driven plan, generally a larger plan, it is possible that some of these functions could be performed in-house. It is almost certain that an ERISA attorney would draft or review the plan document and oversee legal compliance with ERISA. When performing only these non-discretionary plan activities, service providers, in-house personnel, and ERISA attorneys serve in a non-fiduciary capacity. The plan sponsor and/or the named fiduciary retains all the fiduciary liability.

Table 9.1
Non-Fiduciary Service Providers

Role	Sample Function
Third-Party Administrators Plan Administration and Compliance	• Determine vesting and distribution amounts; • Assure plan operation is in compliance with the plan document; • Create required notices; and • Prepare 5500

Recordkeeper Plan and Participant Accounting	• Store employee investment elections; • Track and invest participant contributions; • Process distributions; • Provide a participant call center; and • Provide statements and online access to accounts for employees
ERISA Attorney Legal Compliance	• Review individually designed documents; • Assist with IRS and DOL correction; and • IRS and DOL audit support
Independent CPA Plan Audit	• Audit plans with more than 100 employees; • Offer an opinion on the plan assets; • Work with the TPA and recordkeeper to obtain information; and • Work with the TPA and recordkeeper to identify compliance issues found on audit

ERISA Fiduciary Rules

ERISA regulates the retirement plan industry, so you and the plan sponsor must be familiar with its rules. There are three primary sets of rules that serve as the foundation of fiduciary responsibility common to all ERISA fiduciaries:

- The exclusive purpose rule;
- The fiduciary standard of care; and
- The Prohibited Transaction rules.

Exclusive Purpose Rule

Plan fiduciaries must discharge their duties for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.

ERISA Fiduciary Standards of Care

Fiduciaries have important responsibilities and are subject to higher standards of conduct because they act on behalf of plan participants and beneficiaries. ERISA § 404 establishes the duties owed by a fiduciary to participants and beneficiaries of a plan. This section identifies the following standards of conduct:

- Duties of Loyalty;
- Duties of Prudence;
- Duties to Diversify Investments;
- Duties to Monitor; and

- Duty of Follow Plan Documents.

Let's review each of these duties in greater detail.

Duty of Loyalty

ERISA § 404(a)(1)(A) provides that a fiduciary shall discharge their duties with respect to a plan:

> *"…solely in the interest of the participants and beneficiaries" and for the "exclusive purpose" of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan."*

ERISA § 404(a)(1)(A) is commonly referred to as the "*exclusive benefit rule."* It is considered to command a fiduciary's duty of undivided loyalty. The duty of loyalty applies when the fiduciary is confronted with a potential conflict of interest. For instance, a pension plan trustee has responsibilities to both the plan and the entity (such as the employer or union) sponsoring the plan. Any form of self-dealing is a clear breach of duty of undivided loyalty. The duty of loyalty forbids a fiduciary from using plan assets for their personal interest and from favoring the interests of a third party over the interests of the plan participant, even if the fiduciary's own interests are not implicated. The duty of loyalty requires that trustees avoid placing themselves in a position where their acts as officers or directors of the corporation will prevent their functioning with complete loyalty to participants. 29 C.F.R. § 2550.408(c) (prohibitions are imposed upon fiduciaries to deter them from exercising the authority, control or responsibility which makes such persons fiduciaries when they have an interest which may conflict with the interests of the plans for which they act; a fiduciary may not use the authority, control or responsibility which makes such person a fiduciary to cause a plan to pay an additional fee to be such fiduciary (or to a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as fiduciary). The duty of loyalty may require that a fiduciary disclose material information that the fiduciary knows the participant does not have and will need to make an informed decision. In addition to providing benefits, a plan fiduciary must *"defray reasonable expenses of administering the plan."* The DOL stated that: *"…in choosing among potential service providers, as well as in monitoring and deciding whether to retain a service provider, the trustees must objectively assess the qualifications of the service provider, the quality of the work product, and the reasonableness of the fees charged in light of the services provided."*

Duty of Prudence

ERISA § 404(a)(1)(B) provides that a fiduciary must:

> "*…act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man would use in the conduct of an enterprise of a like character with like aims*."

ERISA § 404(a)(1)(B) is commonly referred to as the "*prudent person rule*." This rule means that a fiduciary's actions will be compared against a hypothetical prudent person's. When examining whether a fiduciary has violated the duty of prudence, courts typically examine the process a fiduciary undertook in reaching a decision involving plan assets. If a fiduciary has taken the appropriate procedural steps, the success or failure of an investment can be irrelevant to a duty of prudence inquiry. Regulations promulgated by the DOL clarify the duty of prudence in regard to investment decisions. These regulations [29 C.F.R. § 2250.404a-1(b)(1)] indicate that a fiduciary can satisfy his duty of prudence under ERISA by giving *"appropriate consideration"* to the facts and circumstances that the fiduciary knows or should know are relevant to an investment or investment course of action. "Appropriate consideration" includes [29 C.F.R. § 2250.404a-1(b)(2)]:

- "A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio...to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment;" and
- "Consideration of the portfolio's composition with regard to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, and the projected return of the portfolio relative to the plans funding objectives."

Courts have interpreted the prudent person rule to focus on the conduct of the fiduciary, the extent of the fiduciary's diligent investigation, and the performance of acts consistent with the purpose of the plan. This is the doctrine of "*procedural prudence*." Whether ERISA's standard of prudence has been breached often depends on whether the fiduciary can demonstrate that it engaged in procedural due diligence before taking the questioned action.

Duty to Diversify Investments

A fiduciary must diversify investments to minimize the risk of loss unless it would be considered prudent not to diversify investments [29 U.S.C. §1104 (a)(1)(C)]. ERISA § 404(a)(1)(C) requires fiduciaries to diversify the investments of a plan:

> *"...so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so*."

In general, it is believed that fiduciaries should not invest an unreasonably large proportion of a plan's portfolio in a single security, in a single type of security, or various securities dependent upon the success of a single enterprise or upon conditions in a single locality. Courts have agreed that ERISA § 404(a)(1)(C) does not create a diversification obligation in terms of fixed criteria but instead requires a determination based on the specific facts of each individual case.

Duty to Monitor

Generally, the act of selecting plan service providers is an exercise of discretion over the management or administration of the plan or its assets. Thus, the person selecting the service provider is a fiduciary within the meaning of ERISA and subject to ERISA's fiduciary standards. ERISA § 405 provides a fiduciary can be held liable for the acts or omissions of their delegate if they know of a breach of fiduciary duty by the latter. Accordingly, a fiduciary must always be ready to step in and reassume a delegated function on behalf of the best interests of the plan and participants/beneficiaries. For this reason, contracts for service providers should permit termination by a plan without penalty on reasonably short notice so that a plan is not locked into an arrangement that is disadvantageous [29 C.F.R. § 2550.408b-2(c)]. After selection, the fiduciary is under a continuing duty to monitor the service provider's performance; to review and evaluate, at reasonable intervals, the performance of others to whom responsibilities are delegated. The review should be done in a manner that may be reasonably expected to ensure that the performance of the responsible individuals complies with the terms of the plan and all statutory standards, including ERISA's exclusive benefit, prudence, diversification, and prohibited-transaction rules [29 C.F.R. § 2509.75-8]. Steps to monitor include the following:

- Review the service providers' performance;
- Read any reports they provide;
- Check actual fees charged;
- Ask about policies and practices; and
- Follow up on participant complaints.

Duty to Follow Plan Documents

A fiduciary must act in accordance with the plan documents but only to the extent that the plan is consistent with ERISA requirements. Thus, a fiduciary must know and act in accordance with the plan and must have sufficient knowledge of the ERISA requirements [28 U.S.C. §1104 (a)(1)(D)]. ERISA § 404(a) (1)(D) requires fiduciaries to:

> "…*discharge their duties in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with.*"

Courts have interpreted this section to apply not only to a document or instrument that establishes or maintains a plan but also to other writings that substantially affect the plan. These writings have included investment management agreements, collective bargaining agreements, and even internal memoranda regarding the sale of plan assets. If a plan provision conflicts with ERISA, a fiduciary is obligated to ignore the plan provision. Courts have evaluated this requirement in the context of when compliance with a plan provision leads to a breach of other fiduciary duties. The DOL has argued that:

> *"…if obeying a plan provision requires the fiduciary to act imprudently and disloyally in violation of ERISA §§ 404(a) (1)(A) and (B) ... the provision is not consistent with ERISA, and the fiduciary has a duty to disregard it."*

This situation was addressed in *Tittle v. Enron*. The pension plan in question required employer contributions to be made "primarily in Enron stock." The court in *Enron* held that the plan fiduciaries had a duty to ignore this provision if it would be imprudent to follow it. In interpreting ERISA § 404(a)(1)(D), courts have also held that fiduciaries do not breach the duty to act in accordance with plan documents if their failure to follow such documents results from erroneous interpretations made in good faith. In *Morgan v. Independent Drivers Association Pension Plan*, the Tenth Circuit found that the trustees of a pension plan did not violate Section 404(a)(1)(D) because their decision to terminate the plan was based on an erroneous interpretation of the effect of a new plan funding method was both considered in good faith and based on consultation with experts.

Investment Advice Fiduciary

Since 1975, ERISA and its implementing regulations have defined "fiduciary" and "investment advice" narrowly. Under ERISA Section 3(21)(A), a fiduciary is someone who:

> *"Renders investment advice to a retirement plan or its participants for a fee, or other compensation, direct or indirect, with respect to any monies or other property of such plan or has any authority or responsibility to do so."*

Once it has been determined that you are providing a recommendation to a recipient while acting in a fiduciary capacity, you have to be compensated for that recommendation as an investment advice fiduciary. Fees under the regulation include:

- Direct fees or compensation received by a fiduciary or an affiliate;
- Any fee or compensation from any source directly or indirectly in connection with a purchase or sale, or the provision of investment advice services;
- Fees such as brokerage fees, mutual fund and insurance commissions, finder's fees, revenue sharing, gifts and gratuities, and expense reimbursements.

The Five-Part Test

In 1975, the DOL created a five-part test to identify an ERISA fiduciary. Under that test, a person who provides investment advice for a fee is not considered a fiduciary under ERISA unless:

- The person must render advice as to the value of securities or other property or the advisability of investing in, purchasing, or selling securities or other property;
- On a regular basis;
- Pursuant to a mutual understanding with the ERISA client;
- That the advice will serve as a primary basis for the ERISA client's investment decisions; and
- The advice will be individualized based on the needs of the ERISA client.

Once the provider is deemed to be a fiduciary, the provider becomes subject to a higher standard of care under ERISA, as well as particular limitations on the conduct of fiduciaries, *i.e.*, prohibited transaction rules.

However, the DOL had determined that all five prongs had to be met for a person to be considered a fiduciary under ERISA and the Code. Largely, as a result of this, financial services firms have often been able to interpret the five-part in a manner that allows the firm and their employees, representatives, and agents not to be fiduciaries. Additionally, DOL guidance issued in 2005 (Advisory Opinion NO. 2005-23A, also referred to as the "Desert Opinion") established that recommendations to take a distribution from a plan and rollover to an IRA was not investment advice for purposes of ERISA and the Code.

DOL Conflict of Interest Rule

Believing that the retirement landscape has changed significantly since 1975, including the prevalence of participant-directed 401(k) plans and the extensive use of individual retirement accounts (IRAs), in 2010, the DOL proposed to broaden the definition of investment advice. The DOL subsequently withdrew the 2010 proposed rule in response to significant pushback from various stakeholders. In 2015, a new proposed rule was published that eliminated the five-part test and extended fiduciary status to those advisers who provide advice that is individualized or specifically directed to the advice recipient. The DOL made significant changes to the final fiduciary rule in response to the wide range of comments on the 2015 proposed rule. Still, it kept much of the expansive nature of the 2015 proposed rule.

On April 6, 2016, the long-awaited DOL Conflict of Interests in Retirement Advice (aka, the new Fiduciary Rule) was released by the Employee Benefits Security Administration (EBSA) and published in the Federal Register on April 8, 2016, with an effective date of June 7, 2016, and an applicability date of April 10, 2017. Under the new Fiduciary Rule, it would require all persons who provide "*investment advice*" or "*recommendations"* for a fee or other compensation, direct or indirect, with respect to assets of an ERISA qualified retirement plan or IRA, they must abide by a "*fiduciary*" standard–putting their clients' best interest before their own profits. This final rule fulfilled the DOL mission to protect, educate, and empower retirement investors as they face important choices in saving for retirement in their employer-sponsored retirement plans (ESRP) and IRAs. However, the industry has much controversy and push back to stop this new fiduciary rule.

On March 15, 2018, the DOL's Conflict of Interest Rule's fate was sealed when a Fifth Circuit Court of Appeals issued a mandate vacating the controversial rule. The ruling invalidated the DOLs rule and essentially made it no longer effective nationwide. And, because the DOL declined to ask the Supreme Court to reconsider the Fifth Circuit's decision, that court's move became the nail in the coffin for the DOL's Conflict of Interest Rule.

In connection with the court's opinion, on May 7, 2018, the DOL issued a temporary enforcement policy for investment advice fiduciaries, announced in Field Assistance Bulletin (FAB) 2018-02. The DOL stated that it would not pursue prohibited transactions claims against investment advice fiduciaries who worked diligently and in good faith to comply with Impartial Conduct Standards for transactions that would have been exempt under the two new exemptions issued in 2016 or treat the fiduciaries as violating the applicable prohibited transaction rules, until after regulations or exemptions or other administrative guidance had been issued.

Prohibited Transactions Rules

To enforce the exclusive purpose and prudency rules, the DOL has set forth certain investment transactions it considers so fraught with the potential to run afoul of the fiduciary requirement to act exclusively in the interests of plan participants that it prohibits these transactions altogether.

Categories of Prohibited Transactions

The Prohibited Transaction rules [29 U.S.C. §1106] fall into three categories restricting transactions between:

- A plan and participant in interest;
- Transactions between a plan and a fiduciary; and
- The transfer of property to a plan by a party in interest.

The prohibited transaction rules cover the self-dealing and conflict of interest prohibitions of ERISA §406(b). The prohibited transaction provisions are found in ERISA §406 and its mirror, IRC §4975. The IRS and DOL coordinate enforcement as they do on other qualified plan issues.

Party in interest and Disqualified Person

Parties in interest are certain people who are prohibited from doing business with the plan because of their close relationship to the plan and, therefore, potential conflicts of interest with the plan. These individuals include plan fiduciaries and other people who have responsibilities with regard to the plan. Parties in interest to the plan include the:

- Employer;
- Participants and beneficiaries;
- An employee organization, such as a union, whose members are covered by the plan;
- Plan fiduciaries;
- Investment Advice Fiduciary advisers;
- Service providers, including TPAs and recordkeepers;
- Custodians;
- Statutorily defined owners;
- Officers; and
- Certain relatives of parties in interest (generally, spouses, lineal descendants, and lineal ascendants).

IRS NOTE: Instead of “party in interest,” the IRC uses the term “disqualified person.” The definitions are not identical, but nearly so. One key difference is that employees are parties in interest but not disqualified persons.

Transactions between parties in interest and the plan are prohibited transactions (PTs). These transactions are prohibited unless an exemption applies (discussed below). Although a prohibited transaction might benefit the plan participants, it is prohibited because it may be harmful due to the relationship between the plan and the party in interest.

Types of Prohibited Transactions

ERISA describes prohibited transactions as:

- A sale, exchange, or lease between the plan and a party in interest;
- Lending money or other extension of credit between the plan and a party in interest;
- Furnishing of goods, services, or facilities between the plan and a party in interest;
- Transfer of plan assets to a party in interest or use of plan assets by or for the benefit of a party in interest; and
- The acquisition or holding on behalf of the plan of any "employer security" or "employer real property" in excess of certain limits.

Prohibited Transactions Exemptions

Some prohibited transactions are exempt from the PT rules. The law includes certain "statutory" exemptions and authorizes the DOL to provide certain "class" exemptions. These transactions are exempt from the PT rules if certain requirements are met. Prohibited transaction exemptions (PTEs) include:

- Participant loans (must follow rules of ERISA 408(b)(1) and IRC 4975);
- Contribution of employer securities under the rules of ERISA 408(e);
- Sale of *qualifying* employer securities to or from the plan or leasing of *qualifying* real property by the plan;
- Life insurance purchase from or sale to a party in interest;
- Purchase of life insurance by the plan for plan participants;
- Reasonable compensation paid for office space or legal, accounting, or other services to establish or operate the plan;
- Payment of benefits to a party-in-interest who is a participant in the plan; and
- Investment manager fiduciary invests in a mutual fund on behalf of the plan.

ERISA § 407 dictates that it is prohibited to include employer securities or employer real property in a plan unless specific conditions are met. The word "qualifying" in the above list denotes that specific conditions apply to the asset. If a plan sponsor wishes to include employer stock, employer debt, or employee-owned real estate, you should recommend that the plan sponsor seek competent legal counsel.

Prohibited Transactions Penalties and Corrections

Under ERISA, a prohibited transaction is a breach of fiduciary duty. Any fiduciary who engages in a prohibited transaction is therefore personally liable for any losses to the plan and must restore any profit made by the fiduciary by using the plan's assets.

If the plan engages in a prohibited transaction with a disqualified person, it will be subject to the IRC § 4975 excise tax. A disqualified person who violates IRS § 4975 must correct the transaction and pay the excise tax based on the amount involved in the transaction. The initial tax on a prohibited transaction is 15% of the amount involved for each year in the taxable period.

If the transaction is not corrected within the taxable period, an additional tax of 100% of the amount involved is imposed. Both taxes are payable by any disqualified person who participated in the transaction (other than a fiduciary acting only as such). If more than one person takes part in the transaction, each person can be jointly and severally liable for the entire tax.

Prohibited transactions will require the inclusion of certain ERISA supplemental schedules in a plan's financial statements but are correctible through the DOL's Voluntary Fiduciary Correction Program (VFCP). Various forms will need to be filed with the DOL, including Part III of Schedule G, Form 5500, Schedule H line 4a-Delinquent participant contributions, Form 5500, and Form 5330.

Prohibited Transaction Exemption 2020-02

In December 2020, the U. S. Department of Labor (DOL) completed its efforts related to the regulation of investment advice under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) by granting a new prohibited transaction class exemption for investment advice fiduciaries, called Improving Advice for Workers & Retirees.

Background

On July 7, 2020, the DOL published in the Federal Register a technical amendment to conform the text of the Code of Federal Regulations to a 2018 decision by the U.S. Court of Appeals for the 5th Circuit. That decision, as discussed above, vacated the DOLs 2016 fiduciary rule and the associated prohibited transaction class exemptions *in toto*, which had the effect of reinstating the previous regulatory test, including the 1975 regulation and its "five-part test" for defining an investment advice fiduciary, as well as Interpretative Bulletin 96-1 regarding participant investment education.

The DOL also proposed a new prohibited transaction class exemption, *Improving Investment Advice for Workers & Retirees*, on July 7, 2020. The proposed prohibited transaction class exemption was based on the DOLs temporary enforcement policy announced in Field Assistance Bulletin (FAB) 2018-02, issued after the 5th Circuit Court's decision.

- The preamble to the proposed prohibited transaction class exemption included discussing how the five-part test set forth in the 1975 regulation applies to recommendations to roll over assets from a workplace retirement plan to an individual retirement account (IRA). The final exemption's preamble adopts the proposal's interpretation of the five-part test and provides additional guidance on rollovers.

The DOL updated its website to reflect changes to its pre-existing prohibited transaction class exemptions to reflect the court's vacatur of the 2016 fiduciary rulemaking.

- Two prohibited transaction class exemptions that the Department had newly granted in 2016–*the Best Interest Contract Exemption* and the *Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs*–were removed; and
- Pre-existing prohibited transaction class exemptions amended as part of the 2016 rulemaking have been reinstated and published on the website in their original form. This includes Prohibited Transaction Exemptions (PTEs) 75-1, 77- 4, 80-83, 83-1, 84-24 and 86-128.

Five-Part Test for Status as an Investment Advice Fiduciary

Title I of ERISA and the Code provide that a person is an investment advice fiduciary to the extent they render investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan or has any authority or responsibility to do so.

As was discussed above, under the DOL five-part test, for advice to constitute "*investment advice*," a financial institution or investment professional who is not a fiduciary under another provision of the statute must:

- Render advice to the plan as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing, or selling securities or other property;
- On a regular basis,
- Pursuant to a mutual agreement, arrangement, or understanding with the plan, plan fiduciary, or IRA owner, that
- The advice will serve as a primary basis for investment decisions with respect to plan or IRA assets, and that
- The advice will be individualized based on the particular needs of the plan or IRA.

A financial institution or investment professional who meets this five-part test and receives a fee or other direct or indirect compensation is an investment advice fiduciary under ERISA and/or under the Code.

- Title I of ERISA imposes fundamental duties of prudence and loyalty on fiduciaries with respect to workplace retirement plans; and
- Title I of ERISA and the Code contain provisions forbidding fiduciaries from engaging in specified "prohibited transactions" involving plans and IRAs, including conflict of interest transactions unless an exemption applies.

Interpretation of Fiduciary Investment Advice Concerning Rollovers from Workplace Retirement Plans to IRAs.

In the final exemption's preamble, the Department provides its interpretation regarding rollovers from workplace retirement plans to IRAs. Because the assets held in workplace retirement plans often represent a lifetime of savings and the largest single sum of money a worker has amassed, the decision to roll over plan assets to an IRA is potentially a very consequential financial decision.

The Department's final interpretation indicates that advice to take a distribution of assets from a workplace retirement plan is advice to sell, withdraw, or transfer investment assets currently held in the plan, and therefore falls within the definition of fiduciary advice if all five parts of the 1975 test are satisfied.

- The DOL has withdrawn Advisory Opinion 2005-23A (the Deseret Letter); and
- The DOL recognizes, however, that some parties may have relied on the Deseret Letter before the effective date of the new exemption. Accordingly, the Department has announced that it will not pursue claims for breach of fiduciary duty or prohibited transactions based on rollover recommendations made before the effective date of the final exemption if the recommendations would not have been considered fiduciary communications under the reasoning of the Deseret Letter.

All prongs of the five-part test must satisfy a financial institution or investment professional to be an investment advice fiduciary when making a rollover recommendation. Status as an investment advice fiduciary will be determined based on all the surrounding facts and circumstances.

- Advice to take a distribution from a workplace retirement plan and roll over the assets to an IRA may be an isolated and independent transaction that fails to meet the five-part test's "regular basis" prong. Isolated or sporadic interactions are generally insufficient to meet the requirement for rendering advice on a "regular basis." Additionally, parties can make clear in their communications that they do not intend to enter into an ongoing relationship to provide investment advice and avoid fiduciary status if they act in conformity with that communication;
- On the other hand, advice to roll over retirement plan assets can occur as part of an ongoing relationship or an intended ongoing relationship that an individual enjoys with their advice provider. The Department's interpretation recognizes that the rollover recommendation can be the beginning of an ongoing advice relationship and that it is important that fiduciary status extend to the entire advisory relationship; and
- The parties' reasonable understandings of their relationship are critical to determining whether they have arrived at a mutual agreement, arrangement, or understanding that the investment advice will serve as a primary basis for investment decisions;
    - Written statements disclaiming a mutual understanding or forbidding reliance on the advice as a primary basis for investment decisions are not determinative, although such statements are relevant to determining whether a mutual understanding exists; and
    - Also relevant to determining whether a mutual understanding exists are marketing materials and other communications in which financial institutions and investment professionals hold themselves as trusted advisers.

Investment advice fiduciaries who recommend a rollover from a workplace retirement plan are subject to the fiduciary duties imposed by Title I of ERISA as well as the prohibited transactions provisions in Title I of ERISA and the Code.

Improving Investment Advice for Workers & Retirees Prohibited Transaction Class Exemption

The prohibited transaction provisions in Title I of ERISA and the Code prohibit investment advice fiduciaries from self-dealing–i.e., causing themselves or their affiliates or related entities to receive additional compensation from transactions involving plans and IRAs–unless an exemption applies.

The new prohibited transaction class exemption is available to registered investment advisers, broker-dealers, insurance companies, banks, and individual investment professionals who are their employees or agents.

The new prohibited transaction class exemption permits investment advice fiduciaries to receive compensation as a result of providing fiduciary investment advice, including fiduciary investment advice to roll over a participant's account in a workplace retirement plan to an IRA and other similar types of rollover recommendations (e.g., IRA to IRA).

The new prohibited transaction class exemption also permits investment advice fiduciaries to enter into "principal transactions" in which they sell or purchase certain securities and other investments from their own inventories to or from plans and IRAs.

Protective Conditions of the Prohibited Transaction Class Exemption

The new prohibited transaction class exemption requires covered fiduciary investment advice to meet the "Impartial Conduct Standards" as follows: a best interest standard, a reasonable compensation standard, and a requirement to make no materially misleading statements about recommended investment transactions and other relevant matters.

The new prohibited transaction class exemption includes other protective conditions requiring disclosure to retirement investors, conflict mitigation, and a retrospective compliance review. • Investment advice fiduciaries could lose access to the class exemption for 10 years for certain criminal convictions in connection with the provision of investment advice to retirement investors or certain egregious conduct with respect to compliance with the class exemption.

DOL's Proposed Retirement Security Rule

On October 31, 2023, the US Department of Labor ("DOL") unveiled a new proposed regulation titled "Retirement Security Rule: Definition of an Investment Advice Fiduciary" (the "2023 Proposed Rule") and proposed amendments to several prohibited transaction exemptions ("2023 Proposed PTE Amendments"). With these proposals, the DOL aims to expand the criteria for determining who would be an "Investment Advice Fiduciary" for purposes of Section 3(21) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and force many such "Investment Advice Fiduciaries" to comply with Prohibited Transaction Exemption ("PTE") 2020-02 for fee and affiliated investment conflicts.

The 2023 Proposed Rule, if finalized, would modify the "Five-Part Test" for determining fiduciary status that has been in effect since 1975. In the preamble to the 2023 Proposed Rule, the DOL stated that the Five-Part Test was no longer suited to addressing the modern landscape of professional investment advice. In particular, the DOL was concerned that the "regular basis" and "mutual understanding" prongs of the Five-Part Test exclude many circumstances in which a fiduciary of an ERISA plan, plan participant or beneficiary, or IRA owner (each, a "Retirement Investor") may reasonably assume that they were receiving investment advice based on the Retirement Investor's best interest.

The 2023 Proposed Rule marks the third attempt since 2010 by the DOL to replace the Five-Part Test. The most recent attempt was an updated regulatory definition of Investment Advice Fiduciary issued on April 8, 2016 (the "2016 Fiduciary Rule"), which was vacated in its entirety by the US Court of Appeals for the Fifth Circuit in 2018. The court's opinion stated that the 2016 Fiduciary Rule had strayed too far from the common-law definition of the term fiduciary, which turns on the existence of a relationship of "trust and confidence" with the client and does not extend to those who merely sell products to their clients.

2023 Proposed Rule

Under Section 3(21) of ERISA, a person is a fiduciary with respect to a plan to the extent that the person:

- Exercises discretionary authority or control over the assets of the plan or
- Renders (or has authority or responsibility to render) investment advice for a fee (direct or indirect) with respect to the asset of the plan ("Investment Advice Fiduciaries").

Under ERISA's current Five-Part Test, as discussed above, a broker-dealer or other person is an Investment Advice Fiduciary if the person:

- Provides investment advice for a fee,
- On a regular basis,
- Pursuant to a mutual understanding with the plan fiduciary,
- That the advice will serve as a primary basis for investment decisions with respect to the assets of the plan, and
- That the advice is individualized based on the particular needs of the plan.

Under the 2023 Proposed Rule, in lieu of the Five-Part Test, a person would be an Investment Advice Fiduciary when that person makes an investment transaction or strategy recommendation involving securities or other investment property to a Retirement Investor; the advice or recommendation is provided for a fee or other compensation (direct or indirect); and the person meets *one* of the following requirements:

- The person has any discretionary authority or control, *whether or not* pursuant to a mutual understanding with respect to the purchasing or selling of securities or other investment property of the investor;

- The person (*or any affiliate of such person*) is in the business of providing investment recommendations to investors, and the investment advice is individualized to the Retirement Investor based on the particular needs of the Retirement Investor and may be relied on by the Retirement Investor in making investment decisions that are in the Retirement Investor's best interest; *or*
- The person has acknowledged that they are a fiduciary in providing the investment recommendations.

The DOL believes that each of the above categories describes circumstances where a relationship of "trust and confidence" has been established between the investment adviser and the Retirement Investor, such that when the adviser makes an investment recommendation regarding the retirement assets of the investor for a fee or other compensation, the adviser should have a fiduciary obligation to the investor under ERISA.

The 2023 Proposed Rule would eliminate the "mutual understanding" and "primary basis" concepts present in the Five-Part Test. The DOL explained that it intends to eliminate these two prongs in order to prevent investment advisers that would otherwise be Investment Advice Fiduciaries from disclaiming any fiduciary status in the "fine print." To further underscore this principle, the 2023 Proposed Rule explicitly states that any language disclaiming fiduciary status would not be of any force to the extent that the facts and circumstances support a finding of a fiduciary relationship.

A necessary precondition to establishing that fiduciary investment advice has occurred is the presence of an investment "recommendation" regarding either a particular transaction or transactions or an investment strategy involving securities or "other investment property." The DOL defines a "recommendation" as a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the Retirement Investor engage in or refrain from taking a particular course of action. Eliminating the "regular basis" prong, the DOL stated that whether there has been a recommendation is an objective analysis based on the facts and circumstances and that the more tailored the communication is to a particular investor, the more likely it is that the communication will constitute a recommendation for purposes of the 2023 Proposed Rule. However, the DOL also stated that a communication need not be addressed to one recipient or investor in order to be considered a "recommendation" for purposes of the 2023 Proposed Rule. Additionally, a series of actions, whether made directly, or through or together with an affiliate, may amount to a recommendation when considered together (regardless of whether each action, considered separately, would constitute a recommendation). If a communication is considered a recommendation under the Securities and Exchange Commission's Best Interest Regulation, it will also be a recommendation under the 2023 Proposed Rule.

The phrase "recommendation of any securities transaction or other investment transaction or any investment strategy involving securities or other investment property" includes recommendations concerning:

- The advisability of the acquisition, holding, disposition or exchanging of securities or other investment property, or as to investment strategy.

- How securities or other investment property should be invested after rollover, transfer, or distribution from a plan/IRA.
- Management of securities or other investment property, and account types (such as brokerage vs. advisory), including recommendations on investment strategies and/or policies and portfolio composition.
- Selection of investment advisers or managers.
- Proxy voting appurtenant to ownership of shares of corporate stock.
- Rollovers, benefit distributions, or transfers from a plan or IRA, including recommendations on whether to engage in the transaction and the amount, the form, and the destination of the rollover, transfer, or distribution.

The DOL explained that the inclusion of the phrase "other investment property" is intended to capture virtually any product with an investment component, including variable and fixed annuities, banking products, and digital assets. Because the rule has the potential to turn each interaction or series of interactions with a Retirement Investor into a fiduciary conversation, it will be critical for sales teams to understand the breadth of the rule and the narrow pathways that remain for staying outside of fiduciary investment advice and in the realm of sales or investment education. Materials will need to be reviewed and potentially revised; these include marketing materials as well as transaction, subscription, investment advisory and other services agreements requesting Retirement Investors to represent and warrant that they did not receive or rely on investment advice from the service provider in deciding to hire the service provider or purchase a product from the adviser. To the extent that plan sponsors include fiduciary advice programs for participants in their retirement plans, sponsors should check with their advice providers and obtain representations and warranties that those providers will follow an applicable prohibited transaction exemption.

2023 Proposed PTE Amendments

Many of the 2023 Proposed PTE Amendments narrow the scope of such PTEs such that Investment Advice Fiduciaries may no longer rely on those exemptions in rendering fiduciary investment advice to a plan. The 2023 Proposed PTE Amendments to PTEs 75-1, 77-4, 80-83, 83-1, and 86-128 (described below) effectively force many Investment Advice Fiduciaries who previously relied on such amended PTEs to instead rely on PTE 2020-02. These PTEs, however, continue to be available for fiduciaries who have full discretion over the covered transactions.

- *PTE 2020-02.* PTE 2020-02 allows Investment Advice Fiduciaries to make rollover recommendations and sell a wide range of investment products, including proprietary products to Retirement Investors. It also provides relief for certain principal transactions. The terms and conditions are onerous requiring compliance with impartial conducts standards, significant disclosure requirements, maintenance of policies and procedures, and retrospective compliance reviews. Proposed amendments to PTE 2020-02 include enhanced disclosure requirements requiring specific disclosure of costs, fees, and compensation the institution receives from the retirement client and other sources as well as broadened criminal disqualification provisions. Similar to the QPAM exemption, a criminal conviction by the financial institution or one of its affiliates could prohibit the institution from relying on PTE 2020-02. We expect the DOL to clarify that it intended the disqualification provisions to apply to convictions received after the date the 2023 Proposed PTE Amendments are finalized.

- *PTE 84-24.* PTE 84-24 has provided relief from the prohibited transaction rules for the sale of annuity and other insurance contracts from an insurance company to Retirement Investors and the payment of sales commissions with respect to those transactions. The DOL's proposed amendments to PTE 84-24 include terms and conditions that resemble PTE 2020-02 but would only extend relief to Investment Advice Fiduciaries who are independent agents of the insurance company and can sell the products of at least two insurance companies. The proposed amendments also require the insurance company to assume oversight and compliance responsibility over the independent agent's activities. Similar to PTE 2020-02, the exemption includes criminal disqualification provisions that would apply to the independent producer or the insurance company and its affiliates that would bar either party from relying on the exemption without obtaining an individual exemption from the DOL. Captive agents who are advice fiduciaries are prohibited from selling not only annuity or other insurance products under PTE 84-24 but also products under PTE 2020-02 as the exemption only covers reasonable compensation and certain principal transactions, which would not extend to the sale of an annuity by an insurance company. Since the DOL stated in the preamble to the amendments to PTEs 84-24 and 2020-02 that captive agents should be able to rely on PTE 2020-02, we hope that the DOL would be willing to consider addressing this issue in the final versions of these exemptions. As currently drafted, the proposed amendments to PTE 84-24 significantly narrow and effectively close important pathways the insurance industry has relied on to sell their products to Retirement Investors over the past 40 years.
- *PTE 75-1.* PTE 75-1 exempts certain transactions between plans or IRAs and certain broker-dealers, reporting dealers, and banks. Service providers wishing to rely on the exemption to execute transactions on a principal basis on behalf of plans or IRAs would have to comply with the new recordkeeping requirements.
- The exemption no longer covers (1) the execution of securities transactions on behalf of Retirement Investors on an agency basis; (2) the performance of clearance, settlement, or custodial functions incidental to affecting such transactions; (3) the furnishing of advice as to the value of securities or other property and related investment matters; and (4) the purchase or sale by a Retirement Investor of mutual fund shares. Parts III and IV of PTE 75-1, which permit fiduciaries to purchase securities in transactions where an affiliate is a member of the underwriting syndicate or a market-maker of the securities, may not be relied on by Investment Advice Fiduciaries. Broker-dealers, reporting dealers, and banks would still be able to use this exemption to receive reasonable compensation for extending credit to a plan or IRA to avoid a failed purchase or sale of securities involving the plan or IRA if (1) the potential failure of the purchase or sale of the securities is not caused by that fiduciary or an affiliate, (2) the terms of the extension of credit are at least as favorable to the plan or IRA as the terms available in an arm's length transaction between unaffiliated parties, and (3) the disclosure requirements are met.
- PTE 86-128. PTE 86-128 permits, subject to multiple conditions, a fiduciary to engage in and be compensated for certain agency transactions. While fiduciaries that exercise full discretionary authority or control with respect to plans and IRAs may continue to rely on PTE 86-128 to effect or execute securities transactions, the proposed amendments would impose the heavy terms and conditions that have applied to fiduciaries of plans to the

fiduciaries executing agency transactions on behalf of IRAs as well. Like new recordkeeping requirements of PTE 75-1, the proposed amendments to PTE 86-128 would also require financial institutions to maintain records necessary for the specified parties to determine whether conditions of this exemption have been met for six years after the transaction.

- *Other PTEs.* In addition to the proposed amendments to PTE 2020-02, PTE 84-24, PTE 75-1, and PTE 86-128 discussed above, the DOL also proposes to amend the following exemptions to exclude Investment Advice Fiduciaries:
  - PTE 77-4, which exempts a plans or IRA's purchase, or sale of open-end investment company shares where the investment adviser for the open-end investment company (such as a mutual fund company) is also a fiduciary to the plan or the IRA
  - PTE 80-83, which allows banks to purchase, on behalf of a plan or IRA, securities issued by a corporation indebted to the bank that is a party in interest to the plan or IRA
  - PTE 83-1, which provides relief for the sale of certificates in an initial issuance of certificates by the sponsor of a mortgage pool to a plan or IRA when the sponsor, trustee, or insurer of the mortgage pool is a fiduciary with respect to the plan or IRA assets invested in the certificates

Many agree that the 2023 Proposed Rule, including the Proposed Amendments, will end up in litigation. It will therefore be up to the courts to ultimately determine whether the DOL has overstepped the boundaries of its authority.

DOL Releases Final Retirement Security Rule

On April 23, 2024, the U.S. Department of Labor (DOL) released the final version of its Retirement Security Rule (the "Final Rule"), which imposes an ERISA fiduciary standard "that applies uniformly to all investments that retirement investors may make with respect to their retirement accounts". The new rule represents the latest attempt by regulators to define the types of individuals and advice that are subject to a fiduciary obligation, following on the heels of the SEC's Regulation Best Interest (Reg BI) and Commission Interpretation Regarding Standard of Conduct for Investment Advisers, as well as the DOL's own 2016 fiduciary rule (which was struck down by Federal courts in 2020) and Prohibited Transaction Exemption 2020-02.

According to a press release from the DOL, the Final Rule:

> *"As compared to the previous regulatory definition, which was finalized in 1975, the final rule better reflects the text and the purpose of ERISA and better protects the interests of retirement investors, consistent with the Department's mission to ensure the security of the retirement, health, and other workplace related benefits of America's workers and their families. The final rule is designed to ensure that retirement investors' reasonable expectations are honored when they receive advice from financial professional who hold themselves out as trusted advice providers"*

Fiduciary Definition Expanded

The Final Rule replaces the 1975 five-part test with a new test that would capture many more activities as fiduciary in nature, including rollover recommendations, one t-time advice and distribution advice.

Under the Final Rule, a person is an investment advice fiduciary under federal pension law (ERISA) if:

- The service provider makes an investment recommendation to a retirement investor.
- The recommendation is provided for a fee or other compensation, such as commissions; and
- The financial services provider hold itself out as a trusted adviser by
- Specifically stating that it is acting as a fiduciary under Title I or Title II of ERISA; or
- Making the recommendation in a way that would indicate to a reasonable investor that it is acting as a trusted adviser making individualized recommendation based on the investor's best interest.

In addition to being subject to ERISA's fiduciary obligations, "investment advice fiduciaries" under ERISA are prohibited from engaging in certain transactions and, more specifically, from using ERISA plan assets for their own account. Consequently, routine transactions, such as an adviser recommending that a retirement investor take a distribution from their 401(k) plan and invest it in an IRA, are now considered prohibited transactions under ERISA Section 406 (b) of ERISA and IRC § 4975.

The penalties for violating the prohibited transaction rules of ERISA and the IRC are severe and can include an excise tax of up to 100% of the amount involved, compounded over time. Therefore, an exemption is required for investment professionals and their firms to continue serving retirement investors.

Recommendations Defined

But what specifically is a recommendation? The Final Rule defines a "recommendation" to include advice about: The Final Rule covers recommendations made in the following contexts:

- The person either directly or indirectly (e.g., through or together with any affiliate) makes professional investment recommendations to investors on a regular basis as part of their business and the recommendation is made under circumstances that would indicate to a reasonable investor in like circumstances that the recommendation:
    - Is based on review of the retirement investor's particular need or individual circumstances.
    - Reflects the application of professional or expert judgment to the retirement investor's particular needs or individual circumstances.
    - May be relied upon by the retirement investor as intended to advance the retirement investor's best interest; or

    - The person represents or acknowledges that they are acting as a fiduciary under Title I of ERISA, Title II of ERISA, or both with respect to the recommendation.

As discussed in the Final Rule's release, the rule covers not only securities recommendations but also recommendations by investment professionals to retirement investors regarding account types, plan investment line-ups, and investment strategies and policies. In addition to securities recommendations, the Final Rule also applies to annuities, fixed indexed annuities, CDs and other banking products, digital assets, commodities, and real estate. The Final Rule does not provide an exception for investments in private funds.

The DOL clarified that the term "investment property" does not include health, term life, and disability insurance policies as long as they do not include an investment component.

In the Final Rule, and in response to public comments, the DOL has also made changes designed to ensure that it did not capture communications that were not properly viewed as fiduciary advice. The DOL in the Final Rule includes a new paragraph expressly stated that investment advice does not include:

- A sales pitch for a product or investment strategy where the recommendation is not made using professional expertise or considering the retirement investor's specific needs and circumstances; or
- Educational information not accompanied by an investment recommendation. Examples include:
    - General conversation about retirement planning.
    - General investment and financial information; and
    - Asset allocation models.

Note: While private fund managers may take advantage of the "sales pitch" exception to avoid being considered an investment advice fiduciary under ERISA when soliciting investors, such managers should be very careful when discussing their funds with retirement investors to avoid making a recommendation. They should adopt an overall communication strategy for retirement investors to help them stay on script and avoid sending any messages that recommend their funds as appropriate investments to meet their specific needs.

Amended PTE 2020-02 and PTE 84-24

The Final Rule also amended existing Prohibited Transaction Exemptions, including PTE 2020-02 and PTE 84-24. PTE 2020-02 allows financial institutions to give fiduciary investment advice to ERISA plans, ERISA plan participants, and IRAs and to receive otherwise prohibited compensation resulting from that advice, provided that certain conditions are satisfied (discussed below). Similarly, PTE 84-24 provides relief for certain parties to receive commissions when plans and IRAs purchase recommended insurance and annuity contracts and mutual fund shares sold by principal underwriters (discussed below).

For the actual Retirement Security Rule (“The Final Rule”) in the Federal Register view at: 2024-08065.pdf (federalregister.gov)

Prohibited Transaction Exemption 2020-02

As was discussed above, PTE 2020-02 allows Financial Institutions to give fiduciary investment advice to ERISA plans, ERISA plan participants, and IRAs and to receive otherwise prohibited compensation resulting from that advice if certain conditions are satisfied. Unlike other transaction specific PTEs that only cover certain types of investment assets, PTE 2020-02 provides relief for an extensive array of investment products and compensation arrangements. It also explicitly covers recommendations to rollover from a plan or IRA.

The Final Rule makes PTE 2020-02 more important than ever for two key reasons.

- First, the Final Rule expands the universe of entities that would be considered investment advice fiduciaries under ERISA and corresponding provisions of the IRC ("Code"). In order to receive compensation that varies based upon their recommendations, investment advice fiduciaries must find exemptive relief, which PTE 2020-02 supplies; and
- Second, DOL has made many other exemptions unavailable to investment advice fiduciaries, with the result that PTE 2020-02 largely stands as the only available option for exemptive relief in many cases. DOL views the amended PTEs 2020-02, 84-24, and the Mass Amendment as supplying a "uniform regulatory structure" to ensure that investment advice fiduciaries are held to a "common set of standards."

The most significant changes to existing PTE 2020-02 include:

- Expanding the availability of PTE 2020-02 to cover "recommendations to engage in any kind of principal transaction" as well as investment advice provided in connection with robo-advice arrangements.
- Adding non-bank Health Savings Account (HSA) trustees and custodians to the definition of "Financial Institution".
- Adding new disclosure requirements with respect to compensation and conflicts of interest to be more in line with the SEC's Regulation Best Interest (Reg BI), the Commission Interpretation Regarding Standard of Conduct for Investment Advisers (the "Interpretation"), and other regulators' disclosure requirements.
- Allowing Pooled Plan Providers (PPPs) to provide investment advice to the extent they are engaged by an independent plan fiduciary and will allow IRS-approved non-bank health savings account ("HSA") custodians to act as Financial Institutions.
- Increasing the circumstances for disqualification from reliance on the PTE.
- Including a correction procedure that allows Financial Institutions to self-correct violations of the exemption without reporting to the DOL; and
- Affirmatively requiring Financial Institutions to correct, report to the IRS, and pay IRC §4975 excise taxes in connection with any non-exempt prohibited transactions the Financial Institution engaged in as a result of providing fiduciary investment advice.

Original PTE 2020-02 Requirements vs Amended PTE 2020-02

While the amended PTE 2020-02 applies starting September 23, 2024, a 1-year phase-in period begins on September 23, 2024, which allows investment professionals to receive reasonable compensation if they comply with the fiduciary acknowledgment requirement and "Impartial Conduct Standards" (as discussed below). The following discussion compares the original PTE 2020-02 as adopted on December 18, 2020, to the amended PTE 2020-02.
Acknowledgments and Disclosures

In the original PTE 2020-02, parties providing fiduciary investment advice to retirement investors were required to make certain disclosures and acknowledgments, including their fiduciary status under ERISA. Amended PTE 2020-02 makes the following changes:

- Adds clarification that the disclosures can be made when recommendations are made, or on the date when the financial institution or investment professional becomes entitled to compensation as a result of the transaction.
- Requires that the acknowledgment make it "unambiguously clear" that the recommendation is being made in a fiduciary capacity under ERISA or the Code.

The original PTE 2020-02 required disclosure to the client about the scope of the relationship and all material conflicts of interest. Where the existing exemption required a written acknowledgment that the firm and its investment professionals are fiduciaries, an explanation of the services to be provided, and an accurate description of material conflicts of interest of the firm and its financial professionals, the Amended PTE 2020-02 also requires:

- A written statement of PTE 2020-02's care and loyalty obligations.
- The written acknowledgment of fiduciary responsibility (described above).
- Disclosure of the material fees and costs that apply to the retirement investor's transactions, holdings, and accounts.
- Disclosure of the scope of services being provided and any material limitations on those services; and
- All material facts relating to conflicts of interest are associated with the recommendation.

The DOL stated that these disclosures were intended to be consistent with a broker-dealer's obligations under Reg. BI.

The original PTE 2020-02 requires that prior to engaging in a rollover recommended under the exemption, the financial institution should provide documentation of specific reasons for the rollover recommendation. The Amended Exemption adds prior guidance from the DOL stating that factors to be considered must include:

- The retirement investor's alternatives to a rollover, including leaving the money in their current employer's plan, if applicable.
- The fees and expenses associated with both the plan and the recommended investment or account.
- Whether the employer pays for some or all of the plan's administrative expenses; and

- The different levels of services and investments available under the plan and the recommended investment or account.

According to the final release for the Amended PTE 2020-02, the exemption no longer requires disclosures regarding advice for a retirement investor to roll over its account from one IRA or another IRA or to change account type. This disclosure requirement only applies when the investment professional provides advice to engage in a rollover to a plan participant or beneficiary regarding the post-rollover investment of ERISA plan assets. Additionally, the rollover disclosure requirement does not apply when the investment professional does not make a recommendation.

Impartial Conduct Standards

The original PTE 2020-02 required investment professionals and financial institutions to comply with the Impartial Conduct Standards, which included a "best interest" standard, when providing fiduciary investment advice to retirement investors.

Best interest is defined under Original PTE 2020-02 as:

> *"Exercising reasonable diligence, care, skill, and prudence in making a recommendation, meaning that the firm and its investment professionals must have a reasonable basis to believe that the recommendation being made is in the best interest of the client, based on that client's investment profile and the potential risks and rewards associated with the recommendation."*

Amended PTE 2020-02 drops the term "Best Interest" and replaces it with the SEC's language from the Commission Interpretation Regarding Standard of Conduct for Investment Advisers (the "Interpretation"), which requires that the financial institution and investment professional provide investment advice which satisfies a duty of care and a duty of loyalty, as discussed earlier.

Simply put, an investment professional is supposed to make investment recommendations that are in the best interest of the client based on their stated needs and not on the amount the investment professional will get paid. The DOL provides specific examples, stating that an "Investment Professional generally could not recommend that the Retirement Investor enter into an arrangement requiring the Retirement Investor to pay an ongoing advisory fee to the Investment Professional, if the Retirement Investor's interests were better served by the payment of a one-time commission to buy and hold a long-term investment."

While the DOL did not provide any further explanation, the SEC has applied a reasonability standard, stating in the Interpretation that,

> *"[i]n providing advice about account type, an adviser should consider all types of accounts offered by the adviser and acknowledge to a client when the account types the adviser offers are not in the client's best interest."*

The remaining Impartial Conduct Standards from the Original PTE 2020-02 did not significantly change in the amended version. These standards include the following requirements for financial institutional and investment professionals:

- Receive only reasonable compensation (as compared to the marketplace) and seek the best execution of the transaction.
- Ensure that statements made to retirement investors about the recommended transaction are not materially misleading (in Amended PTE 2020-02, however, the DOL added language stating that the definition of "materially misleading" includes "omitting information that is needed to prevent the statement from being misleading to the Retirement Investor" under the circumstances); and
- Provide written disclosures to retirement investors of the reasons the rollover recommendation is in their best interest. The DOL also narrowed the required rollover disclosure so that it applies only to recommendations to roll over from an ERISA plan to an IRA. Original PTE 2020-02 also required disclosures for recommendations to roll over from one IRA to another or to change account type.

Correction Of Good Faith Disclosure Errors

Amended PTE 2020-02 allows financial institutions to correct errors or omissions in the required disclosures if they are made in good faith. The corrected disclosure must be provided no later than 30 days after the date the error is, or should have been, discovered.

Changes To Policies and Procedures Requirement

The original PTE 2020-02 requires that financial institutions "establish, maintain, and enforce" written policies and procedures designed to ensure that the firms and their investment professionals comply with the Impartial Conduct Standards. Amended PTE 2020-02 changes this obligation by requiring that the policies and procedures address all the requirements of PTE 2020-02, not just the Impartial Conduct Standards.

While the original PTE 2020-02 prohibited firms from using practices that create an incentive for a financial institution or investment professional to place their interests ahead of retirement investors, amended PTE 2020-02 includes specifics, stating that firms may not use "quotas, appraisals, performance or personnel actions, bonuses, contests, special awards, differential compensation, or other similar actions or incentives" that would lead investment professions from meeting their care or loyalty obligations.

Compliance Review and Self-Correction Procedure

The original PTE 2020-02 required financial institutions to conduct an annual review of the firm's compliance with the Impartial Conducts Standards and its policies and procedures governing compliance with the exemption. and document the results in a written report to a "Senior Executive Officer" of the financial institution.

The amendment requires that the review must test compliance with all the conditions of PTE 2020-02, not just the Impartial Conduct Standards. The review also must include a certification from the Senior Executive Officer that the financial institution has corrected, filed reports with the IRS, and paid excise taxes for any non-exempt prohibited transactions discovered by the financial institution.

The original PTE 2020-02 included a procedure to allow financial institutions to self-correct violations of the exemption. If the procedure was followed, a non-exempt prohibited transaction would not be deemed to occur. PTE 2020-20 also required firms to report each self-correction to the DOL. Amended PTE 2020-02 drops this reporting requirement.

Disqualification Provisions

The original PTE 2020-02 prohibits financial institutions and investment professionals from relying on the exemption for 10 years for certain crimes arising out of investment advice to a retirement investor. Other activities that make PTE 2020-02 unavailable include engaging in a pattern of violating the conditions of PTE 2020-02 or providing materially misleading information to the DOL regarding a financial institution's conduct.

Under Amended PTE 2020-02, the DOL added more crimes to its list, including affiliate and foreign convictions. The exemption also removed the stipulation that the crime arises from the provision of investment advice. Finally, the amendment limits the 10-year disqualification for non-criminal conduct (such as a pattern of violations of PTE 2020-02's conditions) to serious misconduct that has been determined in a court proceeding.

Under the original PTE 2020-02, the DOL had the authority to determine whether an investment professional or financial institution should be disqualified for non-criminal conduct.

Relief For RFP Responses

Amended PTE 2020-02 clarifies that responding to a Request for Proposal (RFP) to provide services as an ERISA Section 3(38) fiduciary does not qualify as fiduciary investment advice if certain conditions are satisfied. To qualify, the RFP responder must comply with the Impartial Conduct Standards of PTE 2020-02. This relief is limited to the RFP process; activities after being hired are not covered.

Effective Date

The final rule is effective September 23, 2024. The amendments to the PTEs 2020-02 and 84-24 are also effective September 23, 2024. Both amended PTE 2020-02 and PTE 84-24 include a one-year transition period after their effective dates under which parties have to comply only with the "impartial conduct" and provide a written acknowledgement of fiduciary status for relief under these PTEs.

For the actual Amendment to PTE 2020-02 in the Federal Register view at: Federal Register :: Amendment to Prohibited Transaction Exemption 2020-02

Prohibited Transaction Exemption 84-24

Under the Final Rule, insurance producers and other persons who recommend annuity and insurance products in transactions involving ERISA plans and IRAs are generally categorized as advice fiduciaries. These investment advice fiduciaries require relief from the prohibited transaction restrictions of ERISA and/or the Code to cover their receipt of commissions and other third-party paid compensation. Relief under PTE 84-24 is available to "Independent Producers" with respect to fiduciary recommendations of annuities and other insurance products that are not "securities" under Federal securities laws.

DOL's final PTE 84-24 amendment leaves this section 406 (a) relief provisions in place and largely unchanged with respect to any transactions that do not involve provision of fiduciary investment advice. With respect to those transactions where fiduciary advice is involved, the final amendments transform the existing relief framework in the following ways –

- Relief for the receipt of compensation in connection with proprietary mutual fund recommendations is no longer available (with the result that PTE 2020-02 must generally be relied upon for such transactions);
- Similarly, relief is no longer available for fiduciary recommendations of annuity or insurance products by insurance companies or their employees (including "career agent" statutory employees of the recommended insurance company);
- Nor is any relief available for recommendations of variable annuities and other insurance products that are securities; and
- Relief for fiduciary recommendations of non-securities annuity and insurance products (generally, fixed and fixed index products) by Independent Producers (defined as persons or entities licensed to sell, solicit, or negotiate insurance contracts of multiple unaffiliated insurance companies and who are not insurance company employees, including Code section 3121 statutory employees) is available under the PTE 84-24 final amendments subject to compliance by Independent Producers and insurance companies with separate sets of conditions.

Importantly, the PTE 84-24 final amendments broadly cover all compensation types and sources, consistent with the approach taken under PTE 2020-02. The final amendments completely abandon the restrictive approach taken under DOL's amendment proposal that would have limited covered compensation to "Insurance Sales Commissions" (defined as commissions paid by an insurance company or an affiliate for recommending and effecting the sale of a product, including renewal and trailing fees, but excluding "revenue sharing payments, administrative fees or marketing payments and payments from any party other than the insurance company or its affiliate"). Similarly, DOL's preamble commentary indicates that it has retreated from statements made in the proposal and in connection with its 2016 rulemaking effort that compensation covered by PTE 84-24 is limited to so-called "simple commissions."

Note that insurance products that do not have an investment component, e.g., term insurance, are not subject to these rules. However, annuities, whole life, universal life, and other insurance products with investment elements are.

As was discussed above, unlike PTE 2020-02 where the investment professional and the financial institution are co-fiduciaries (in the sense that they are both fiduciaries for compliance with the terms of the PTE), under PTE 84-24 the independent producer is a fiduciary, but the insurance company is not. However, insurance companies will have significant oversight responsibilities, including the review of each application for compliance with the new requirements. (Note, though, the oversight responsibilities will not be effective until September 23, 2025, even though the new fiduciary definition will apply to independent producers a year earlier—on September 23, 2024.)

To obtain the protection of PTE 84-24, four categories of "conditions" must be satisfied. Those are:

- The Impartial Conduct Standards.
- Written Disclosures.
- Policies and Procedures
- Annual Retrospective Review and Report

These conditions are imposed on the independent producer and not on the insurance company.

Impartial Conduct Standards

Of the four Impartial Conduct Standards, the requirements for reasonable compensation and no misleading statements are the easiest to understand and comply with. As a result, this post will focus on the two obligations (although there will be a future article on the provisions related to compensation).

The Care Obligation is defined in the PTE as follows:

> *"Advice meets the ''Care Obligation'' if, with respect to the Retirement Investor, such advice reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor."*

This is very close to the prudent person rule in ERISA. It is a process-driven approach measured by the hypothetical standard of a knowledgeable person—"a prudent person … familiar with such matters."

In essence, it requires that an independent producer consider the relevant information about

- The retirement investor (e.g., the needs and circumstances of the investor),
- The investor's current situation (e.g., the investor's current investments and strategies, including the investments, services and costs), and
- The potential recommendation contemplated by the independent producer. The current and potential arrangements would then be evaluated in light of the retirement investor's

> profile…in a knowledgeable, careful, skillful, diligent, and prudent manner. That process would result in a recommendation that is in the best interest of the retirement investor.

The Loyalty Obligation is defined in the PTE as follows:

> *"Advice meets the ''Loyalty Obligation'' if, with respect to the Retirement Investor, such advice does not place the financial or other interests of the Independent Producer, Insurer, or any Affiliate, Related Entity, or other party ahead of the interests of the Retirement Investor, or subordinate the Retirement Investor's interests to those of the Independent Producer, Insurer, or any Affiliate, Related Entity, or other party."*

This is similar to the SEC's approach in Regulation Best Interest for broker-dealers. In practice, it means that an independent producer cannot place his or her interest ahead of the retirement investor's by, e.g., recommending a higher cost and compensating annuity when an alternative would be better for the retirement investor. Another example is that an independent producer cannot recommend a rollover where the better course of action for the participant would be to leave the money in the plan.

The Fiduciary Acknowledgement

PTE 84-24 describes the disclosure of the fiduciary acknowledgement as follows:

> *"A written acknowledgment that the Independent Producer is providing fiduciary investment advice to the Retirement Investor and is a fiduciary under Title I of ERISA, Title II of ERISA, or both with respect to the recommendation."*

Fortunately, this disclosure is straight forward, although independent producers may need help from insurance companies and intermediaries to draft the disclosure.

The remaining disclosure requirements, the policies and procedures requirements, and the annual retrospective review effective dates are delayed until September 23, 2025. For the actual Amendment to PTE 84-24 in the Federal Register view at:
Federal Register :: Amendment to Prohibited Transaction Exemption 84-24

Texas Courts Stayed DOLs Fiduciary Rule

Shortly after the DOLs new regulation defining fiduciary advice and amended Prohibited Transaction Exemptions 2020-02 and 89-24 were finalized, two lawsuits were filed in Federal District Courts in Texas—one in the Eastern District of Texas and the other in the Northern District. The lawsuits sought to "vacate," or overturn, the regulation and exemptions as being beyond the authority of the DOL. In addition, the plaintiffs requested that the courts "stay" the effective dates of the regulation and exemptions pending outcomes of the lawsuits.

Both courts have "stayed" the effective dates, meaning that the private sector will not have to comply with the DOL Retirement Security Rule ("the fiduciary rule") and amended exemptions until the cases are resolved.

As a result, the current fiduciary regulation, with its 5-part test, will continue in effect pending the final resolution of the lawsuits. In the same vein, the current PTEs 84-24 and 2020-02 will continue in effect until a final decision is reached on the validity of the amended PTEs.

Note: On September 20, 2024, the Department of Labor (DOL) appealed to the Fifth Circuit Court for a reversal of the ruling by the U.S. District Court for Eastern Texas. The move came three days before the rule's original effective date.

DOL Rule and the Trump Administration

Now, with Trump winning a second term as President, it is anticipated that there would be efforts to roll back the Retirement Security Rule. Historically, the Trump Administration has favored deregulation, particularly concerning fiduciary standards. Many analysts suggest that a renewed Trump administration might abandon the current fiduciary rule, potentially reverting to previous standards or introducing new exemptions. Stay Tuned!

Best Interest Standard

Investment advice fiduciaries relying on the class exemption must provide advice in the best interest of retirement investors.

The best interest standard is satisfied if the advice is:

- *Prudent:* the advice reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor; and
- *Loyal:* the advice does not place the financial or other interests of the investment professional, financial institution, or any affiliate, related entity, or another party ahead of the interests of the retirement investor or subordinate the retirement investor's interests to their own.

The DOL aligned the best interest standard in the new prohibited transaction class exemption with the conduct standards in the Securities and Exchange Commission's Regulation Best Interest and the fiduciary duty of registered investment advisers under securities laws.

Under the prohibited transaction class exemption, financial institutions would be required to document the specific reasons that recommendations to roll over workplace retirement plan assets from a plan to an IRA or from one type of account to another are in the retirement investor's best interest.

Disclosure

The new prohibited transaction class exemption requires financial institutions to disclose to retirement investors their status as investment advice fiduciaries under Title I of ERISA and the Code, as applicable, and provide an accurate written description of their services and material conflicts of interest.

This disclosure should ensure that the fiduciary nature of the relationship is clear to all parties. The Department does not intend that the fiduciary acknowledgment or disclosure obligations create a private right of action between a financial institution or investment professional and a retirement investor, and it does not believe the exemption would do so.

Prior to engaging in a rollover recommended pursuant to the exemption, financial institutions must provide documentation of specific reasons for the rollover recommendation to the retirement investor, including why it satisfies the best interest standard.

(You can view the document at: https://www.federalregister.gov/documents/2020/12/18/2020-27825/prohibited-transaction-exemption-2020-02-improving-investment-advice-for-workers-and-retireesrtment

Fiduciary Breach

A fiduciary breach is a failure to fulfill any of the obligations or responsibilities imposed on fiduciaries under ERISA. This includes breaches of the four core duties of the fiduciary under ERISA 404(a)–loyalty, prudence, diversification, and following plan documents–but also failures to provide summary plan descriptions, file reports, ensure vesting and participation standards are met, and especially failures to invest monies on behalf of participants, which the “borrowed deferrals” could represent.

ERISA §409 says:

> *(a) Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through the use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. A fiduciary may also be removed for violating section 1111 of this title.*
>
> *(b) No fiduciary shall be liable with respect to a breach of fiduciary duty under this subchapter if such breach was committed before, he became a fiduciary or after he*

ceased to be a fiduciary.

ERISA Civil Enforcement Scheme

ERISA provides that civil actions to obtain appropriate relief for a breach of fiduciary duty may be brought by a participant, a beneficiary, a fiduciary, or the Secretary of Labor [29 U.S.C. §1132 (a)]. The statute provides the following:

- That civil actions may be brought to recover benefits due under the plan, to enforce rights under the terms of the plan, or clarify rights to future benefits under the terms of the plan;
- A participant, beneficiary, or fiduciary may bring a civil action to enjoin any practice which violates any provision of ERISA or the terms of the plan; and
- Attorney fees and costs may be awarded to the prevailing party [29 U.S.C. §1132 (g)(1)].

Limiting Fiduciary Liability

With the responsibility of a fiduciary, there is also some potential liability. Plan sponsors who go it alone can hire a service provider (a financial institution or an investment consultant (advisor) who accepts no fiduciary responsibility for their advice. This does nothing to mitigate the sponsor's fiduciary risk. However, the plan sponsor can take actions to demonstrate that they carried out their responsibilities properly and ways to limit their liability.

One way to limit the plan sponsor's liability is to hire outside fiduciaries (service providers/advisors). A survey conducted by Franklin Templeton/Chatham Partners found that 81 percent of the plan sponsors surveyed said their service providers/advisors acted as an ERISA fiduciary. But when asked what kind of fiduciary role their service providers/advisors were taking on, 63 percent of them didn't know. This can be a problem because not knowing the nature of their fiduciary responsibility can lead to unintended liability. So, for plan sponsors who are uncomfortable with bearing the risk alone, ERISA provides them with three options to choose. They are:

- ERISA § 3(16) Fiduciary;
- ERISA § 3(21) Fiduciary; and
- ERISA § 3(38) Fiduciary.

ERISA § 3(16) Fiduciary

The employer (plan sponsor) may hire third-party administrator (TPA) firms who are willing to be named as ERISA § 3(16) plan fiduciaries for various plan administration duties. Typically, the different administrative services that these TPAs are willing to serve as fiduciaries for are listed.

As a result, the type and quality of § 3(16) offerings vary by provider. For example, some TPAs are willing to serve as distributions and loans but cannot decide whether a Domestic Relations Order is qualified.

Other responsibilities of a § 3(16) fiduciary may include hiring service providers, such as a § 3(38) fiduciary. However, plan sponsors should keep in mind that choosing a § 3(16) fiduciary to be responsible for some or all plan administration duties does not relieve them of all fiduciary responsibility.

ERISA § 3(21) Fiduciary

The ERISA § 3(21) fiduciary is typically an investment advisor or service provider that provides investment advice and recommendations. Many financial advisors recommend and provide non-discretionary investment advice to the plan sponsor as 3(21) Fiduciaries. These investment advisors customarily acknowledge in writing that their advice will include "investment advice" for ERISA purposes. They expect the plan sponsor and/or the participants to rely on this advice as the primary basis for their investment decisions.

ERISA expressly authorizes the plan's Named Fiduciary to hire other fiduciaries to provide investment advice and assist the plan sponsor in discharging its investment duties under the plan. Under relevant case law, the courts have ruled that plan sponsors are permitted to rely on the advice they obtain from independent experts, including 3(21) Fiduciaries. However, the courts have ruled that the plan sponsor is prohibited from blindly following an expert's advice. Instead, the plan sponsor must:

- Investigate the expert's qualifications.
- Provide the expert with complete and accurate information, and
- Make certain that reliance on the expert's advice is reasonably justified under the circumstances.

Often, the investment advisor would be a co-fiduciary with the plan sponsor or an investment committee in this type of situation. The plan fiduciary would work in conjunction with this investment advisor. Together, they develop and draft the investment policy statement (IPS), design the fund menu and monitor the investments. When the investment advisor recommends changes and mapping strategies, the plan sponsor makes the decisions jointly. The plan sponsor retains the responsibility to appoint and monitor the service provider/investment advisor and ultimately make investment decisions.

ERISA § 3(38) Fiduciary

Rather than relying on the services of a 3(21) Fiduciary that provides non-discretionary advice, a plan sponsor may utilize the services of a wholly different type of fiduciary advisor, a 3(38) Fiduciary.

3(38) Fiduciaries were historically associated with defined benefit pension plans. However, this type of fiduciary can also provide investment services to defined contribution plans. They offer the greatest fiduciary protection available under ERISA. A 3(38) Fiduciary, by its nature, must have discretionary investment authority. In the case of a defined contribution plan, this means that the 3(38) Fiduciary must have the authority to unilaterally add or remove investments from the plan's menu on behalf of the plan.

The fiduciary protection gained by plan sponsors willing to surrender this level of investment control over the plan's menu is meaningful. If the plan sponsor appoints a 3(38) Fiduciary, the plan sponsor will not be liable for the individual acts or omissions of the investment manager and will not have any direct oversight responsibility for the plan investments under the investment manager's control. Instead, the 3(38) Fiduciary alone is responsible for the prudence of its individual acts or omissions under ERISA.

This means the ERISA § 3(38) service provider/advisor is the one who drafts the investment policy statement, designs and builds the initial fund menu, and monitors the investments. The service provider/advisor also makes whatever changes need to be made, determines mapping strategies, and provides overall documentation. In exchange for ceding total decision-making authority over the plan to the 3(38)-service provider/advisor, the plan sponsor relieves themself of all fiduciary responsibility for the plan– with one important exception. Plan sponsors still must exercise due diligence in selecting a plan service provider/advisor. They must check out their credentials, background, and track record. If they fail to do so, the service providers/advisors § 3(38) status won't protect the sponsor from liability and litigation if the investment advisor does something drastically wrong. The § 3(38) arrangement can be attractive to many plan sponsors who don't want to be bothered with the details of managing a 401(k) plan and are very wary of the potential for litigation. In their view, passing fiduciary responsibility onto a third party enables them to disengage from the plan and get on with their real business. However, the § 3(38) route can be very expensive. And the liability protection under a § 3(38) relationship is not without limits. Even if they've taken prudent care in selecting a fiduciary, plan sponsors still need to monitor their activities continuously. Plan sponsors also can't second-guess or resist the fiduciary's decisions, or they risk losing whatever liability protection the § 3(38) status affords them.

Hiring a Service Provider

As discussed above, even if the plan sponsor hires a service provider/advisor to administer and/or manage the plan, they retain some fiduciary responsibility to select and keep that person or entity as the plan's service provider. Thus, the plan sponsor should document their selection process and monitor the services provided to determine if a change needs to be made.

Some items the plan sponsor should consider when selecting a plan service provider:

- Information about the firm itself: affiliations, financial condition, experience with 401(k) plans, and assets under their control.
- A description of business practices: how plan assets will be invested if the firm will manage plan investments or how participant investment directions will be handled, and proposed fee structure.
    - Information about the quality of prospective providers: the identity, experience, and qualifications of the professionals who will be handling the plan's account; any recent litigation or enforcement action that has been taken against the firm; the firm's experience or performance record; if the firm plans to work with any of its

affiliates in handling the plan's account; and whether the firm has fiduciary liability insurance; and once hired, these are additional actions to take when monitoring a service provider:

- Review the service provider's performance.
- Read any reports they provide.
- Check actual fees charged.
- Ask about policies and practices (such as trading, investment turnover, and proxy voting); and
- Follow up on participant complaints.

Fiduciary Insurance

As was discussed above, fiduciaries are personally liable in the event of a breach of their responsibility, even if they hire service providers to assist with their fiduciary duties. However, a plan, fiduciary, employer or employee organization may purchase insurance to cover potential liability for one or more persons who serve as a fiduciary.

Fiduciary insurance is not required by law, but it is often recommended because it may protect *plan fiduciaries* and their personal assets from losses resulting from claims of alleged errors, omissions, or breaches of fiduciary duties. There are several issues to think about when considering fiduciary liability insurance. Among them are:

- The annual premium cost.
- Amount of coverage needed.
- Amount of any deductible.
- Whether the deductible is charged any time a claim is made or only if there is a settlement or judgment; and
- Whether the limits of liability under the policy are reduced by attorney's fees and costs incurred in defending against a claim.

The cost of this insurance has been increasing, but it is still considered affordable in many cases. Fiduciary liability insurance can be purchased as a stand-alone policy or as add-on coverage to other bundled policies, such as a Business Owner's Policy. A policy typically costs around $500 to $2,500.

Fiduciary Insurance Claims

Generally speaking, fiduciary liability insurance pays the legal liability arising from claims for alleged failure to act prudently under ERISA on behalf of the insured fiduciaries. Examples of fiduciary liability insurance claims include payment for the personal liability incurred in the following actions against fiduciaries:

- The DOL brought a claim against fiduciaries alleging that negligent investment practices needlessly depleted plan assets.
- A beneficiary sued the plan trustees individually in an attempt to recover a benefit lost because of inadequate instruction.

- The DOL claimed the trustees' failure to sell the employer/sponsor's stock caused material depletion of plan assets; and
- A beneficiary sought compensation from the plan administrator for a pension lost by reason of incorrect interpretation of eligibility.

Paying for Fiduciary Insurance

Fiduciaries may purchase insurance on their own behalf (or the sponsor may purchase it for them) using non-plan funds, and/or a plan may purchase insurance for itself or its fiduciaries.

According to the statutory wording of ERISA § 410, fiduciary liability insurance may be paid for from plan assets:

> *"… [there is nothing to prevent] a plan from purchasing insurance for its fiduciaries or for itself to cover liability or losses occurring by reason of the act or omission of a fiduciary, if such insurance permits recourse by the insurer against the fiduciary in the case of a breach of a fiduciary obligation by such fiduciary…"*

This means that insurance policies paid for from plan assets must protect the plan, not the fiduciaries. Recourse against the fiduciaries means the insurer has the right to pursue the fiduciaries for payment. If the fiduciaries want protection, they have to pay for the protection themselves.

Fidelity Bond

The ERISA fiduciary bond (or fidelity bond as it is often referred to) is an employee dishonesty insurance policy. A fiduciary bond is required under ERISA §412.

> *(a) Requisite bonding of plan officials*
>
> *Every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan (hereafter in this section referred to as "plan official") shall be bonded as provided in this section…*
>
> *…The amount of such bond shall be fixed at the beginning of each plan's fiscal year. Such an amount shall be not less than 10 per cent of the amount of funds handled. In no case shall such bond be less than $1,000 nor more than $500,000 except that the Secretary…may prescribe an amount in excess of $500,000, subject to the 10 per centum limitation of the preceding sentence… [Note that PPA amended section 412(a) to increase the maximum to $1 million for plans holding employer securities.]*
>
> *...Such bond shall provide protection to the plan against loss by reason of acts of fraud or dishonesty on the part of the plan official, directly or through connivance with others…*

…Any bond shall be in a form or of a type approved by the Secretary, including individual bonds or schedule or blanket forms of bonds, which cover a group or class.

[Most bonds are blanket bonds that cover all officers, directors, and employees of a plan sponsor to ease the burden of administering compliance with the bonding requirements.]

(b) Unlawful acts

It shall be unlawful for any plan official to whom subsection (a) of this section applies to receive, handle, disburse, or otherwise exercise custody or control of any of the funds or other property of any employee benefit plan without being bonded as required by subsection (a) of this section and it shall be unlawful for any plan official of such plan, or any other person having authority to direct the performance of such functions, to permit such functions, or any of them, to be performed by any plan official, with respect to whom the requirements of subsection (a) of this section have not been met…

Requirements of Fidelity Bond

Unlike fiduciary insurance, ERISA requires plans to purchase a fiduciary, or fidelity, bond. The practical requirements of an ERISA fiduciary bond are:

- All plan officials, including fiduciaries and persons who handle plan funds, must be bonded.
- The bond covers fraud and dishonesty by a plan official, "directly or in connivance with others;"
- The bond can name individuals (rare and tedious to manage) or a blanket bond which covers a group or class; most bonds are blanket bonds covering all officers, directors, and employees of a sponsor.
- It is unlawful for an un-bonded plan official to receive, handle, disburse, or otherwise exercise custody or control over plan assets.
- A plan can pay for the bond, even if it covers a service provider (e.g., an investment manager).
- It is unlawful for a fiduciary to permit an un-bonded official to handle funds.
- Investment Advice Fiduciaries who do not have discretion or control of assets do not have to be bonded; and
- Discretionary fiduciaries such as ERISA §3(38) managers, independent fiduciaries acting as named fiduciaries, or any other discretionary fiduciaries must be bonded unless it can be clearly shown that the risk of loss due to fraud or dishonesty is negligible

Minimum Bond Amount

The amount of the bond must be fixed at the beginning of each plan year in an amount that is not less than 10 percent of the amount of funds being handled. The amount of the bond may not be less than $1,000, even if 10 percent of the amount of funds being handled would permit a smaller dollar amount, and need not be greater than $500,000, even if 10 percent of the amount of funds being handled would otherwise require a larger dollar amount.

The bond does not have to state a specific dollar amount of coverage, so long as the bond provides the required statutory amount per plan, per plan officially covered under the bond.

Increased Bonding Requirements

The maximum bond amount increases to $1 million for a plan that holds employer securities. The ten percent rule would still apply, so the amount of the bond would be less of 10 percent of the amount of funds being handled or $1 million. For plans subject to this rule, the ten percent bonding requirement applies up to $10 million, rather than $5 million, of funds handled. The requirement is not dependent on whether the employer securities are publicly traded.

Small Plan Audit Waiver Rule

DOL has published extensive temporary regulations under § 2550.412 with details of who must be bonded, the form of the bond, etc. However, the small plan audit waiver rule is the regulation of the greatest interest for a 401(k) adviser.

DOL Reg. §2520.104-46 specifies how plans with fewer than 100 employees eligible to participate can be exempt from the annual audit requirement. One of the conditions for the exemption is that a plan holding non-qualifying assets is subject to additional bonding requirements. Here is a summary of those requirements:

- The Form 5500 must include an audit report, but there is a waiver for small plans (under 100 employees eligible to participate, as properly counted);
- To be eligible for the waiver, a plan must either consist of at least 95 percent of "qualifying plan assets" or plan officials must be bonded for the full amount of non-qualifying assets; and
- The summary annual report (SAR) must include additional information (so a small plan's SAR using the audit waiver rule is different from a large plan SAR).

"Qualifying plan assets" are:

- Qualifying employer securities
- Compliant participant loans
- Assets held by certain financial institutions
- Mutual funds
- Insurance company investment and annuity contracts
- Any self-directed assets for which the participant has the opportunity to exercise control

The implication is that a small plan (under the 5500 definition) holding unusual assets (such as direct investment in real estate, limited partnerships, hedge funds, or other illiquid or unusual investments not custodied by a regulated financial institution) is subject to the annual audit requirement unless it complies with the additional bonding requirements.

Chapter 9
Review Questions

1. Which of the following U.S Presidents signed into law The Employee Retirement Income Security Act (ERISA) of 1974?

( ) A. President Jimmy Carter
( ) B. President Gerald Ford
( ) C. President John F. Kennedy
( ) D. President Richard Nixon

2. Which of the following would **NOT** be considered a named fiduciary?

( ) A. Plan Trustee
( ) B. Plan Sponsor
( ) C. Accountant
( ) D. Plan Administrator

3. Which type of fiduciary service will provide full discretion over investment options for a plan and select, monitor, and replace investment options based on plans investment policy statement (IPS)?

( ) A. ERISA § 3(38)
( ) B. ERISA § 3(21)
( ) C. ERISA § 3(36)
( ) D. ERISA § 3(16)

4. Under ERISA, a plan sponsor may hire which of the following plan fiduciaries to provide only administrative services for their 401(k) plan?

( ) A. ERISA § 3(21)
( ) B. ERISA § 3(16)
( ) C. ERISA § 3(38)
( ) D. ERISA § 3(36)

5. A plan will meet ERISA § 404(c) guidelines if participants can choose from at least a minimum of how many diversified investment alternatives, each of which offers significantly different risk and return characteristics?

( ) A. 1
( ) B. 3
( ) C. 6
( ) D. 9

CHAPTER 10

401(k) PLAN INVESTMENTS AND FEES

Overview

The evolution of investment offerings has come full circle since the inception of 401(k) plans. The first plans generally offered a few diversified choices. Still, many plan sponsors offered an overwhelming number of options over time. Today, we are again seeing plan sponsors streamline the number of investment options they offer to participants and make a shift in responsibility for investment decision-making away from the participant and back to employer-selected investment and advice programs.

This chapter will examine the broad range of investment alternatives in a participant-directed 401(k) plan. In addition, it will also examine the role of automatic enrollment and the Qualified Default Investment Alternatives (QDIAs) as required by the Pension Protection Act (PPA) of 2006 and the role of target date funds (TDFs) and qualified longevity annuity contracts (QLACs). At the end of the chapter, we will examine the fees associated with 401(k) plans and the issues of employees purchasing employer securities in their 401(k) plan, the benefits of investment advice, and the purpose of developing an Investment Policy Statement for a 401(k) plan.

Learning Objectives

Upon completion of this chapter, you will be able to:

- Describe the characteristics of different investment alternatives;
- Describe the background and history of ERISA.
- Outline the broad range of investment alternatives in a 401(k) plan;
- List the various qualified default investment alternatives (QDIAs);
- Describe the features and benefits of target date funds;
- Apply the rules and regulations of qualified longevity annuity contracts (QLACs);
- Identify the risk and rewards of owning employer securities in a 401(k) plan;
- Recognize the role of giving investment advice to a participant of a 401(k) plan; and provide an Investment Policy Statement.
- Outline the Considerations for Adopting an Eligible Combination Plan.

Investing in a 401(k) Plan

Employers choose whether to offer 401(k) plans to their employees, and if so, how to design their plans to attract and retain qualified workers. These design choices include a menu of different types of investment options in the plan. According to Brightscope/ICI "*Defined Contribution Plan Profile: A Closer Look at 401(k) Plans, 2021"*, released August 2024, reported on average, large 401(k) plans offered participants 28 investment options in 2021. The number of investment options offered varies little among 401(k) plans with $1 million or more in plan assets (ranging between 28 options and 30 options). Plans with less than $1 million in plan assets offered 22 options, on average. Because plans may offer suites of target date funds with options tailored to multiple anticipated retirement dates, an adjusted number counts a suite of target date funds as one investment option is also presented. On average, large 401(k) plans offer 20 options according to this target date fund–adjusted number, similarly with little variation across plan size categories.

You can view the report at: The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans,2021

A recent report released by Vanguard, "How America Saves, 2024," reported that the average Vanguard plan offered 27.5 investment options in 2023, up slightly form 27.2 in 2022, although generally in line with the past 10 years. However, when each distinct target-date (or target-risk) fund is counted as a single offering, the average number of investment options was 17.4. By this measure, sponsors have dropped one investment option on a net basis since 2013.

The number of funds used by participants has declined over the past 10 years. This is directly attributable to the growth of target-date funds. Counting a target-date or target-risk series as a single-fund offering, the median plan sponsor offered 16 investment options in 2023. Only 8% of plans offered more than 25 distinct investment options, while 8% of plans offered 10 or fewer.

Types of Investments

When it comes to selecting funds for a 401(k) plan, virtually all plans offer an array of investment options covering the four major investment categories:

- Equities;
- Bonds;
- Balanced (including target date and target-risk strategies); and
- Money market or stable value options.

Given most plan sponsors (employers) desire to promote equity-oriented portfolios for retirement, diversified equity funds are the most popular type of fund offered. Equity offerings typically include both indexed and actively managed U.S. stock funds, including large-capitalization and mid or small-capitalization stocks, as well as one or more international funds.

According to Vanguard's report, "*How America Saves, 2024*," the percentage of plan assets invested in equities stood at 74% in 2023.

Over the past decade, several 401(k) plans expanded their investment options to various asset allocation funds, target date funds (TDFs), guaranteed income annuity contracts, REITs, alternative investment vehicles such as separately managed accounts and commingled trust funds, emerging markets, and the conversation has begun to offer ETFs.

In addition, there seems to be a shift in responsibility for investment decision-making away from the participant and back to employer-selected investment and advice programs (professionally managed allocations). Participants with professionally managed allocations are those who have their entire account balance invested in a single target date or balanced fund or a managed account advisory service.

You can view the Vanguard report, "How America Saves 2024", at:
https:///institutional.vanguard.com/content/dam/inst/iig-transformation/has/2023/pdf/has-insights/how-america-saves-report-2024.pdf

Mutual Funds

The most common type of investment options in 401(k) plans are mutual funds or similar investment vehicles that pool funds managed by a professional fund manager. The menu of mutual funds, from which an employee can choose, is ultimately constructed by the plan sponsor (employer). However, the actual assembly of the menu is often done in consultation with plan service providers.

The mutual fund is merely a "wrapper" containing various investments such as stocks, bonds, and cash. By owning shares (or units) of a mutual fund, participants own a fraction of each security purchased by that mutual fund.

According to the Investment Company Institute (ICI), Retirement Assets mutual funds managed $5.2 trillion, or 65, of assets held in 401(k) plans at the end of June 2024.

You can view the ICI report at: https:// www.ici.org/statistical-report/ret_24_q2

Equity Funds

With $3.1 trillion, equity funds were the most common type of funds held in 401(k) plans at the end of June 2024. Equity funds accounted for 39% of total 401(k) assets, down from 44% in 2016, according to the Investment Company Institute (ICI). On average, 401(k) participants had 79% of their 401(k) plan balances invested directly or indirectly in equity securities.

According to Vanguard, as reported in their report, "*How America Saves 2024,"* seventy-four percent of plan assets were invested in equities in 2023. This allocation includes the equity component of balanced strategies. The overall equity allocations for the past 10 years have remained relatively consistent. The average participant-weighted asset allocation to equities was 78% in 2023, and asset allocation decisions varied among participant demographics. In the past, higher-income participants tended to assume more equity market risk, on average, than lower-income participants. However, with the rising adoption of target-date funds and automatic enrollment, participants of all income segments now have similar equity risk. All participants, regardless of income level, had slightly more than three-quarters of their average account balance allocated to equities in 2023; at the median, participants allocated 87% to equities. Participants younger than 45 had the highest equity exposure, with about 90% of plan assets, at the median, invested in equities. Equity allocations were lowest for participants older than 65, many of whom are retired or will be soon. Participants older than 65 had a median equity allocation of 47%.

Private Equity Funds

Participants seeking to enhance their 401(k)-retirement savings can now use professionally managed funds to invest in private equity firms. According to the EBSA, plan sponsors can incorporate private equity into diversified investments, such as target date funds that automatically adjust holdings to maximize returns and minimize risk based on a projected retirement date.

In the past private equity was off the menu in most cases because of uncertainty regarding fiduciary responsibilities by plan sponsors and liability surrounding the investments held by private companies. The change makes it, so private equity activity within a broader fund complies with publicly traded companies' investing standards.

To view the DOL letter on Private Equity Investments, go to:
https://www.dol.gov/newsroom/releases/ebsa/ebsa20200603-0

Balanced Funds

A balanced fund is very similar to a moderate-style target risk fund. Balanced funds tend to target an asset allocation between 40% to 60% stocks and 40% to 60% bonds that can vary–with some stretching even beyond these parameters. They are typically well-diversified, and they have been popular because of their favorable return/risk profile over the years (Target date funds). Most avoid significant losses in adverse times by altering their allocation to stocks and bonds within the allowed prospectus parameters. In contrast, a target risk fund would remain relatively true to allocating stocks and bonds and be less likely to avoid such movements.

According to the Brightscope/ICI report, balanced funds held 41% of large private-sector 401(k) plan assets in 2021, with most of that being held in target date funds). Smaller plans were more likely to offer non-target date-balanced funds. While 6.3% of plans with less than $1 million in plan assets and 7.3% of 401(k) plans with $1 million to $10 million offered non-target date balanced funds, 1.2% of plans with more than $1 billion did.

Vanguard, in its report, "*How America Saves 2024,"* states that in 2023, investments in balanced strategies reached 45%, including 41% in target-date funds and 4% in other balanced options. The growth of target-date funds is dramatically reshaping DC plan investment patterns by increasing age-appropriate equity allocations and reducing extreme allocations

Stable-Value Funds

Since the SEC money market fund reform rules went into effect, there has been a meaningful movement away from money market funds as a capital preservation option in 401(k) plans, with just over half of plan sponsors now offering money market as a capital preservation option.

Stable value is only available in tax qualified plans, most notably defined contribution plans, and is offered in approximately 3 out of 4 defined contribution plans according to the Alight Solutions Trends & Experience in Defined Contribution Plans survey. A stable value fund attempts to maintain a constant price, or principal value, regardless of stock market or interest rate environments.

A stable value fund may seem like mutual funds, but they are structured and managed slightly differently. They come in a few types:

- *Separately managed accounts*: These are customized investment accounts designed to meet a specific goal for a single retirement plan. Returns are backed by assets in another account, and the returns can be fixed, indexed, or may adjust annually according to the performance of the market;
- *Commingled funds*: These types combine assets from a variety of sources, just like a mutual fund. This helps smaller plans gain economies of scale;
- *Guaranteed Investment Contracts (GIC)*: This is an account where the manager invests in an annuity, and the investors in the retirement plan are the beneficiaries. So there is a guaranteed amount of principal and interest; and
- *Synthetic GIC:* The account invests in a portfolio of fixed-income investments "wrapped" in insurance contracts that protect the underlying value of the investment. These make up a good percentage of today's stable value funds.

A stable value fund offers an attractive combination of income generation and share-price stability that stands in stark contrast to riskier assets available in most 401(k) plans. These funds are sometimes referred to as "*Fixed Accounts*" or "*Fixed Income Accounts*," and they typically offer interest rates 1 to 2% higher than ordinary money market accounts.

The returns for stable value are like intermediate bonds but the volatility is the lowest of all asset classes shown. This results in a very attractive risk/return profile highlighting that stable value has historically been successful delivering on its objectives. According to the Stable Value Investment Association (SVIA) data, over 15 years as of 3/31/2024 the risk vs. return for stable value funds is 2.47 vs. 2.45% for intermediate bonds.

You can visit their website at: https://www.stablevalue.org

Because they can be structured differently, stable value funds are regulated by various agencies. They are run by laws set up by Financial Accounting Standards Board, the Government Accounting Standards Board, and the DOL. Comingled funds are also regulated by the SEC.

Target Risk Funds

Target risk funds target a certain risk level that participants can choose. Like target date funds, they also represent easy-to-use, one-stop, well-diversified investment solutions that automatically rebalance. It is also common to find them in a fund of funds structure. They differ from target date funds in one aspect: target risk funds do not become more conservative over time, while target date funds do. Many fund families offer target risk funds. Table 10.1 illustrates a typical suite of target risk funds looks like the following:

One potential drawback with target risk funds is that they do not change their asset allocation formula. Given the inertia seen with participants who make an investment election and then never change, the concern here is that participants will choose an aggressive style target risk fund when they are younger and then never change it. They then become older and still have the same aggressive-style fund, which may no longer be appropriate. Therefore, if plan sponsors/fiduciaries select Target Risk Funds as their QDIA, they should educate participants on the risk of not changing their asset allocation.

Table 10.1
Suite of Target Risk Funds

Style	Asset Allocation
Aggressive Moderately	100% stocks / 0% bonds
Aggressive Moderate	80% stocks / 20% bonds
Moderately	60% stocks / 40% bonds
Conservative	40% stocks / 60% bonds
Conservative	20% stocks / 80% bonds

Index Funds

A newer investment menu design development offers a passive (or index) core. A passive core is a comprehensive set of low-cost index options that span the global capital markets.

According to BrightScope/ICI Defined Contribution Report, 2021, since 2006 (the earliest data in the BrightScope database), 79% of large 401(k) plans offered index funds, and 17% of plan assets were invested in such products. The use of index funds increased to 95% of large 401(k) plans and 41% of assets in 2020. Although the percentage of large 401(k) plans offering index funds increased for almost all plan asset groups, smaller plans experienced larger increases. As a result, index funds are widely offered across large 401(k) plans. More than 95% of 401(k) assets with more than $10 million in plan assets offered index funds in their plan lineups in 2020, and 86% of large 401(k) plans with less than $1 million offered them. This trend is great news for 401(k) fiduciaries because index funds can lower their investment-related liability.

Why are investors flocking to index funds? The answer is simple: index funds that track the broad stock market indices are more likely to offer superior returns, net of fees charged, compared to their actively managed counterparts. According to the latest SPIVA U.S. Scorecard, over the last

15-year investment horizon, 92% of large-cap managers, 74% of mid-cap managers, and 75% of small-cap managers failed to outperform their respective index benchmark. You can view the report at: https://www.spiva-us-mid-year-2020.pdf

401(k) fiduciaries should be able to confirm an index fund's market correlation and low fees. This is not hard. To confirm an index fund's market correlation, you just need to look up the fund's Beta and R-Squared statistics–which can be found in fund fact sheets.

- Beta is a measure of sensitivity to the correlated moves of a benchmark, a fund, or asset. A beta of 1 indicates that the fund's price will move with the market.
  - A beta of less than 1 means that the fund will be less volatile than the market. A beta of greater than 1 indicates that the fund's price will be more volatile than the market. For example, if a stock's beta is 1.2, it's theoretically 20% more volatile than the market.
- R-squared measures the percentage of a fund's movements that can be explained by movements in the benchmark index.
  - R-squared values range from 0 to 1. An R-squared of 1 means that all movements of the fund are completely explained by movements in the index. Index funds should have a high R-squared vs. their benchmark.
  - A higher R-squared will indicate a more useful beta figure. If the R-squared is lower, then the beta is less relevant to the fund's performance.
  - General Range for R-Squared:
    - 0.70-1.00 = good correlation between the portfolio's returns and the benchmark's returns
    - 0.40-0.70 = average correlation between the portfolio's returns and the benchmark's returns
    - 0.00-0.40 = low correlation between the portfolio's returns and the benchmark's returns

Index funds with highly correlated returns have a 0.95-1.05 beta and 0.95-1.00 R-squared, based on trailing 36-month returns vs. the benchmark. Generally, a higher R-squared will indicate a more useful beta figure. If the R-squared is lower, then the beta is less relevant to the fund's performance.

A simple way to confirm an index fund's low fee status is to compare its expense ratio against its peer group. It is recommended that the fund chosen ranks in the lowest quintile (20^{th} percentile).

According to Vanguards study, "*How America Saves 2024 Report*", in 2023, 67% of Vanguard plans offered at least four options within an index core, and more than 7 in 10 Vanguard participants were offered an index core. In addition, many of these plans also offered a passive target-date fund to further simplify participant portfolio construction. Sixty-five percent of plans offered both an index core and passive target date funds and 73% of participants had access to these fund lineups. Compare this with 2014 when 52% of plans offered an index core and 47% offered both an index core and passive target date funds. Sixty-four percent of participants were offered an index core in 2104, with 62% offered both an index core and passive target-date funds. An index core includes broadly diversified index funds for U.S. stocks, U.S. bonds, and international stocks. At a minimum the definition includes index funds for large-cap U.S. stocks, intermediate or long-term bonds and developed markets. mediate

Target-Date Funds

Target-date funds (TDFs), also known as life cycle or age-based funds, invest in a portfolio where the asset allocation mix becomes more conservative as the target date approaches. Funds in bonds, for example, might grow as a percentage of the portfolio over time, as the share of more volatile equities drops.

TDFs can be attractive investment options for employees who do not actively manage their retirement savings. A *"set it and forget it"* investment solution. TDFs automatically rebalance to become more conservative as an employee gets closer to retirement. The "target date" refers to a target retirement date and is often part of the fund's name.

> ***For Example:*** TDFs with names like "*Portfolio 2030*," "*Retirement Fund 2030*," or "*Target 2030*" are designed for individuals who intend to retire during or near the year 2030.

Because of these features, many plan sponsors decide to use TDFs as their plan's qualified default investment alternative (QDIA) under Department of Labor regulations (QDIAs discussed below).

TDFs offer a long-term investment strategy based on holding a mix of stocks, bonds, and other investments (this mix is called an asset allocation) that automatically changes over time as the participant ages. When the target date is several years away, the TDF initial asset allocation usually consists mostly of stocks or equity investments, which often have greater potential for higher returns, be more volatile, and carry greater investment risk. As the target retirement date approaches (and often continuing after the target date), the fund's asset allocation shifts to include a higher proportion of more conservative investments, like bonds and cash instruments, which generally are less volatile and carry less investment risk than stocks. The shift in the asset allocation over time is called the TDF "*glide path*."

It is important to know whether a TDF glide path uses a "*to retirement*" or a "*through retirement*" approach. A "*to*" approach reduces the TDF equity exposure over time to its most conservative point at the target date. A "*through*" approach reduces equity exposure through the target date, so it does not reach its most conservative point until years later.

However, there are considerable differences among TDFs offered by different providers within this general framework, even among TDFs with the same target date. Available in a variety of flavors – packaged, custom, proprietary, and multi-manager – and with several different glide paths and underlying investments, TDFs are a prevalent investment choice in today's 401(k) plans. Because these differences can significantly affect the way a TDF performs, fiduciaries must understand these differences when selecting a TDF as an investment option for their plan.

According to Morningstar's 2024 Target Date Fund Landscape, total assets in target date strategies increased to $3.5 trillion at the end of 2023 compared to $2.82 trillion in 2022, due to positive flows and strong market appreciation. Investors have deposited nearly $522 billion into target-date strategies over the past four years. Some additional information from Morningstar's report:

- Target-date strategies raked in $156 billion in net assets in 2023; collective investment trust (CITs) attracted the newest money, continued to dominate in 2023, even as their flow decreased slightly, and target date mutual funds increased slightly in 2023. CITs collected roughly $104.5 billion in net inflows in 2023, or 67% of the total, down from 79% in 2022. Target-date mutual funds took in roughly $51.8 billion up from $32 billion in 2022.
- CITs dominated net inflows but at the end of the year reached 49% of the market share. That was up from 47% in 2022 and 9 percentage points from five years earlier, but it was short of overtaking mutual funds as the most popular target-date vehicle. Still, CITs are poised to become the most popular target-date vehicle by the end 2024.
- Plan sponsors continue to display a strong preference for lower-cost target-date strategies, exhibited by both inflows to lower-cost mutual fund series and the growing popularity of CITs.
- The top five target-date managers made up about 80% of the market gathering nearly $76 billion in flows compared to mutual funds with $71 billion. The top 10 brought it up to about 94%,
- Vanguard Target Retirement led the way in asset gathering, with $44 billion in net flows for the year. It has topped the net flow charges every year but one since 2008. At the end of 2023, 51% of Vanguard's target-date assets were in its CIT version, marking the first time it surpassed the mutual fund version in assets.
- Fees continued their downward trend. Targe-date investors are paying less. Over the past decade, the average target-date funds' prospectus net expense ratio weighted by year-enbd assets has fallen. The asset weighted fee dropped 4.6% to 30 from 32 basis points in 2023.

You can view the report at: Target_Date_Landscape.2024.pdf (contentstack.io)

According to Vanguard's study, "*How America Saves 2024 Report*," 64% of plan contribution dollars were invested in target date funds. Plan sponsor interest in target date funds remained strong with 96% of plans offering them at year end 2023.

Note: Several TDFs are now using an annuity as a funding option. The funds are created for a cohort of investors of the same age and shift their mix of holdings based on how close the group's retirement date is. Annuities could be a logical product to add, especially with concerns rising about guaranteed income in the wake of equity market volatility. According to a recent report released by Cerulli Associates, sixty-three percent of target-date investment managers expect demand for guaranteed investments to grow.

Managed Accounts

The percentage of plans offering managed accounts as a broad investment option has generally increased over the past few years. This usage can largely be attributed to the evolution of personalization (the mantra of "one size does not fit all") in the retirement industry. Managed accounts are viewed as the most "personalized" option.

Managed accounts are a full fiduciary service provided by third-party investment advisers. Some act as discretionary investment managers under ERISA 3 (38), meaning that they have exclusive authority over investment decisions and accept full fiduciary responsibility for their discretionary investment decisions. These managers provide a custom asset allocation for the participant and rebalance the portfolio periodically. This type of vehicle is most popular with participants with high account balances and outside resources. Monitoring managed accounts from a fiduciary perspective is based on reviewing the service provider, the model's methodology, and the asset allocator's integrity.

According to Vanguards' study, "*How America Saves 2024 Report*" in 2023, 66% of Vanguard's participants were invested in a professionally managed allocation.

Separate Accounts

If a plan is large enough, instead of purchasing mutual funds or other institutional funds such as insurance separate accounts or standard bank CIFs, the plan may instead offer Managed Separate Accounts. The solution might be structured as follows:

- Large money managers are chosen to manage style-specific pools of money. For example, a manager may be chosen to manage the large-cap value investment option. Managers may also be chosen to mimic an existing mutual fund at an overall lower cost to the plan.
- For a fee, the recordkeeper or a separate vendor unitizes the portfolio so that it can be traded like a mutual fund within the plan.
- Alternatively, the manager may offer a CIF, or the plan itself may build a CIF in which participants in multiple plans may invest.
- The manager accepts investment manager status as defined by ERISA §3(38); and
- A consultant assists with vendor searches, investment policy, and drafting the managers' investment guidelines.

Contrast this with the use of mutual funds or other investment types. With a mutual fund, the ability to trade electronically already exists, whereas the separate account or CIF is actually a pool of stocks and bonds that must be unitized before it can be traded efficiently. However, once it has been unitized, there is no effective difference between the managed separate account and the mutual fund from the participant's investment standpoint, though reporting portfolio information and transparency may vary.

Separate accounts allow large participant-driven plans to offer professionally managed investments to their participants with varying investment strategies. These separate accounts are managed by a professional investment manager, who often takes on a 3(38) fiduciary role. The investment manager will follow an investment strategy that is either passive, active or a mix of both. It is important to remember that it is the fiduciary's duty to determine if the investment strategy of the separate account manager is prudent. As with mutual funds, understanding the fees and revenue sharing in the separate account is also a fiduciary responsibility.

Active vs. Passive Investments

Once the asset allocation policy is set, the focus can turn to implementation. So begins one of the fiercest debates in the investment industry: Should the menu be built around actively managed funds or low-cost index-tracking (i.e., passive) funds or both?

- *Passive Management*. Funds that use a passive strategy do not attempt to "beat the market." Instead, they select a market benchmark, such as the S&P 500 for large U.S. stocks and the Russell 2000 for small U.S. stocks and try to track the index closely without incurring high expenses. Index funds are typically chosen based on having the lowest fees and tracking error relative to the index; and
- *Active Management*. Funds that use an active strategy will select an asset class benchmark and attempt to outperform that benchmark by making better investment decisions. These funds have a larger range of potential outcomes–the possibility of significantly outperforming or underperforming the benchmark–and will have higher fund management fees (i.e., expense ratios).

The debate on the superiority of active or passive management will never be fully settled. There will always be market participants who have a strong view either way. Importantly, there are many investment situations where it is beneficial to use active, passive or a combination of the two. In the end, it is the fiduciary's duty to evaluate all the investment choices in light of the goals of the plan and the participant demographics and work with an expert adviser to assist in this process. There is no one right answer.

Collective Investment Funds

The Collective investment trust (CIT) is no longer the retirement industry's best-kept secret. According to the Callan Institute's "*2024 Defined Contribution Survey,*" it reported that CITs were the #1 most prevalent investment vehicle with usage at 82%, surpassing mutual funds at 80%.

CITs are pooled, tax-exempt investment vehicles sponsored and administered by a bank or trust company that acts as the trustee and regulated by the Office of the Comptroller of the Currency rather than the Securities Exchange Commission.

The underlying assets of a CIT are plan assets, making the bank trustee or investment manager a fiduciary. This is different than the fiduciary definition of the underlying assets of a mutual fund, which technically are not plan assets (the shares of the fund are the plan assets). One of the major advantages of a CIT is that they have lower operational expenses than mutual funds. They're restricted from advertising to the public (only sold inside retirement plans). They don't have to file prospectuses, shareholder reports, and proxy statements.

CITs are a versatile, cost-effective, and competitive alternative to mutual funds for 401(k) plans. As these plans have evolved to become the core retirement option for most workers, plan sponsors have become increasingly concerned about their fiduciary responsibility to provide appropriate and reasonably priced investment options.

CITs are not newcomers to the retirement landscape. Although first launched in 1927, they were not broadly used until the 1950s, when Congress first allowed banks to combine assets from stock bonus plans, pensions, and corporate profit-sharing plans. CITs are not necessarily new vehicles to plan sponsors either, as DB and large DC plans have long used them.

When the National Securities Clearing Corporation (NSCC) added CITs to its mutual fund trading platform in 2000, they became quickly and widely transacted. They received another boost in 2006 when the Pension Protection Act was signed into law, requiring DC plan sponsors to invest unallocated 401(k) assets into qualified default investment alternatives (QDIAs), most commonly target-date funds (TDFs).

TDFs are one obvious example where CITs have experienced an increase in the amount of assets under management. According to Cerulli Associates, The Cerulli Report, "*U.S. Retirement Markets 2023: Analyzing the Impact of Retirement Landscape"*, it reports total CIT assets have doubled over the past decade due to its increased adoption among 401(k) plans. In 2022, total CIT assts were $4.6 trillion, and comprised 37%, or about $2.5 trillion, of total 401(k) plan assets. CIT growth has come primarily at the expense of mutual funds, which saw their share of the 401(k) assets decline to 42% of total 401(k) assets. According to Morningstar's "*2024 Target-Date Strategy Landscape*," CITs made up 49% of target-date strategy assets as of year-end 2023 and are poised to become the most popular target-date vehicle by the end of 2024. In 2023, CITs collected roughly $104.5 billion in net new flows, or 57% of the total—down from 79% in 2022

Note: As discussed above, currently, the federal government prohibits all 403(b) and 457 plans from accessing CITs. This should change. There is general support for new legislation that would allow 403(b) plans to invest in CITs. In 2020, bipartisan legislation was introduced in the House of Representatives that seeks to address this specific issue. The *Public Service Retirement Fairness Act* aims to "ensure public sector and nonprofit retirement savings programs have the same access to low-cost investments as for-profit plans do." At the time of writing this paper, there is hope that this bill will be reintroduced.

ESG Funds

As investors show increased interest in environmental, social and governance (ESG) investing, the government has taken notice. In June 2020, the Department of Labor (DOL) issued a proposed rule focused on the use of ESG options within retirement plans (such as 401(k)s), citing concerns that investment options were being evaluated using non-financial factors. The DOL softened its stance in its Final Rule, "*Financial Factors in Selecting Plan Investments*," released on October 30, 2020, by shifting its regulatory focus away from specifically ESG criteria to the use of broadly defined "pecuniary factors," or financial considerations, and permitting additional flexibility to consider ESG factors in a financial analysis of investment options.

The Final Rule sets forth that investment fiduciaries may not prioritize other objectives over the interest that participants and beneficiaries have in returns generated from their retirement investments (i.e. their future retirement income), such as sacrificing return or taking an additional risk to promote non-pecuniary goals. In other words, the duty of loyalty requires fiduciaries to act in the best financial interests of participants.

In addition, fiduciaries must also consider reasonably available alternatives, but not every possible alternative in the market.

You can view the DOLs, Financial Factors in Selecting Plan Investments at: https://www.federalregister.gov/documents/2020/11/13/2020-24515/financial-factors-in-selecting-plan-investments

Note: On July 22, 2024, the 5th Circuit Court sent the DOL ESG case back to the Texas district court. The Texas district court will rehear a challenge to the DOLs social and governance rule for investment in defined contribution retirement plans after the U.S. Fifth Circuit Court of Appeals remanded the case due to a recent Supreme Court Decision that overturned the longstanding Chevron standard, a rule that the district court had relied upon in the original decision. Stay Tuned!

Real Estate Investment Trusts (REITs)

A real estate investment trust (REIT for short) is a company that invests in different kinds of income-producing real estate — like shopping centers, condominiums, housing developments, hospitals, parking garages and more. You can buy shares of the REIT in order to get exposure to its real estate investments and have that real estate be part of your 401(k) plan without actually managing the property. In fact, according to research from NAREIT, a resource platform for real estate companies, 145 million Americans are invested in REIT stocks, as of Oct. 2020**.**

Plan sponsors of 401(k) plans can only choose publicly traded RITs as part of their investment menu. Many employers only allow you to invest in a target date fund through their 401(k). But a participant can always contact their company's benefits team to get some clarification on whether or not they have the option to invest in REITs through their 401(k) plan.

Employer Securities

Employer securities have a long tradition in retirement plans. It was often the only retirement savings option employers offered before the growth of defined contribution (DC) plans as we know them. Today, on the one hand, employer securities remain a valued investment option for many plan sponsors and participants. Company shares can help align participants with their employer's goals while providing employees with a sense of ownership.

But on the other hand, holding employer securities in a 401(k) plan can pose a significant retirement risk. One of the most common examples cited when discussing the dangers of holding employer stock in a 401(k) plan is Enron, which collapsed in 2001. At Enron, 62% of 401(k) plan assets were invested in shares of Enron stock (on the basis of 11-K filing at the end of 2000), which fell in value by 98.8%. Not only did Enron employees lose their jobs, but many also lost a significant portion of their retirement savings, if not their entire balance.

While employer securities are still common in 401(k) plans, they are becoming less so. According to Vanguard's report, "*How America Saves, 2024*," company stock is more likely to be offered as an investment option by large plans–26% of Vanguard plans with 5,000 or more participants offered company stock in 2023, compared with only 2% of plans with fewer than 500 participants.

As of 2023, 8% of Vanguard recordkeeping plans offered company stock as an investment option. However, because large plans are more likely to offer company stock, 22% of Vanguard recordkeeping participants had access to company stock in their employer's plan. Among all Vanguard participants in 2023:

- 93% had no company stock investments—either because their employer did not offer company stock (79%) or because they chose not to invest in it (14%).
- 4% had company stock holdings of 1% to 20% of their account balance.
- 3% had concentrated company stock positions exceeding 20% of their account balance.

Among Vanguard plans actively offering company stock, 93% had 20% or less of plan assets invested in the option. The remaining 7% had concentration levels above 20%.

Qualified Default Investment Alternatives (QDIAs)

When Congress passed the Pension Protection Act (PPA) of 2006, they addressed a major problem faced by many employers sponsoring 401(k) plans: How to handle a case in which a participant is given investment options but does not make a written investment election on how to invest his money.

PPA added ERISA § 404(c)(5) to provide relief to plan fiduciaries who invest participant assets in default investments in cases where the participant has not made an affirmative investment election. Under this rule, if a participant fails to exercise control over their investments, they will be deemed to have exercised control if the employer defaults them into a qualified default investment alternative or QDIA. This means fiduciaries will not be liable for any loss that is the direct and necessary result of investing in the QDIA, provided that the participants are given appropriate notice and opportunity to provide affirmative investment direction. If the only plans with participant investment direction were 401(k) plans in which the participant completed a payroll withholding election. The election was not considered valid until he also completed an investment election; this problem might not exist. However, there are a number of plans in which the participant has money in the plan even without making a payroll withholding election. For example:

- The participant may share in a non-matching company contribution (e.g., a "profit-sharing" contribution); or
- The plan has an "*automatic enrollment*" provision, whereby the employee is automatically treated as deferring part of his pay into the plan, even without making any written election.

Congress assigned to the DOL the job of defining a Qualified Default Investment Alternative, which can be used in these cases. On October 24, 2007, the DOL issued final regulations with an effective date of December 24, 2007. The regulations were then updated in 2008 with technical amendments that clarified certain provisions (discussed below).

QDIA Qualification

Six conditions must be satisfied by plan fiduciaries to qualify for relief:

- The investments must be put into a QDIA (defined below).
- The participants must have been allowed to direct their investments but did not give directions.
- Both an initial and an annual notice must be given to participants (discussed below);
- A fiduciary must provide the participant with investment materials related to the investment in the QDIA.
- The participant must have the option to transfer some or all of their money out of the QDIA, without penalty, to any available investment alternative. This option must be provided at least quarterly; and
- The plan must offer a broad range of investment alternatives.

Fund Information

Some requirements must be met for the plan QDIA to be used:

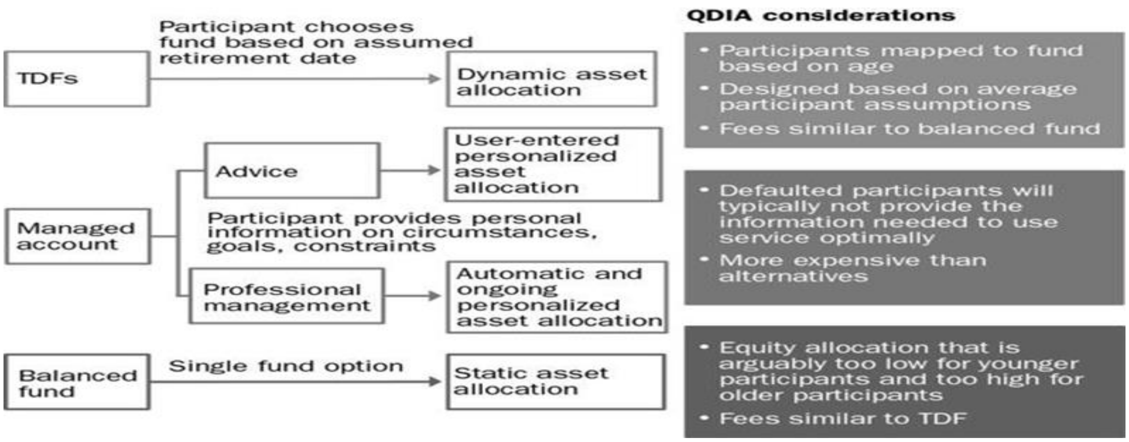
- The QDIA must not hold or permit the acquisition of employer securities. (There are a couple of minor exceptions).
- There must be no penalty imposed on the participant who chooses to later move out of the QDIA.
- The QDIA must be managed by a "*permitted*" manager. A "*permitted*" manager is a registered investment company, an investment manager as defined in ERISA § 3(38), a trustee of the plan that meets the requirements of ERISA § 3(38), or the plan sponsor who is a named fiduciary within ERISA § 402(a)(2).
- The plan must offer a broad range of investment alternatives; and
- The QDIA must be either a:
    - Balanced fund;
    - Capital preservation fund (however, this fund is only allowed if the plan uses automatic enrollment, and assets may not remain in the fund for any specific participant for more than 120 days);
    - Age, target retirement date, life expectancy fund or model portfolio; or
    - Professionally managed account where a mix of fixed income and equity investments are utilized.

Plan sponsors recognize the vital nature of selecting the correct QDIA. They are tasked with regulatory scrutiny and reminders to evolve how they approach the design, selection, and monitoring of the default option. Figure 10.2 displays the three QDIA options.

QDIA Investment Options

Target date funds continue to dominate the Qualified Defined Investment Alternatives (QDIA) landscape. According to Callan Institutes 2024 Defined Contribution Survey, in 2023 94% of plans offered a target date suite and 90% of plans used a target date fund as their default for non-participant-directed monies. It's important to remember because they are relatively easy to implement (especially off-the-shelf TDFs such as mutual funds and collective investment trusts), TDFs are a one-fits-all approach to investing (i.e., lack customization), are difficult to (properly) benchmark, and are often constructed using proprietary funds.

Figure 10.2
The Three QDIA Options



According to PLANSPONSOR 2024 DC Benchmarking report, TDFF's make up 57% of deferrals from automatic enrollment across plan sponsors though it is notable that among plan sponsors with $50 million to $200 million in asset, that figure jumps to 81.6%. Meanwhile, professionally managed accounts came in at 16.2% overall, most popular among plans with less than $25 million of assets. The breakdown was rounded out by balanced funds (5.7%), money market funds (2%), stable value funds (7%) and risk-based lifestyle funds (.7%). Meanwhile, 11.2% of plan sponsors who took the survey were unsure, and 8.8% just chose "other" for options not listed.

Moreover, nearly half of plans had streamlined their investment options over the prior five years, giving participants a less bewildering set of choices and concurrently emphasizing the importance of the remaining investment options and QDIA.

QDIA Notices

The *Initial QDIA Notice* must be provided:

- At least 30 days in advance of the date of plan eligibility (for automatically enrolled participants); or
- At least 30 days in advance of the date of any first investment in a QDIA (for rollovers or actively enrolled participants); or

- On or before the date of plan eligibility, provided the participant has the opportunity to make a permissible withdrawal.

The annual notice must be provided at least 30 days in advance of each subsequent plan year if any portion of a participant's account is invested in a QDIA. The notice may not be provided in a Summary of Plan Description (SPD) or a Summary of Material Modifications. The notice may be provided with other materials and combined with a Qualified Automatic Contribution Arrangement Notice.

The QDIA notice must explain the following information:

- A description of the circumstances under which assets may be invested in a QDIA.
- A description of the circumstances under which elective deferrals will be made on behalf of the participant, the deferral percentage, and the right to change or opt-out of the election (if the plan has an automatic enrollment feature).
- An explanation of the right to direct the investment of assets in their account.
- A description of the investment objectives, risk and return characteristics, and fees and expenses of the QDIA.
- A description of the right of participants to direct the investment of those assets to any other alternative of the plan (and the fees, restrictions, or expenses related to such transfer); and
- An explanation of where the participant can obtain investment information concerning other alternatives available under the plan.

In addition, to the QDIA notice, a plan sponsor/fiduciary must make available material relating to a participant's investment in a QDIA. This information includes details on the QDIA assets, prospectuses, financial statements, and fee disclosures similar to those for other plan investments.

Note: The "*Fee Disclosure Rules*" require that participants who are allowed to direct their investments must receive detailed investment performance and fee/expense information about all mutual funds offered by the plan, not just the QDIA. But the "*Fee Disclosure Notice"* is a separate notice requirement from the QDIA Notice.

Next, we will review some of the more favorable investment choices within a 401(k) plan, beginning with the most prominent target date funds, also referred to as lifecycle funds.

Notice Requirements for Target Date QDIAs

In late 2010, the DOL issued rules that would expand the required content of QDIA notices. The QDIA notices include:

- The name of the investment issuer;
- A description of the investment's objectives, principal strategies, and risks;
- A description of the investment's historical performance data; and
- A description of the investment's attendant fees and expenses.

In addition, if the QDIA is a target date fund, the notice must also include an explanation of the asset allocation.

Treas. Reg. Notice 2014-66

To help retirees manage their savings and ensure they have a stream of regular income throughout retirement, the U.S. Department of the Treasury and the Internal Revenue Service (IRS) issued guidance designed to expand the use of income annuities in 401(k) plans. The guidance (Notice 2014-66) clarifies that plan sponsors can include deferred income annuities in target date funds used as a default investment in a manner that complies with plan qualification rules. This option is voluntary for plan sponsors and participants.

This guidance provides plan sponsors an additional option to make it easier for employees to consider using lifetime income. Instead of having to devote all of their account balance to annuities, employees use a portion of their savings to purchase guaranteed income for life while retaining other savings in other investments.

Under the guidance, a target date fund may include annuities allowing payments, beginning either immediately after retirement or at a later time, as part of its fixed-income investments, even if the funds containing the annuities are limited to employees over a specified age. The guidance makes clear that plans have the option to offer target date funds that include such annuity contracts either as a default or as a regular investment alternative.

In an accompanying letter, the Department of Labor also confirmed that target date funds serving as a QDIA may include annuities among their fixed-income investments. The letter also describes how ERISA fiduciary standards can be satisfied when a plan sponsor appoints an investment manager that selects the annuity contracts and annuity provider to pay the lifetime income.

You can view the notice at: https://www.irs.gov/pub/irs-drop/n-14-66.pdf

DOL Proposes ESG-Related Updates to the ERISA Investment Duties

On October 13, 2021, the U.S. Department of Labor ("DOL") announced a proposed rulemaking to amend the Investment Duties regulation under Title I of the Employee Retirement Income Security Act of 1974 ("ERISA") that would clarify the application of ERISA's plan fiduciary duties of prudence and loyalty to selecting investments and investment courses of action, including selecting qualified default investment alternatives ("QDIAs"), and to exercising shareholder rights, including proxy voting. While the proposal retains the core principle that the duties of prudence and loyalty require ERISA fiduciaries to focus on material risk-return factors, the proposal is intended to remove barriers implemented by the prior administration that the DOL believes limited fiduciaries' ability to consider climate change and other ESG matters as factors when selecting investments and exercising shareholder rights. Title I governs private pension plans.

The new proposed amendments to the regulation would specify that "appropriate consideration" may often require an evaluation of the economic effects of climate change and other ESG factors on the particular investment or investment course of action when considering the projected return of the portfolio relative to the funding objectives of the plan. The proposal also would remove the requirement to consider only pecuniary factors and instead add a new provision that would clarify and confirm that a fiduciary may consider any factor material to the risk-return analysis, including climate change and other ESG factors. The proposed amendments include three non-exclusive examples that a fiduciary may consider in the evaluation of an investment or investment course of action if material:

- Climate change-related factors, such as a corporation's exposure to the real and potential economic effects of climate change, including its exposure to the physical and transitional risks of climate change and the positive or negative effect of government regulations and policies to mitigate climate change.
- Governance factors, such as those involving board composition, executive compensation, and transparency and accountability in corporate decision-making, as well as a corporation's avoidance of criminal liability and compliance with labor, employment, environmental, tax, and other applicable laws and regulations; and
- Workforce practices, including the corporation's progress on workforce diversity, inclusion, and other drivers of employee hiring, promotion, and retention; its investment in training to develop its workforce's skills; equal employment opportunity; and labor

The proposal would also clarify that, under the ERISA fiduciary duty of loyalty, ESG considerations, including climate-related financial risk, are, in appropriate cases, risk-return factors that fiduciaries should take into account when selecting and monitoring plan investments and investment courses of action. Comments on the proposed rule were due by December 13, 2021. Stay Tuned!

ERISA § 404(c)

By default, ERISA fiduciaries are responsible for how plan assets are managed, but the statute includes a safe harbor, ERISA Section 404(c), which protects plan sponsors from fiduciary liability if employees allocate their own portfolios experience losses because of their choices. More specifically, the statutory provision applies to plans that:

> "*…permit a participant or beneficiary to exercise control over the assets in his account and holds that no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control."*

The provision intends to relieve participant-directed plans from liability for participant decisions. For example, a plan sponsor would be insulated from fiduciary liability under 404(c) if an employee, despite being presented with a well-diversified menu, experienced severe financial losses because she decided to hold all of her portfolio in company stock.

To qualify for ERISA § 404(c) relief, there are a number of requirements that must be met, including:

- *Offer a broad range of diversified investments.* To satisfy the broad-range investment alternatives, the following conditions must be met:
  - Participants are given a reasonable opportunity to materially affect the level of return and degree of risk to which their accounts are subject.
  - Participants are given the opportunity to choose from at least three (3) investment alternatives that satisfy the following:
    - Each alternative is diversified. (A fund that invests only in assets within the same industry may not be considered adequately diversified).
    - Each alternative is materially different in terms of risk and return characteristics.
    - In the aggregate, the alternatives enable participants to achieve a portfolio with aggregated risk and return characteristic at any point within a range normally appropriate for the participants; and
    - When combined with other alternatives, each of the three funds tends to minimize through diversification the overall risks of loss.
  - Participants must have the opportunity to diversify to minimize the risk of large losses, taking into account the nature of the plan and the size of participant accounts.

  Note: A self-directed plan–that is, one that permits participants to invest in any asset of their choice–should automatically satisfy the broad-range requirement.
- *Allow participants to transfer among investment options.* Participants must be able to transfer between investments at least quarterly or within a timeframe deemed appropriate based on the market volatility of the offered investments. The more volatile an investment option is, the greater the need for more frequent transfers to enable participants to maintain appropriate control over their accounts. With today's investment products, like mutual funds, these requirements are usually easily satisfied, with trading permitted on any day in which the major securities markets are open; and
- *Provide participants with adequate information about their investment options:*
  - Section 404(c) requires that each participant receive the following information:
    - An explanation that the plan intends to comply with the Section 404(c) requirements and that; as a result, the plan fiduciary may be relieved of liability for losses resulting from investment directions of the participants.
    - A description of the plan's investment options, including a general description of the investment objectives and the risk and return characteristics of each investment option.
    - Identification of any investment managers for the plan.
    - An explanation of how participants can give investment instructions, including an explanation of any limits or restrictions on making purchases or sales in their account.
    - A description of any transactions or other expenses charged to participants' accounts.
    - A description of any transaction or other expenses charged to participants' accounts.

  - A description of additional information that must be provided to participants upon request and the contact information of the individual responsible for providing that information; and
  - For registered investments (like mutual funds), a copy of the most recent prospectus is provided to the plan. The prospectus must be given to a participant immediately preceding or following the participant's initial investment in an option.

In addition to the information that must be provided to participants, this information must be made available to participants if they ask for it:

- For each designated investment option, a description of the annual operating expenses which reduce the rate of return to participants and beneficiaries expressed as a percentage of the investment's average net assets.
- Copies of any prospectuses, financial statement, and reports, as well as other materials relating to available investment options, to the extent such information is provided to the plan.
- For designated investment options that constitute plan assets, a list of the assets comprising the portfolio of each investment and the value of each asset or its proportion. For fixed-rate investment contracts that banks, savings and loan associations, or insurance companies' issue, the contract's issuer, term, and rate of return must also be furnished.
- Information about the value of shares or units of each investment option, as well as the past and current investment performance of each option; and
- Information concerning the value of shares or units in the investment options held in the participant or beneficiary's account.

Note: There are additional requirements for plans offering employer stock of fixed-rate investment contracts and plans that pass-through voting rights (discussed below).

ERISA 404(c) and Employer Securities

ERISA §404(c) protection is available in the following circumstances:

- The stock must be publicly traded on a recognized market, and trading volume must be sufficient for transactions to be executed promptly;
- Shareholder information must be provided; additionally, voting and similar rights must be passed through to participants;
- Information relating to the purchase, holding or sale of employer securities, as well as the exercise of voting rights must be maintained in accordance with procedures designed to safeguard the confidentiality of such information, except to the extent necessary to comply with relevant federal and state laws; and
- The plan must designate a fiduciary to be responsible for ensuring the confidentiality procedures mentioned above are being followed.

Also, an independent fiduciary must be appointed to carry out activities involving a potential for undue employer influence upon participants concerning exercising their shareholder rights.

If the employer stock fund fails to meet the above requirements, the plan may still obtain ERISA §404(c) compliance for the other investments available under the plan. However, plan fiduciaries would not be relieved of the liability for participants' directions relative to investments in the employer stock fund. The bottom line is that 404(c) compliance requirements increase when employer stock is included in a plan.

IRC § 401(a)(35) Diversification Requirement

On May 18, 2010, the IRS and the Treasury Department released final regulations on IRC § 401(a)(35) investment diversification requirements for certain defined contribution plans with publicly traded employer securities. Defined contribution plans holding publicly traded employer securities are considered "*applicable defined contribution plans*" and subject to the diversification requirements of IRC § 401(a)(35), which apply to employee contributions and employer contributions allocated to participants (or their beneficiaries) with at least three years of service.

The diversification requirements for participant-directed plans with employer stock are as follows:

- The rule only applies to publicly traded stock;
- Participants must be permitted to diversify deferrals and employee contributions (i.e., after-tax contributions made at the election of the employee) at any time;
- The funds available for diversification must meet requirements similar to ERISA §404(c)'s broad range requirement–at least three funds with materially different risk and return characteristics;
- Participants must be permitted to diversify employer contributions in employer stock after three years of service.

It is important to note that there are two potential reasons to purchase employer stocks or to continue holding them:

- Discounts; and
- Tax benefits.

Net Unrealized Appreciation

In some instances, it's possible to purchase employer securities at a discount. This could be advantageous depending on the holding period requirements and the discount level. The second reason is potential tax benefits, known as net unrealized appreciation (NUA).

With an NUA strategy, individuals can request a distribution of employer stock from their qualified plan be moved into a taxable account. At this time, ordinary income tax is due on the basis of the shares. The difference between the cost basis and the market value of the securities is what's known as net unrealized appreciation (NUA). It is taxed at long-term capital gains rates when the stock is sold, regardless of the holding period. This results in more favorable tax treatment since some potential gains in the employer securities are taxed at long-term capital gains rates versus ordinary income rates. NUA is a complex strategy that should only be made after consultation with an experienced financial advisor, accountant, or tax attorney.

Here are some general guidelines that plan sponsors and participants should be aware of with respect to employer securities in a 401(k) plan:

- Having employer stock in a 401(k) plan increases the fiduciary risk to the plan sponsor; therefore, the perceived benefit of including from employee morale or corporate culture perspective must outweigh these risks;
- Limiting the total allocation to employer stock in an employee’s account makes sense. For example, mandating that no individual can hold more than 25% of employer securities as a core investment option reduces the risk of holding securities in the 401(k) to both the employer and the employee. Using an even more conservative maximum target (e.g., 10%) should also be considered;
- For those plans with employees that have high allocations to employer stock, especially those employees near retirement, it would likely make sense to implement a “phased approach” to reduce each employee’s allocation to employer stock;
- Employees holding employer stock should likely take less risk in other areas of their portfolio. A participant with a 100% allocation to employer stock does not have the same risk characteristics as someone with a 100% allocation to a diversified equity portfolio; and
- Employees with employer securities should regularly be notified about the risks of such a strategy, potentially beyond the IRS mandated disclosures.

QLACs Qualified Longevity Annuity Contracts

In July 2014, the U.S. Treasury Department removed a significant impediment to the ability of IRA participants (and qualified plan participants) to balance their use of annuities and other investments in their retirement savings arrangements, issuing final regulations that generally allow those individuals to bypass required minimum distribution (RMD) rules. The regulations create a qualified longevity annuity contract, or *“QLAC,”* a deferred annuity under which the amount of annuity payments is locked in at purchase, and those payments begin at any age up to age 85. These annuities are referred to as deferred income annuities or “*DIAs*.”

QLAC Concept

A QLAC was designed to serve two primary purposes at different ends of the retirement spectrum. First, it provides a way for persons concerned with not having enough income in later years of their retirements to ensure an additonal income stream. Second, it allows retirees in the early years of their retirement to reduce their Required Minimum Distributions (RMDs).

The basic concept of a longevity annuity is that, like an immediate annuity, a lump sum payment is made in exchange for guaranteed payments (typically for life) in the future. The difference is that while the lifetime payments from a single premium immediate annuity (SPIA) start immediately–as the name implies–with a QLAC, the onset of those payments is deferred until some point in the future (thus the term "Deferred Income Annuity").

> ***For Example:*** A 65-year-old couple today could put $100,000 into an SPIA and get (level) payments of almost $6,564/year for life, but if the couple were willing to wait until age 80 to get the first payment, the subsequent payments would be nearly $32,000/year for life instead! The good news of this approach is that the payments in the later years are *dramatically* larger with a QLAC than an immediate annuity. The bad news, of course, is that you have to wait 20 years to get the first check!

Even when adjusting for the waiting period and the time value of money, the reality is that in the long run (for those who actually *do* live a long time), a longevity annuity's payments provide a better internal rate of return (IRR) than an SPIA. In other words, while the longevity annuity buyer is at risk for a greater loss in the early years (since it may take 20 years just to get the first payment), those greater payments pay off in the long run with a superior implied return (for those who live long enough to see them).

QLAC Rules

The Treasury issued Proposed Regulations 1.401(a)(9)-6 in 2012, and the Regulations were finalized in July 2014. The basic approach of the Regulations is to define a "*Qualified" Longevity Annuity Contract (QLAC)* and then declare that any longevity annuity that meets the QLAC requirements will not conflict with the RMD rules.

To be eligible as a QLAC must be purchased from an insurance company with a portion of the assets of the qualified retirement plan or IRA not to exceed the lesser of 25% of the account balance or $125,000 (inedexed with inflation). This figure was scheduled to be increased to $200,000 in 2023. The participant (account holder) can defer the cost of the annuity from RMD calculatons for a period of years. For the 25% test, all IRA accounts maintained by an individual are aggregated. Unlike Roth IRAs, Roth accounts (Designated Roth IRAs) within retirement plans are eligible for QLACs because they are also subject to required minimum distribution (RMD) requirements. Under a plan, the 25% limit applies to the plan's most recent valuation. Under an IRA, it applies to the prior 12/31 aggregated IRA balance.

To be a QLAC, besides the premium limitation, the annuity must meet the following requirements:

- The contract provides that distributions under the contrct must commence not later than a specified annuity starting date that is no later than the first day of the month next following the 85th anniverary of the employee's birth;
- The contract does not make available any commutation benefit, cash surrender right, or other similar feature;
- It provides no benefits under the contract after the death of the employee (IRA participant);
- When issued, the contract states that the contract is intenended to be a QLAC;

- The contract is not a variable or an indexed contract, or a similar contract although a cost-of-living adjustment is permitted; and
- The issuing insurance company must file annual reports on the QLC to the IRSD and copy participants.

Death benefits are permitted both before and after income payments commence. Such benefits are not considered to violate the limitations on cashability, provided that the death benefits fit within specific QLAC requirements.

Death benefits prior to when income payments begin generally are limited to a return of the original premium (ROP), with no interest credited. Comments on the Treasury Department's earlier proposed regulations had noted the importance of this return of the original premium (ROP) feature to encouraging individuals to consider the QLAC options. A QLAC also may include a return of premium death benefit that applies after income payments commence upon the death of the annuitant (and, if applicable, spousal joint annuitant).

QLACs also include payments to joint annuitants, whether or not the joint annuitant is the individual's spouse. Such payments, however, also should be life contingent. Thus the annuity cannot include the minimum guaranteed annuity period component ("period certain annuity" or "installment refund"). Additionally, if the joint annuitant is not the individual's spouse, and if the QLAC includes a return of original premium death benefit prior to the commencement of income payments, then the regulations apply new limits to the non-spousal survivor annuity benefit. Additionally, a QLAC payable to a non-spouse beneficiary upon the death of the owner can include either a joint-life income, or a return of original premium death benefit for income payments, but not both.

Additional Considerations

Plan sponsors are generally responsible for selecting or authorization of any investments under the plan, including QLACs and NQLACs. In the case of a plan subject to fiduciary rules under Title I of ERISA, that selection or authorization is a fiduciary decision. Even for non-ERISA plans, plan sponsors or fiduciaries generally must authorize the offering of either QLACs or NQLACs to plan participants.

If a plan does not permit the offering of these contracts, then the plan account balance is disregarded in determining a participant's eligibility for QLAC or NQLAC purchases under other plans or traditional IRAs.

A QLAC or an NQLAC can either stand alone as an Individual Retirement Annuity or be held under an IRA account. Similarly, in the case of employer plans, the contract can be held under the plan as a stand-alone annuity under IRC §§§ 403(a), 403(b), or 457(b), as applicable, or it can be held under a trust or custodial agreement under an IRC § 401(a) IRC § 401(k) or IRC § 457(b) plan. A QLAC cannot generally be held under an IRC § 403(b)(7) custodial agreement.

If the QLAC or NQLAC is obtained from the plan service provider, and the employer later replaces that service provider with another service provider, the QLAC or NQLAC contract will remain with the issuing provider. However, the plan may have the option of:

- Retaining the contract as a stand-alone qualifying plan investment;
- Distributing the contract out of the plan to the participant (if the participant satisfies applicable distribution requirements); or
- If it is issued under a group annuity contract, and if the new plan is a 401(a) or 457(b) plan that would accept it, transferring the ownership of the group contract to the new plan.

If the plan is an ERISA plan, unless the contract is distributed to the participant, the plan will need to continue to maintain plan records of the contract(s) and, where applicable, incorporate relevant information into the documents and reports.

SECURE 2.0 Act of 2022 Section 202

Section 202 eliminated the rule that previously limited the value of a QLAC to 25% of the account's value. Further, the law modified the previous rule that limited the value of the QLAC to $125,000 by raising the cap to $200,000 beginning January 1, 2023 (the $200,000 limit will be indexed for inflation in future years).

For 2025, the QLAC amount will increase to $210,000 from $200,000 in 2024.

The law also provides for a "free-look period" of up to 90 days, during which the taxpayer can rescind the purchase of the QLAC without penalty.

The new law clarified that if the QLAC was purchased with joint and survivor annuity benefits for the individual and a spouse, and assuming that the contract was permissible under regulations in place at the time of purchase, a divorce occurring after the original purchase and before annuity payments begin will not affect the permissibility of the joint and survivor annuity benefits. Further, the divorce will not affect any other benefits under the contract (or require any adjustment to the amount or duration of the benefits).

That is the case provided that a qualified domestic relations order (QDRO):

- Provides that the former spouse is entitled to the survivor benefits under the contract,
- Provides that the former spouse is treated as a surviving spouse for purposes of the contract,
- Does not modify the treatment of the former spouse as the beneficiary under the contract who is entitled to the survivor benefits, or
- Does not modify the treatment of the former spouse as the measuring life for the survivor benefits under the contract.

The latest update on the QLAC rules could significantly increase the appeal of these types of longevity insurance contracts going forward — and, depending on the client's circumstances, reduce RMD obligations in future years.

RMD Rules on Variable Annuity Contracts

As discussed in Chapter 6, an IRS regulation enacted on January 1, 2006, has impacted calculations of required minimum distributions (RMDs) from variable annuity contracts.

The IRS has adopted revisions to Treas. Reg. §1.401(a)(9)-6 related to RMDs under deferred annuity contracts, effective June 15, 2004. This effective date was extended to December 31, 2005, to ensure adjustments are needed to comply with the regulations.

The revised IRS regulation's primary change that impacts VA carriers involves the definition of "*entire interest under an annuity contract*." Historically, the entire interest equaled the account value determined on Dec. 31 of the relevant valuation calendar year. The revised regulation now defines the contract's entire interest as the account value plus the actuarial value of any additional benefits (in excess of the account value) provided under the contract. For VAs, this is interpreted to mean that the actuarial value of any guaranteed minimum death benefits (GMDB) or any guaranteed living benefits (GLBs) must be considered when calculating RMDs.

This new regulation will result in increased RMD amounts that policyholders must be prepared to take on their VA contracts with enhanced benefits.

The SECURE Act of 2019: Guaranteed Retirement Income

The Act has three provisions relevant to guaranteed retirement income. They are:

- Section 109 dealing with the "*Portability of lifetime income options*." Generally, it permits special distributions of a "lifetime income investment" when the investment is no longer authorized to be held under the plan. This makes it possible for a participant to keep the investment even if the plan sponsor changes recordkeepers or decides to eliminate the investment from the plan lineup. This provision is effective now. It also addresses the concerns of plan sponsors reluctant to add these options to their plan menu for fear that a change in recordkeepers could be disruptive to participants who had invested in those options;
- Section 203 relates to "*Disclosure regarding lifetime income*." This section requires plans to give participants projections of their current account balance as a monthly benefit using assumptions prescribed by the Secretary of Labor. This is designed to inform participants about how their accounts translate into income when they retire and to, at least partially, shut the focus from account balance to retirement income. This section goes into effect 12 months after the DOL issues guidance.

  Note: The DOL has issued its final rule on August 18, 2020, and published in the Federal Register September 18, 2020; You can view the Rule at https:// www.federalregister.gov/documents/2020/09/18/2020-17476/pension-benefit-statements-lifetime-income-illustrations

The Interim Rule offers an example of what this illustration might look like:

Account Balance as of [DATE]	Monthly Payment at 67 (Single Life Annuity)	Monthly Payment at 67 (Qualified Joint and 100% Survivor Annuity
$125,000	$645/month for life of participant	$533/month for life of participant $533/month for life of participant's surviving souse

- Section 204 provides the fiduciary safe harbor for the selection of a guaranteed retirement income provider, which is effective now.

Investment Policy Statement (IPS)

The increasing emphasis on plan investment issues by the Department of Labor (DOL) increases the need for a written "*investment policy statement"* (IPS). ERISA § 402(b)(1) requires that a retirement plan provide:

> *"…a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan."*

An (IPS) defines the processes that a company has adopted to make investment-related decisions with respect to the assets of a 401(k) plan. The IPS identifies the investment goals and objectives of the plan, establishes how decisions will be made regarding the selection of investments, and specifies the procedures for measuring investment performance. While the law does not require that a plan adopt an IPS, it may be the single most important task that a fiduciary performs for the following reasons:

- An IPS documents that there is a defined process by which the 401(k) is being managed;
- It helps prevent fiduciaries from making unsteady investment decisions when markets are turbulent;
- It clearly identifies plan fiduciaries and helps them manage their responsibilities;
- An IPS defines roles and responsibilities of trustees, advisors, custodians, and investment managers;
- It explains how to hire, monitor, and replace investment managers when necessary;
- It provides evidence that a clear process and a methodology exist for selecting and monitoring plan investments; and
- It is a well-articulated, documented procedure for investment selection and ongoing investment evaluation, which are fiduciary obligations.

The first step in developing an IPS is to gather all of the plan documents (trust documents, summary plan descriptions, printed minutes, current vendor service agreements, investment performance reports, enrollment reports, participant educational material, procedural manuals, and Form 5500) and review them to determine whether:

- The plan documents identify the trustees and named fiduciaries.
- The plan is intended to be ERISA Section 404(c)-compliant.
- There is a clear understanding of the plan expenses and whether they are reasonable.
- There is a formal process for making investment-related decisions.
- There is a clear paper trail relative to the process being followed.
- It is clear who has the authority to make investment decisions; and
- The trust documents prohibit certain asset classes.

While no single approach is appropriate for everyone, a typical IPS may cover the following:

- *The Plan*–General explanation of the purposes and goals of the IPS; acknowledges the applicability of ERISA fiduciary standards and rules; addresses whether the plan is intended to be ERISA section 404(c)-compliant;
- *Purpose of the IPS*–Identifies the objective of the investment policy statement and states the intention to review the policy quarterly, or at least annually, and to amend it as necessary;
- *The Investment Objectives*–Identifies the plan investment philosophy and the processes for the selection, monitoring, and evaluation of plan investments;
- *Duties, Roles, and Responsibilities*–Generally defines the roles of the parties involved in the management of plan assets and administration of the plan. If there is an investment committee, the members are identified, and their roles stated;
- *Investment and Manager Selection*–Identifies the policies and guidelines to be followed when selecting investments and managers;
- *Investment Monitoring and Reporting*–Provides a process by which investment options are regularly reviewed and evaluated for continuing appropriateness;
- *Investment Manager Monitoring and Termination*–States how investment managers will be monitored and how often. Explains how underperforming managers will be evaluated and replaced if necessary;
- *Coordination with the Plan Document*–Clarifies that in the event of conflict between the IPS and the plan document, the plan document controls; and
- *Controlling and Accounting for Investment Expenses*–Defines the process of reviewing expenses for reasonableness.

It is important to remember; it is not enough for the plan sponsor to simply write an IPS. They must also follow it, communicate it and review it. An ignored IPS is evidence that the plan sponsor is not managing or using the plan the way it was intended.

Communicating the IPS is important for ensuring everyone–participants, managers, and service providers–is aware of what the plan involves and whether it complies with the law. The needs and expectations of the plan and participants can change over time, which is why the IPS also needs to be reviewed and, if necessary, revised regularly. An IPS should be reviewed by legal counsel prior to implementation with any plan document.

Fees

As American workers have increasingly come to rely on their 401(k) plans for retirement income, policymakers have focused their attention on the fees charged to the plan sponsor–typically the employer offering the plan–and plan participants. Many studies have shown that the amount of plan fees paid by participants can significantly reduce retirement savings and is dependent on several factors, including the decisions made by the plan sponsor to hire service providers–outside entities to help administer their plans. Industry organizations have also conducted studies to understand sponsors' decisions better to manage their 401(k) plans. However, these studies are generally based on surveys of larger plans–those with more than 500 participants–and most have not specifically focused on the fees charged by plan service providers. As a result, uncertainty remains about the fees paid by small and medium-size plans, which account for the majority of all 401(k) plans, about the level of knowledge and expertise sponsors of these plans have to determine the fees charged by service providers.

In 2006, the GAO wrote a report titled, "*Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information*." The report wrote:

> "*…fees are one of many factors–such as the historical performance and investment risk for each plan option–participants should consider when investing in a 401(k) plan because fees can significantly decrease retirement savings over the course of a career. Even a small fee deducted from a worker's assets today could represent a large amount of money years later had it remained in the account to be reinvested.*"

The first page of the GAO report gets right to the heart of the issue by graphically illustrating the effect on account balances over 20 years of fees that differ by just 1 percent. The GAO chart shows an account of just $20,000, earning seven percent over those twenty years, will be worth $70,500 if the account's fees are 0.5%, but worth only $58,400 if the fees are 1.5%.

Plan sponsors and investment advice fiduciaries have an obligation, disclose and review fees and revenue sharing under the ERISA "reasonable fee" standard. Remember that investment recommendations are now fiduciary investment advice. Those recommendations–and the costs associated with those recommendations–are subject to the same fiduciary rules and oversight as other service provider fees. Most importantly, investment fiduciary advisers must assure that expense and services reviews–and decisions about those services–are documented.

In the Exclusive Purpose Rule, one short line– "defraying reasonable expenses" tells us that fiduciaries have an affirmative duty to ensure reasonable expenses. We also know that:

- Per the prohibited transaction rules, any compensation for service providers and fiduciaries is prohibited unless an exemption applies;
- The self-dealing rules further clarify that fiduciaries may not act in a capacity where they stand to benefit based on the choices they make or the advice they render, such as when some funds pay more than others;
- Any fiduciary who agrees to pay a service provider or other fiduciary in a manner that is prohibited is guilty of breaching the duty of prudence; and
- Fiduciaries must discover the full extent of plan costs and service provider compensation, from whatever source–including revenue sharing and conflicts of interest–to insure expenses are reasonable.

Revenue Sharing

The term "revenue sharing" means different things to different people in our industry. In the ERISA world, revenue sharing refers to virtually any payment from a fund or manager to a platform or service provider. (A platform is a roster of investment options made available by a financial institution that is preselected either for plan fiduciaries or that is chosen from by plan fiduciaries to populate plan investment menus.) However, in the SEC and securities world, 12b-1s, shareholder servicing fees, and sub-transfer agency fees are distinct types of payments called by their distinct names, and "revenue-sharing" refers to payments by a fund family from its own assets for business purposes. The distinction might seem merely semantic but is important to securities regulators. The emphasis for fiduciaries is dramatically different from that of the SEC for funds and brokers.

Mutual funds and money managers make these payments to vendors as a legitimate marketing or servicing fee regardless of what they are called. The payments typically take the form of rebates of fund expense ratios (or "revenue sharing" in the SEC sense, meaning the payments come from the fund family's own assets).

Amounts range from .25% to .50%, though the full range historically has been more like 0 to 1.00%. We can divide revenue sharing into the following five primary types of payments:

- *Finder's Fees*–typically a 1.00%, one-time payment to the broker of record that does not incur any sales charge to the client. The payment comes from the fund family's pocket. These payments have rapidly become a thing of the past as fund families realize the economics do not support these payments, and most of the big load fund families (only load funds pay finder's fees) have long since discontinued most finder's fee payments;
- *12b-1 fees*–typically a .25% "trail" payment to the broker of record commencing as soon as assets are transferred or, for funds paying a finder's fee in year one, commencing in the thirteenth month. 12b-1s are likely to be phased out by SEC and replaced by a combined .25% "marketing and service fee" and "ongoing sales charge;"
- *Shareholder Servicing Fees*–another name for 12b-1s paid by "no-load" families, since 12b-1s are considered a commission or load. Fund families known as "no-load" families

can pay up to .25% and not be required to call it a 12b-1, but only service providers, not brokers, can receive these payments;

- *Sub-Transfer Agency Fees (Sub-T/A Fees)*–originally a payment to a recordkeeper with an "omnibus" account at the fund family, which allows the fund family to eliminate hundreds or thousands of individual client accounts in exchange for one big account. Eliminating those small accounts saves money, and the fund family passes part of the savings to the recordkeeper. In recent years, however, the use of sub-T/A fees has expanded to become an alternate means of providing revenue sharing to various service providers, not just recordkeepers. For example, the same no-load fund families limited to a .25% shareholder servicing fee often offer an "Adviser" or similarly named share class that offers an additional .25% sub-T/A payment for a total of .50% revenue sharing. Again, however, brokers are not eligible to receive these payments; and
- *"Revenue-Sharing" in the SEC Sense of the Term*–payments from a fund family's assets as opposed to from a fund's assets. For example, a fund family might offer a high-producing broker or broker/dealer an additional 10bp trail commission as a reward for production.

The sixth form of revenue sharing is the standard sales commissions paid by load funds. Since no qualified plans pay up-front sales loads anymore, loads are generally considered separate from revenue sharing.

Revenue Sharing in ERISA Plans

Investment providers, including insurance and mutual fund companies, commonly lump together 12b-1 payments, shareholder servicing fees, and sub-T/A fees as "revenue sharing." This is different from the SEC revenue sharing previously defined. These providers can and do pay advisers or TPAs, recordkeepers, custodians, or other providers "revenue sharing" for plan-related services.

Revenue sharing monies are frequently held in either actual or hypothetical accounts until they are used to pay the plan's operational expenses. The terminology of revenue sharing "bucket accounts" often varies with how recordkeepers maintain these accounts. One way to track revenue sharing is to set it up as actual asset-based accounts in the plan, in which one can see money flowing in and out of the account as revenue sharing fees are collected and expenses are paid.

A common name for this type of account is an ERISA Budget Account or ERISA Bucket Account. An alternative name is Plan Expense Reimbursement Account (PERA). A PERA is a hypothetical bookkeeping account maintained by the recordkeeper. In this case, the plan's service providers (recordkeeper, trust company, broker, etc.) may retain actual revenue sharing money and is used to pay plan expenses as directed by the plan sponsor. It is more of a "back-office" account, and generally, this money does not flow through the plan. However, there are still fiduciary obligations of prudence, due diligence, and oversight over these accounts.

Revenue sharing is often used to offset administration and recordkeeping costs for the plan. When revenue sharing payments are high enough, expenses that might otherwise be billed to the plan or plan sponsor can be significantly reduced or eliminated. For some plans and plan sponsors (and even service providers), reducing plan expenses as low as possible or zero ($0.00) is an explicit goal.

Some may even say that the plan is "free" simply because the plan or plan sponsor does not need to write a check to pay for any plan services. Of course, the plan is in no way free! Therefore, plan expenses are paid by revenue sharing and from plan assets that belong to plan participants. (Remember, all plan expenses will be reflected in the 408(b)(2) disclosures.)

When plan expenses are paid by revenue sharing, some plan participants may also believe that the retirement plan is free. That is because most revenue sharing payments are made directly between a fund or manager and a recordkeeping platform or provider. The revenue sharing payments never pass directly through a participant's account, so they never see the money paid to the various service providers. Remember, expenses paid by plan participants, including revenue sharing, will be reflected in the 404(a)(5) disclosures. However, revenue sharing is usually not itemized.

There is nothing inherently wrong with revenue sharing; it is both legal and common industry practice. However, because it involves using plan assets to pay for expenses, fiduciaries must be aware of the cost of services and amount of revenue sharing generated by the plan. As an investment advice fiduciary, you have a duty to select investments using the exclusive purpose and prudent man rules (see the Introduction section of this unit), regardless of revenue sharing.

Revenue sharing presents some issues for fiduciaries:

- Revenue sharing is a plan asset and therefore is subject to the ERISA exclusive benefit and DOL disclosure rules;
- Revenue sharing is subject to the ERISA prudency rules, e.g., plan fiduciaries cannot select an investment solely because the revenue sharing of the investment offsets plan fees;
- Fiduciaries have the duty to be aware of the revenue sharing of all the plan investments and whether those amounts are being used to benefit participants and beneficiaries of the plan; and
- Revenue sharing cannot be used to pay fees that do not directly benefit participants or beneficiaries of the plan. For example, the fees cannot be used towards a feasibility study by the employer to determine alternative plan designs–such a study is a settlor function.

In a recent court case, a plan participant sued the plan fiduciaries for not acting in the best interest of the participants. The appeals court's decision focused on fiduciaries' actions with regard to revenue sharing: "[the company] used revenue sharing to benefit [the company] at the Plan's expense."

The court found "ample support in the record" that the plan fiduciaries had failed to calculate recordkeeping fees and revenue sharing amounts, assess whether the fees were reasonable, negotiate lower fees, or prevent the use of revenue sharing to subsidize administrative costs unrelated to the plan.

ERISA § 408(b)(2)

As discussed above, a fiduciary's primary responsibility is to run the plan solely in the interest of its participants and their beneficiaries. A fiduciary must administer a plan for the exclusive purpose of providing benefits and paying plan expenses. This includes ensuring that the plan pays only *"reasonable"* expenses for administering the plan and investing its assets. There was little guidance on how fiduciaries should determine if fees were reasonable in the past.

On July 15, 2010, the DOL issued an interim final regulation under ERISA § 408(b)(2) in an effort to assist fiduciaries of *"covered plans"* in determining the reasonableness of fees. The regulation was deemed an interim final regulation due to the potential for revisions. The DOL requested additional comments because the regulation contained substantial changes from the proposed regulation published in 2007. The DOL considered those comments in drafting the final regulation, released on February 1, 2012.

The regulation became effective July 1, 2012, and applies to existing service arrangements as well as service arrangements entered into on or after that date. Accordingly, for those service arrangements in place on the effective date, the required disclosures were to be made by July 1, 2012.

Prior to ERISA § 408 (b)(2), service providers did not have to fully disclose the fees and other expenses paid to third parties, much less make them transparently clear.

Section 408(b)2 Service Provider Fee Disclosure

The final regulation provides:

> *"No contract or arrangement for services between a 'covered plan' and a 'covered service provider,' nor any extension or renewal, is reasonable within the meaning of Section 408(b)(2) unless certain disclosures are made to the responsible plan fiduciary."*

"Covered plans" include defined contribution (DC) and defined benefit (DB) tax-qualified retirement plans subject to ERISA. The regulation does not include SEP IRAs, SIMPLE IRAs, IRAs, or any non-ERISA tax-qualified plan, such as an individual (solo) 401(k) plan.

A *"covered service provider"* is a person or entity that enters into a contract or arrangement with a "covered plan" and reasonably expects to receive $1,000 or more in direct or indirect compensation during the term of the arrangement.

"Covered Service Provider" Categories

There are three categories of services that cause a service provider to be considered a *"covered service provider:"*

- First, fiduciary services, including:
    - Services provided directly to a plan as a fiduciary under ERISA § 3(21);

    - Services provided directly to a plan as an investment advisor registered under either the Investment Advisers Act of 1940 or under state law (this includes services provided by Registered Investment Advisors (RIAs), who are not automatically fiduciaries under ERISA but are fiduciaries under securities law); and
    - Services provided as an ERISA fiduciary to an investment contract, product, or entity that holds plan assets and in which the plan has a direct equity investment.
- Second, recordkeeping services or brokerage services, but only when such services are provided to a participant-directed individual account plan and when the plan makes one or more designated investment alternatives available.
- Third, other services for which the provider receives indirect service provided need only report changes in investment-compensation, including, but not limited to: related information annually:
    - Consulting services; and
    - Third-party administrator services.

Required Disclosures

Under the regulation, written disclosures must be provided to the plan for the following:

- *Services*–a description of the service provider's services that will be provided to the plan;
- *Status*–if applicable, a statement describing services to the plan as an ERISA fiduciary and/or services to the plan as an investment advisor;
- *Compensation*–the service provider must describe all compensation it expects to receive, including:
    - Direct compensation;
    - +
    - Indirect compensation;
    - Compensation paid among related persons; and
    - Compensation for termination of the arrangement.
- *Investment Disclosure*–for certain fiduciary services or recordkeeping and brokerage services:
    - Compensation that may be directly charged against assets, such as sales loads or redemption fees;
    - Annual operating expenses if the investment returns are not fixed; and
    - Ongoing expenses, such as wrap, mortality or expense fees.
- *Recordkeeping Services*–compensation associated with recordkeeping services or, in certain cases, an estimate of cost for recordkeeping services. Any offsets in compensation due to other sources of revenue, such as revenue sharing, must be included; and
- *Manner of Receipt*–a description of how compensation will be received such as billed or deducted from plan assets.

Timing of Disclosure Requirements

- *Initial disclosure requirements.* The information listed above must be provided *"reasonably in advance"* of the date of the arrangement. While the timing is not clear, it would be prudent to provide notices, so the responsible plan fiduciary has a realistic opportunity to review the materials in advance and seek advice, as needed;

- *Changes.* A service provider must report changes in its disclosures as soon as practical, but not later than 60 days from the date the service provider is aware of the changes. However, a service provider need only report changes in investment-related information annually;
- *Existing clients.* In addition to the initial disclosure requirements for new clients, service providers also must provide existing clients with the information outlined above; and
- *Ongoing disclosure requirements.* Following the initial disclosures, service providers must provide information within 30 days following receipt of a written request.

The burden of proof for providing appropriate disclosure rests with the covered service provider.

Format of Disclosures

Service providers may select the manner and format of the disclosure as long as it meets the regulatory time frames. However, the DOL strongly suggested that covered service providers provide a guide.

Monitoring and Assessing the Reasonableness of Plan Fees

With greater transparency around fees under ERISA § 408(b)(2), employers (plan sponsors) now have more information than ever before to evaluate the fees they are paying for plan services. This is good news for plan sponsors as they try to meet their long-standing fiduciary obligation to monitor and assess the reasonableness of their plans' fees.

However, many plan sponsors are uncertain about how best to meet their fiduciary obligations. They aren't quite sure how to use and apply the large amounts of information provided by DOL § 408(b)(2) fee disclosure regulations (discussed above). When assessing fees, many plan sponsors frequently focus on seeking out the lowest costs for plan services and investments when fees are just one part of the story. As a result, many plan sponsors may not fully consider the quality and effectiveness of the services they are receiving and how they contribute to positive outcomes for their employees.

As the advisor, it is critical for you to assist plan sponsors in developing a well-thought-out plan for fiduciary compliance. An intentional, carefully designed fiduciary process can help the plan sponsor organize and evaluate the available data to help answer fairness and value questions. And, ultimately, following a prudent fiduciary process can also help drive better plan outcomes for their employees. To assist plan sponsors with this task, fiduciary expert Donald Trone, CEO of 3ethos, developed a four-step process that can help plan sponsors in all organizations make reasonably informed and knowledgeable assessments about fees by asking and answering the following four questions:

- *Who* is receiving compensation from the plan?
- *What* are the fees and expenses associated with the plan?

- *How* do the fees and expenses compare to other service providers or investment options?
- *Why* is compensation warranted?

Who is Receiving Compensation from the Plan?

The first step is to identify a list of all covered service providers, including any plan fiduciaries, investment advisors, recordkeepers, brokers, and providers receiving *"indirect compensation"* such as investment or plan consultants (advisors). The required ERISA § 408(b)(2) service and fee disclosures the plan sponsor is now required to receive from each provider should help assemble an initial list and validate ***who*** is being compensated.

Table 10.3 displays some considerations for best practices in identifying and evaluating each plan provider. Consider each provider's relationships, their impact on the fees the plan pays, and any interdependencies. As the plan sponsor reviews the list, they should ask the following questions:

- Are all the plan relationships accounted for?
- Has the plan sponsor reviewed each provider recently?
- Are any providers' fees above the norm?
- Does the plan sponsor need the help of a third-party professional to evaluate the plan providers?

Table 10.3
Best Practices in Reviewing Service Providers

Task	Best Practices Considerations
Identify all "covered service providers."	Includes fiduciaries, investment advisors, record-keepers, brokers, and providers receiving "indirect compensation," such as consultants.
Gather complete information regarding your providers, services and fees.	Provider qualifications. Scope and quality of services Fees charged for services and investments
Consider indirect compensation when evaluating investments and services.	Require disclosure of all compensation arrangements. Understand any potential conflicts of interest.
Use procedural prudence when selecting a new provider or evaluating an existing one.	Thoroughly review and document the process. Regularly monitor the reasonableness of fees. Review total cost plus individual fee components
Conduct fiduciary reviews regularly and maintain supporting documentation.	Periodically audit invoices to assure compliance with agreed-upon fees. Ask for a thorough itemization if necessary

Source: TIAA-CREF Financial Services, "*Deciding what is reasonable: Assessing fees using value and outcome*, 2014

ERISA Section 404(a)(5)

Participants and beneficiaries in participant-directed individual account plans (except SEPs, IRAs, SIMPLE, and government plans) are subject to the ERISA Section 404(a)(5) disclosures. The disclosures must be provided on or before the date a participant can first direct their investments and at least annually thereafter. Participants must be informed of changes at least 30 but not more than 90 days in advance of the change if applicable. In addition, certain information must be provided quarterly, such as dollar amounts charged attains the account and description of relevant services.

Here is a checklist:

- Plan Related Information:
    - An explanation of the circumstances under which participants may give investment instructions;
    - An explanation of any specified limitations on investments instructions, including restrictions on transfer to or from a designated investment alternative;
    - A description of or reference to the exercise of voting, tender and similar rights in a designated investment alternative as well as any restrictions on such rights;
    - An identification of any designated investment alternatives (DIA) under the plan and identification of any designated investment managers;
    - A description of any brokerage window, self-directed brokerage account, or similar plan arrangements that enable participants to select investments beyond those designated by the plan;
- Administrative expenses:
    - An explanation of any fees and expenses for general plan administrative expenses (e.g., legal, accounting, recordkeeping), which may be charged against the participant's individual account and is not reflected in the total annual operating expenses of any DIA as well as the basis for the charge (e.g., pro rata, per capita);.
- Individual expenses:
    - An explanation of any fees and expenses that may be charged against the individual account of a participant (e.g., plan loans, QDROs, investment advice, brokerage window fees, commissions, front or back-end loads or sales charges, redemption fees, transfer fees and similar expenses and optional rider charges in annuity contracts) which are not reflected in the total annual operating expense of any designated investment alternative;
- Investment related information (see also Comparative Chart section):
    - The name of each designated investment alternative;
    - The type or category of the investment (e.g., money market, balanced fund;
    - The average annual return (or if applicable, the fixed or stated rate of return and the term of investment) of the DIA for 1, 5, and 10 calendar year periods (or the life of the DIA if less) ending on the date of the most recently completed calendar year; as well as a statement indicating that an investment's past performance is not necessarily an indication of how the investment will perform in the future. **Note:** If the issuer of a DIA with a fixed return reserves the right to adjust the fixed or stated rate of return prospectively during the contract or agreement, the current rate of

return, the minimum rate guaranteed under the contract, if any, and a statement advising participants and beneficiaries that the issuer may adjust the rate of return prospectively and how to obtain (e.g., telephone or website) the most recent rate of return;

  - Benchmarking information (not applicable to DIAs with fixed returns)-the name and returns of an appropriate broad-based securities market index over the 1, 5, 10 calendar year periods (or the life of the DIA if less) comparable to the performance data periods and which is administered by an affiliate of the investment issuer, its investment adviser, or a principal underwriter, unless the index is widely recognized and used;
  - Fee and expense information (not applicable to DIAs with fixed returns)-the amount and description of each shareholder type fee (fees charged directly against a participant's investment, such as commissions, sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees and purchase fees which are not included in the total annual operating expense of any DIA) and a description of any restriction or limitation that may apply to a purchase, transfer, or withdrawal of the investment in whole or in part (such as round trip, equity wash, or other restrictions);
  - The amount and description of each shareholder type fee (fees charged directly against a participant's investment, such as commissions, sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees which are not included in the total annual operating expense of any DIA) and a description of any restriction or limitation that may apply to a purchase, transfer, or withdrawal of the investment in whole or in part (such as round trip, equity wash, or other restrictions);
  - The total annual operating expense of the investment expressed as a percentage (i.e., expense ratio) The total annual operating expenses of the investment for one year expressed as a dollar amount for a $1,000 investment;
  - A statement indicating that fees and expenses are only one of several factors that participants should consider when making investment decisions;
  - A statement that the cumulative effect of fees and expenses can substantially reduce the growth of a participant's or beneficiary's retirement account and that participants and beneficiaries can visit the EBSA website for an example demonstrating the long-term effect of fees and expenses; and
  - For DIAs with respect to which the return is fixed for the term of the investment the amount and a description of any shareholder-type fees and a description of any restriction or limitation that may be applicable to a purchase, transfer or withdrawal of the investment in whole or in part.
- Internet web site address:
  - Must be sufficiently specific to provide participants and beneficiaries access to the following information regarding the DIA;
  - The name of the DIA issuer;
  - The DIA objectives or goals in a manner consistent with SEC requirements;
  - The DIA principal strategy (including a general description of the types of assets held by the investment) and principal risks in a manner consistent with SEC requirements;

- The portfolio's turnover rate in a manner consistent with SEC requirements;
    - The DIA performance data described at least quarterly or more frequently if required by other applicable law; and
    - The DIA fee and expense information Glossary A general glossary of terms to assist participants in understanding the designated investment alternatives or an internet website address that is significantly specific to provide access to such a glossary along with a general explanation of the purpose of the address.

- Comparative Chart. A chart or similar format designed to facilitate comparison that includes:
    - A statement indicating the name, address and telephone number of plan administrator or person designated by the plan administrator to contact for more information;
    - A statement that additional information (including more current performance information) is available at the DIA website; and
    - A statement explaining how to request and obtain free of charge, paper copies of the information required to be made available on the website.
- Other Disclosures:
    - Information to be provided subsequent to investment; and
    - The plan administrator must furnish to each investing participant any materials provided to the plan relating to the exercise of voting, tender and similar rights to the extent that such rights are passed on to the participant under the terms of the plan.
- Information to be provided upon request:
    - Copies of prospectuses or short form prospectuses or similar documents;
    - Copies of any financial statements, reports such as statements of additional information and shareholder reports, and of any similar material related to the DIAs to the extent such material is provided to the plan;
    - A statement of the value of a share or unit of a DIA as well as the valuation date; and
    - A list of the assets comprising the portfolio of each DIA which constitutes plan assets and value of each such asset or the proportion of the investment which it comprises.
- Information to be provided at least quarterly:
    - In addition to the initial and annual disclosure, quarterly disclosures must be provided to participants. The phrase "at least quarterly" is defined by the regulations as "At least once in any 3-month period, without regard to whether the plan operates on a calendar or fiscal year;"
        - Administrative expenses:
            - The dollar amount of the fees and expenses that are actually charged a description of the services to which the charge relates (e.g., administration, including recordkeeping, legal, accounting services) If applicable, an explanation that, some of the plan's administrative expenses for the preceding quarter were paid from the total annual operating expenses of one or more of the plan's designated

investment alternatives (e.g., revenue sharing, 12b-1 fees, sub-transfer agent fees); and

- Individual expenses
    - The dollar amount of fees that are charged during the preceding quarter to the participant's account for individual services A description of the services to which the charges relate (e.g., loans processing).

Fee Benchmarking

Although fee disclosure under 408(b)(2) helps with fee monitoring, it is a best practice to benchmark fees against similar plans as part of the process. Benchmarking can also help plan sponsors determine the value of the services provided to the plan by the TPA, the adviser, the recordkeeper, and other providers. The adviser can assist the fiduciaries in obtaining a fee benchmarking analysis.

You may be able to get fee benchmarking tools through your financial institution (broker-dealer, RIA, insurance company, etc.). Some benchmarking tools are included with investment monitoring software. Independent companies also offer benchmarking tools/software and publications that offer fee benchmarking/averaging data. While the tools listed here are generally convenient and easy to use, they do not provide data on fees and services for a specific plan. As a result, it may be advisable to request a proposal (RFP) to get market-based quotes for fees and services for a particular plan.

It is best practice to benchmark fees every two to three years in larger plans and smaller owner-driven plans, three to five.

Benchmarking fee reports can be used to show that a prudent fiduciary process is being followed and documented regarding the reasonableness of plan fees. The benchmarking report should be included in the fiduciary file with other best practice prudent process documents.

The fiduciary or adviser assisting the plan fiduciary should fully understand the detail behind any benchmarking service, including how the reference data was gathered. Choosing a benchmark service should not be taken lightly and should involve comparisons between benchmarking services.

Chapter 10
Review Questions

1. Another term used for automatic enrollment is:

( ) A. Negative election
( ) B. Payroll deferral
( ) C. Opt-out mechanism
( ) D. None of the above

2. All of the following are requirements that must be met for the plan QDIA to be used, EXCEPT?

( ) A. The QDIA must permit the acquisition of employer securities
( ) B. There must be no penalty imposed on the participant who chooses to later move out of the QDIA
( ) C. The plan must offer a broad range of investment alternatives
( ) D. The QDIA must be managed by a "permitted manager"

3. The QDIA Notice must be provided at least within how many days in advance of plan eligibility?

( ) A. 3 days
( ) B. 7 days
( ) C. 10 days
( ) D. 30 days

4. Which of the following has become the most popular QDIA?

( ) A. Balanced funds
( ) B. REITs
( ) C. Alternative investments
( ) D. Target date funds

5. For tax year 2025, what is the maximum premium placed in a QLAC?

( ) A. $100,000
( ) B. $145,000
( ) C. $175,000
( ) D. $210,000

CHAPTER 11

LIFE INSURANCE IN 401(k) PLANS

Overview

As the advisor, you understand that life insurance should be integral to every financial plan. However, determining the type of insurance, comparing the costs, and deciding the most economical way to purchase the protection may continue to be open for debate. Some advisors may recommend buying life insurance within a 401(k) plan if used correctly. Others may say that wrapping up insurance inside a 401(k) plan makes little sense.

This chapter will examine the pros and cons of purchasing life insurance inside a 401(k) plan. Then we will examine the amounts of insurance that can be purchased in a 401(k) plan under the incidental benefit rules, review the various income tax rules for owning life insurance inside a 401(k) plan. And, finally, at the end of the chapter, we will review the distribution rules for a life insurance policy inside a 401(k) plan and how to properly calculate the life insurance policy's fair market value (FMV).

Learning Objectives

Upon completion of this chapter, you will be able to:

- Identify the pros and cons of owning a life insurance policy inside a 401(k) plan;
- Apply the incidental benefit rules and calculate the percentage test and determine the seasoned money exception;
- Describe the income tax consequences of owning a life insurance policy inside a 401(k);
- Relate the economic benefit rules and how to create basis in the life insurance policy;
- Describe distribution tax rules of the life insurance policy at death prior to retirement, at retirement, or termination; and
- Determine the fair market value of a life insurance contract inside a 401(k) plan.

Pros and Cons of Purchasing Life Insurance in a 401(k) Plan

First, let's state upfront that life insurance must be purchased in good faith. The insured must have a need for protection before recommending purchasing a policy inside a 401(k) plan or outside (individually owned). Once you have met those suitability requirements, the next question should be: What is the most cost-effective way to purchase life insurance?

I know you have heard the argument that a 401(k) plan is an investment and life insurance is not. The excess costs of insurance are considerably more than similar investments. "Buy term insurance outside your 401(k) plan and invest inside your 40(k) plan." Sound familiar?

The Pros

However, there are some advantages of purchasing life insurance for a plan participant inside a 401(k) plan that should not be overlooked. They are:

- *Tax-Deductible Contributions*. The contributions made to the participant's 401(k) by the employer are fully deductible. The participant does not need to report such contributions on their tax return. Within certain limits (as we will discuss below), premiums paid to buy life insurance within a 401(k) may also be deductible;
- *Cost Can be Significantly Less.* The current cost to the participant may be significantly less than the actual premiums. If the benefits end up being too large, the participant will be taxed on what the IRS considers "excess." The positive side of this is that the table used to determine the taxable portion of such contributions, known as the P.S. 58 Table, downplays the real economic benefit of such excess (see Table 10.1). This means that if there are taxes due, it is normally a bargain compared to the value of the insurance the participant bought (see Economic Benefit Value discussed below); and
- *Death Benefits Pass Income Tax-Free to the Beneficiary*. Life insurance proceeds pass to a beneficiary income tax-free to the extent they exceed the policy's cash surrender value [IRC § 101].

The Cons

While using pre-tax money for needed coverage is helpful, there are also disadvantages to using plan assets to purchase life insurance. They are:

- *Fees*. There are relatively high costs of setup and implementation, especially if the plan does not yet exist or allow for the purchase of life insurance;
- *Income Taxes*. The participant must recognize the economic benefit value of the death benefit as taxable income, and the cost of unwinding the coverage can be high;
- *Valuation*. The fair market value of the policy must be ascertained to avoid severe tax consequences; and
- *Estate Taxes*. If left in the 401(k) plan, life insurance is estate taxable.

Next, let's examine the incidental benefit rule set forth by the Internal Revenue Service (IRS).

The Incidental Benefit Rule

Under Treas. Reg. § 1.401-1(b)(ii)], life insurance is allowed to be part of a 401(k) plan, but only if it is *incidental* to the retirement plan. This means that it represents less than a certain percentage of the total cost of the retirement plan. The total cost is measured by adding together all contributions.

The Premium Percentage Test

According to the IRS, the "*incidental death benefit rule*" has been refined over time through a number of revenue rulings, beginning with Rev. Rul. 54-51, to mean the following:

- Premiums for life insurance must be less than 50 percent of the contributions for the participant [Rev. Rul. 73-501]; and
- It also required that, at or before the participant's retirement, the policy's full cash surrender value (CSV) must be converted to provide periodic income and not portion used to continue life insurance coverage.

Under IRS Rev. Rul. 60.83, it was determined by the IRS that the use of plan contributions or funds for current benefits, including life insurance protection, was a distribution from the plan.

Then in 1961, the IRS issued Rev. Rul. 61-164, which has developed two practical tests for life insurance in a 401(k) plan. If the amount of insurance meets either of the following tests, it is considered incidental:

- The participant's insured death benefit is no more than 100 times the expected monthly normal retirement age benefit (for defined benefit plans); or
- The aggregate premiums for any insured death benefit is less than the following percentages of the overall cost to provide plan benefits for that participant:
  - For term and universal life insurance, the aggregate total premiums paid must be 25 percent or less of the aggregate employer contributions and forfeitures allocated to the account over time; and
  - The aggregate total premiums paid for whole life insurance must be less than 50 percent of the aggregate employer contributions and forfeitures.

Note: Universal life insurance policies (which led to the marketing of variable universal life and index universal life policies) were developed after the publication of Rev. Rul. 54-51. Looking for guidance today on those types of policies, we would look to the only guidance provided by the IRS with FSA 1999-633, which concludes that the 25 percent test applies to Universal Life policies. Keep in mind that there is an exception to the 25% rule for "*seasoned money*."

Seasoned Money Exception

In a series of Revenue Rulings, the IRS has stated that a profit-sharing plan may permit in-service distributions of funds that have been in the plan for at least two years or all of the funds if the participant has participated in the plan for at least five years. In a profit-sharing plan permitting such in-service distributions, participants may pay premiums using the "*seasoned money*" without regard to the incidental death benefit limit. The plan document must permit in-service withdrawals.

If the plan provides that life insurance can be purchased with funds that have been on deposit for two years or more, there is no limit as to how much can be used to purchase life insurance.

Note: The seasoned money rule does not apply to 401(k) salary deferrals or employer qualified matching contributions.

Income Tax Consequences

The fact that life insurance premiums in a 401(k) plan are tax-deductible is very compelling for certain participants in high income tax brackets or whose premiums are more expensive because of health issues or risky pastimes. Although the portion of the employer's contribution that is attributable to life insurance is deductible to the company, the participant insured is required to annually include in income the value of the "*pure insurance protection*" [IRC § 72(m)(3) (B); Reg 1.72-16(b)].

Economic Benefit Value

The amount of pure insurance protection provided to the participant is the *economic benefit value*. The economic benefit value (the taxable benefit) is calculated on the amount at risk–that is, the difference between the policy's cash value and its death benefit. The amount at risk is taxed annually to the participant at the lower of:

- The IRS Table 2001 (see Table 11.1) cost, the so-called "P.S. 58 Cost" [Rev. Rul. 55-47]; or
- The life insurance company's actual rates for individual one-year term policies are available to all standard risks [Rev. Rul. 66-10].

***For Example**:* Bob, age 50, is covered by $100,000 of life insurance coverage offered through his employer's 401(k) plan. The policy's cash surrender value at the end of the calendar year is $15,000, making the net insurance amount provided to be $85,000. Based on the IRS Table 2001 (see Table 10.1), the value of life insurance for a 50-year-old is $2.30 per thousand coverage. Bob must recognize income of $195.50 for the value of the insurance protection ($100,000-$15,000)/1,000 x $2.30 = 85 x $2.30 = $195.50. This creates $195.50 of basis in the policy.

Although Table 2001 increases as the insured ages, it's a good deal until around age 70. If the policy in question is a survivorship contract (covering two lives), as long as both insureds are alive, the imputed income is less than under a single life contract.

Creating Basis in the Contract

The economic benefit value included in the participant's taxable income creates basis in the contract [Treas. Reg. § 1.72-16(b)(4]. The participant will be allowed to recover the basis in the contract when the contract is either surrendered or distributed to the participant.

Table 11.1
IRS Table 2001 Interim Table of 1-Year Term Premiums for $1,000 of Life Insurance Protection

Attained Age	Sec. 79 Extended Interpolated Annual Rates	Attained Age	Sec. 79 Extended Interpolated Annual Rates	Attained Age	Sec. 79 Extended Interpolated Annual Rates
0	$0.70	34	$0.98	68	$16.92
1	$0.41	35	$0.99	69	$18.70
2	$0.27	36	$1.01	70	$20.62
3	$0.19	37	$1.04	71	$22.72
4	$0.13	38	$1.06	72	$25.07
5	$0.13	39	$1.07	73	$27.57
6	$0.14	40	$1.10	74	$30.18
7	$0.15	41	$1.13	75	$33.05
8	$0.16	42	$1.20	76	$36.33
9	$0.16	43	$1.29	77	$40.17
10	$0.16.	44	$1.40	78	$44.33
11	$0.19	45	$1.53	79	$49.23
12	$0.24	46	$1.67	80	$54.56
13	$0.28	47	$1.83	81	$60.51
14	$0.33	48	$1.98	82	$66.74
15	$0.38	49	$2.13	83	$73.07
16	$0.52	50	$2.30	84	$80.35
17	$0.57	51	$2.52	85	$88.76
18	$0.59	52	$2.81	86	$99.16
19	$0.61	53	$3.20	87	$110.40
20	$0.62	54	$3.65	88	$121.85
21	$0.62	55	$4.15	89	$133.40
22	$0.64	56	$4.68	90	$144.30
23	$0.66	57	$5.20	91	$155.80
24	$0.68	58	$5.66	92	$168.75
25	$0.71	59	$6.06	93	$186.44
26	$0.73	60	$6.51	94	$206.70
27	$0.76	61	$7.11	95	$228.35
28	$0.80	62	$7.96	96	$250.01
29	$0.83	63	$9.08	97	$265.09
30	$0.87	64	$10.41	98	$270.11
31	$0.90	65	$11.90	99	$281.05
32	$0.93	66	$13.51		
33	$0.96	67	$15.20		

Source: IRS Notice 2001-10; https://www.irs.gov/pub/irs-drop/n-01-10.pdf

Death of Participant Prior to Retirement

If the participant/insured dies prior to retirement, the life insurance's death benefit and the other account will be paid to the named beneficiary. This is where the greatest downside associated with life insurance in a 401(k) plan (or any DC plan or DB plan for that matter) surfaces. The death benefit in excess cash value is tax-free income, but the amount attributable to the cash value less the participant/insured's basis in the contract is taxable income to the beneficiary. The income taxation of an insured death benefit paid to the participant's beneficiary is as follows:

- The death benefit less any cash value is income tax-free to a participant's beneficiary;
- The total of all economic benefit costs paid by the participant can be recovered tax-free from the cash value part of the death benefit; and
- The remainder of the distribution is taxed as a qualified plan distribution;

Contrast this to the situation where the insured owned the life insurance personally: the death benefit would have been entirely income tax-free. Again, some clients may consider this a relatively small cost to pay for life insurance purchased with tax-deductible dollars.

From an estate tax perspective, the death benefit paid under the plan, including the life insurance, will be included in the decedent's estate if the decedent-insured possessed any incidents of ownership in the policy [Rev. Rul. 82-199]. Under IRC Section 2042, incidents of ownership include the ability to:

- Name or change the beneficiary;
- Surrender the policy;
- Pledge policy cash values; or
- Borrow against the policy.

Thus, the qualified plan death benefits are generally includible in the participant's taxable estate for federal estate tax purposes if they possessed any of these incidents of ownership at death or received a distribution of the policy and transferred it by gift within the three years before death (IRC § 2035). To the extent the beneficiary is either the deceased participant's spouse or a qualified charity, the estate should be entitled to an offsetting estate tax deduction.

Distribution Options at Retirement or Termination

Upon retirement or termination of the plan, the participant has the following options:

- *Option 1–Cash-out (Surrender) the Policy.* Direct the plan trustee to surrender the policy and distribute its fair market value along with other funds in the account as a lump sum. Because the policy no longer exists following surrender, immediate tax on the distribution can be avoided by rolling over the distributed funds to an IRA;
- *Option 2–Direct the plan trustee to distribute the policy to him or her*. The life insurance policy is distributed to the participant directly from the 401(k) plan and the participant (insured) continues to maintain the policy on a non-qualified basis. At the time of the

distribution income tax is due on the fair market value of the policy less the accumulated one year term (P.S. 58) costs;

- *Option 3–Exchange the Policy.* Several carriers have an exchange option feature allowing the policy inside the plan to be exchanged for a new policy outside the plan. The participant's insurability will remain the same as that of the 401(k) policy, regardless of the participant's current health;
- *Option 4–Purchase the policy from the trustee*. The life insurance policy is purchased for its FMV. The assets of the plan are not depleted; the insurance is maintained outside of the plan unchanged. This purchase is not a taxable event. However, this requires the participant to come up with the value of the policy out of pocket. Still, this may be a small price to pay if the participant needs the insurance and/or is uninsurable due to health problems. One concern with purchasing the policy from the plan is that the purchase could be construed as a prohibited transaction (discussed below) if the client is an owner or executive of the company. Fortunately, a prohibited transaction exemption is available so long as the client files the appropriate paperwork; and
- *Option 5–Transfer to an Insurance Trust (ILIT).* An irrevocable life insurance trust (ILIT) is created. The trust purchases the policy from the 401(k) plan. The dollars used to purchase the policy roll over to the participant's IRA while the policy itself transfers to the insurance trust. Properly structured, the policy proceeds will be income and estate tax-free. Or the ILIT could purchase the policy from the profit-sharing plan using regulations included in Rev. Proc. 2005-25 (discussed below).

The next major question is how to determine the *"fair market value"* of the life insurance policy.

Determining Fair Market Value

Theoretically, fair market value (FMV) is the standard of value used for federal estate and gift purposes. FMV is generally defined as the price at which a property would change hands between a willing buyer and willing seller, with neither under compulsion to buy or sell and both having reasonable knowledge of the relevant facts. When conducting an FMV analysis of a particular asset, valuation experts will typically use market, asset, or income approaches. Other than instances in which cash surrender value is used, it doesn't appear as though insurance companies pay attention to FMV in their efforts to value life insurance policies. This disconnect may provide a legitimate opportunity to dispute high valuation numbers:

- *Market approach.* A valuation expert will consider pricing and financial metrics of market transactions involving similar policies to estimate the value of the subject policy. The availability of relevant transaction information is critical to the process. Currently, no transparent market discloses important details of life insurance policy transactions. Consequently, use of the market approach is difficult to employ;
- *Asset approach.* A valuation expert will typically consider the subject policy's liquidation value or replacement cost. FMV will generally be the premiums paid to date for newly issued policies. For one-time, single premium policies that are paid up, the value of the policy will be an estimate by the insurance carrier of the replacement cost of an identical policy. For policies that have been in force for some time and on which additional

premiums are due, the greater of the CSV, ITR, or PERC methods may be relevant (discussed below). In certain circumstances, it may be beneficial to retain a valuation expert to value the insurance policy when the number provided by the insurance company is substantially greater than the CSV. This approach may permit the opportunity to challenge some of the analytical assumptions used by the insurance company to determine the ITR or PERC value; and

- *Income approach.* A valuation expert will model the future cash flows of the policy and discount them back to the valuation date using an appropriate risk-adjusted discount rate. Life insurance policies are financial instruments with characteristics and features that lend themselves to valuation using the income approach. Like many other types of financial instruments, life insurance policies require a stream of payments, have a cash reserve value, pay dividends and/or interest, are subject to tax consequences and provide a terminal payment. Each of these characteristics may affect the projected cash reserves, premium payments, dividends, interest income, income tax, capital gains tax, and the eventual net death benefit.

Each policy has a unique set of characteristics, including the timing of cash receipts and payments and the insured's expected remaining life and the insurance carrier's credit quality. In other words, a life insurance policy is an illiquid financial instrument with characteristics that a valuation expert can model to determine FMV.

Next, let’s review the various valuation methods used to calculate the FMV of a life insurance policy.

Life Insurance Valuation

Often, the value of a life insurance policy becomes an issue when there’s a contemplated or actual transfer of a policy. The transfer may involve an estate or gift matter or moving a policy to an irrevocable life insurance trust (ILIT), as was discussed above. When an estate or gift matter is involved, the Internal Revenue Service (IRS) requires that IRS Form 712 Life Insurance Statement be included in the returns. This form is a statement prepared by an insurance company that provides policy values as of the date of transfer. So, a trustee or advisor will likely request an IRS Form 712 from the subject insurance company.

Life insurance companies and valuation experts currently use various methods and analytical assumptions to determine the value of life insurance policies. These tools can have a material effect on the value of the policy. Consequently, advisors and trustees need to have a basic understanding of the various techniques used in life insurance valuation, including Form 712 policy valuations.

In general, insurance companies estimate the FMV of life insurance policies using one of the following three methods:

- Cash surrender value (CSV);
- Interpolated terminal reserve (ITR); or
- Premiums plus earnings less reasonable charges (PERC).

Let’s review each of these FMV methods in greater detail.

Cash Surrender Value (CSV)

The CSV is the policyholder's value to surrender their policy to the insurance carrier and receive cash back. Insurance companies will often reduce the CSV for surrender charges.

> ***For Example*:** If a policy shows cash or accumulated value of $5,000 and a surrender value of $3,000, the carrier has reduced the CSV for surrender charges of $2,000 for early cancellation. If the CSV doesn’t reflect surrender charges, an advisor or trustee may wish to inquire about whether surrender charges are applicable to the subject policy.

Once a policyholder cancels and surrenders the policy, most insurance companies pay out the net CSV within a few weeks. However, many states allow insurance companies to defer payment for up to six months after cancellation. If this is the case, a valuation discount for the lack of liquidity of the CSV may be appropriate.

Interpolated Terminal Reserve (ITR)

Interpolated terminal reserve (ITR) is the most common method for valuing life insurance policies. Insurance companies typically use this method when the valuation date falls between the anniversary dates of the subject policy. Whenever a policy must be valued on other than its anniversary date, the reserve value must be “approximated” (that is, interpolated). This worked fine for Whole life (WL). The reserve value at the next anniversary date is known in advance for a WL policy, so the terminal reserve value can be “interpolated” to reflect a valuation before the next anniversary date. The analysis involves making a pro-rata adjustment between the previous terminal reserve and the subsequent terminal reserve, plus the unearned premiums paid during the partial period. The terminal reserve of a policy is essentially the amount that–when combined with future premiums and investment income–will pay the future maturities (death benefit) of the policy computed using mortality rates and an assumed dividend or interest rate.

However, the constantly evolving landscape of insurance policy types has left room to interpret the primary components used in the ITR method. For example, variable universal life (VUL) policies have valuation issues related to future reserve value because stock or bond market performance can affect the investment return of these policies. Consequently, the insurance company doesn’t know the terminal reserve value until the next anniversary date.

In addition, the definition of “*reserve*” used in the analysis can materially affect the value of a life insurance policy. That definition is subject to different calculations and interpretations, including:

- Statutory reserve;
- Tax reserve used for federal tax reporting;
- Actuarial Guideline 38 Reserve; and
- Deficiency reserve.

It's important to obtain and understand the definition of "reserve" used by the insurance carrier and ascertain its impact on the estimated value of the policy.

Premiums, Earnings, and Reasonable Charges (PERC)

The PERC method is generally calculated as follows:

- Premiums paid from the date of issue;
- Plus, dividends used to purchase paid-up insurance prior to the valuation date;
- Plus, amounts credited to the policyholder from premiums and interest;
- Minus reasonable mortality charges and other charges; and
- Minus distributions, withdrawals, or partial surrenders taken prior to the valuation date.

According to Revenue Procedure 2005-25 (discussed below), the general rule is to value the policy at the greater of the ITR or PERC. Other language in the Treasury regulations appears to leave the door open for alternate life insurance policy valuation methods for federal tax-related matters, such as estate and gift.

Rev. Rul. 2005-25

In reaction to perceived abuses in undervaluing policies, the IRS issued Revenue Procedure 2005-25, which applies to qualified plan distributions (IRC § 402), employer distributions to service providers (IRC § 83), and distribution of permanent group term policies (IRC § 79). Rev. Proc. 2005-25 provides guidance on how to determine the FMV of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection for purposes of applying the rules of IRC §§§ 79, 83, and 402. It provides two safe harbor formulas that, if used to determine the value of an insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection that is distributed or otherwise transferred from a qualified plan, will meet the definition of fair market value.

FMV of Non-Variable Insurance Contracts

The FMV of a non-variable insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection may be measured as the greater of:

- *Formula Option A:* The sum of the interpolated terminal reserve (ITR) and any unearned premiums plus a pro-rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience, (This formula resembles the one commonly used in the gift tax valuation context under Reg. 25.2512-6.); or
- *Formula Option B:* The result of multiplying the PERC amount (the amount described in the following sentence based on Premiums, Earnings, and Reasonable Charges) by the applicable Average Surrender Factor (ASF).

Note: In the case of Universal Life (UL) contracts, since there is no interpolated terminal reserve (ITR), the "A" option will not be available, and this forces the use of the "B" option. In other words, there is no substitute for "interpolated terminal reserve."

FMV of Variable Insurance Contracts

If the insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection being valued is a variable contract, the fair market value may be measured as the greater of:

- *Formula Option A:* The sum of the interpolated terminal reserve and any unearned premiums plus a pro-rata portion of a reasonable estimate of dividends expected to be paid for that policy year based on company experience; or
- *Formula Option B:* The product of the variable PERC amount (the amount described in the following sentence based on premiums, earnings, and reasonable charges) and the applicable Average Surrender Factor described below.

The variable PERC amount is the aggregate of:

- The premiums paid from the date of issue through the valuation date without reduction for dividends that offset those premiums; plus
- Dividends applied to increase the value of the contract (including dividends used to purchase paid-up insurance) prior to the valuation date; plus (or minus)
- All adjustments (whether credited or made available under the contract or to some other account) that reflect the investment return and the market value of segregated asset accounts; minus
- Explicit or implicit reasonable mortality charges and reasonable charges (other than mortality charges), but only if those charges are actually charged on or before the valuation date, and those charges are not expected to be refunded, rebated, or otherwise reversed at a later date; and minus
- Any distributions (including distributions of dividends and dividends held on account), withdrawals, or partial surrenders taken prior to the valuation date.

Average Surrender Factor

The *Average Surrender Factor* (ASF) for purposes of IRC Code §§§ 79, 83, and 402(b) (for which no adjustment for potential surrender charges is permitted) is 1.00. In other words, no adjustment for potential surrender charges is permitted with respect to IRC §§§ 79, 83, and 402 (b).

As noted above, in the case of a distribution or sale from a qualified plan, if the contract provides for explicit surrender charges, the *Average Surrender Factor* is the unweighted average of the applicable surrender factors over the 10 years beginning with the policy year of the distribution or sale. For this purpose, the ASF for a policy year is equal to the greater of:

- 70%; or

- Projected amount of cash that would be available if the policy were surrendered on the first day of the policy year) / (Projected (or actual) PERC amount as of that same date). (In the case of the policy year of the distribution or sale, use in place of the projected amount the amount of cash that was actually available on the first day of that policy year. If there is no surrender charge, the applicable surrender factor for a year is 1.00).

To further prevent abuse, a surrender charge is permitted to be considered only if it is contractually specified at issuance and expressed in the form of non-increasing percentages or amounts.

The fraction's numerator is the amount remaining after surrender charges are deducted.

> ***For Example***: If the PERC amount was $100,000 and the surrender charge was $20,000, the numerator would be $80,000. Since the fraction is the proportion, the amount received after surrender ($80,000) bears to the PERC amount ($100,000), the fraction would be $80,000/$100,000, i.e., .8. Here, the fraction is greater than the alternative factor, .7, so it becomes the ASF. However, if the surrender charge were much larger, for instance, $40,000, the result of subtracting $40,000 from $100,000 would be $60,000, and the fraction would be $60,000/$100,000, i.e., .6, and the alternative factor would be chosen. So if the amount received is reduced to .7 or less of what it would have been, the fair market value is .7; if not, it is whatever is received.

The ASF is the non-weighted average of ten years of applicable surrender factors from the year of distribution. If there is no surrender charge in a given year, the applicable surrender factor is 1. And as noted above, surrender charges can be considered only if the surrender charge is contractually specified at issuance and expressed in the form of non-increasing percentages or amounts.

This, of course, is to prevent the use of springing cash value contracts. At this point, the ASF is multiplied by the PERC amount. It is then measured against the "A" formula (interpolated terminal reserve plus premiums plus dividends. The greater of the two must be used as the fair market value of the insurance contract.

The 2005 Rev. Proc. requires that the two formulas be interpreted in a "reasonable manner," consistent to identify the fair market value of a contract. For instance, if income is calculated with respect to premiums paid under the contract, that amount must be included in the formulas, even if the income can only be realized through an exchange right that gives rise to a springing cash value under another policy. Similarly, if a mortality charge or other amount charged under a contract can be expected to be directly or indirectly returned to the contract holder (whether through the contract, a supplemental agreement or under a verbal understanding and regardless of whether there is a guarantee), the charge is not permitted to be subtracted under the formulas. In addition, a surrender charge cannot be considered in determining an ASF if it may be waived or otherwise avoided or created for transfer or distribution purposes.

Furthermore, at no time are these rules to be interpreted in a manner that allows the use of these formulas to understate the FMV of the life insurance contracts and associated distributions or transfers.

> ***For Example:*** If the insurance contract has not been in force for some time, the value of the contract is best established through the sale of the particular insurance contract by the insurance company (i.e., as the premiums paid for that contract).

In the case of a distribution or sale of a contract from a qualified plan, the date the FMV is to be determined is the date of that distribution or sale. The date of determination in the provision of permanent benefits subject to IRC § 79 is when those benefits are provided. The date of determination in the case of a transfer of an insurance contract subject to IRC § 83 is the date on which fair market value must be determined under the rules of IRC § 83. The date of determination in the case of a non-exempt employees' trust under IRC § 402(b) is the date on which fair market value must be determined under IRC § 402(b) rules.

If a loan (including a loan secured by the cash value of a life insurance contract) is made to an employee or other service provider in connection with the performance of services, to the extent the debt owed by the employee or other service provider is terminated upon distribution or transfer of the collateral, the terminated loan or debt amount constitutes an additional distribution to the employee or service provider at that time. For this purpose, it is irrelevant whether the loan is described as having been forgiven, canceled, satisfied, extinguished, or otherwise offset, provided that the loan no longer exists after the distribution or transfer.

Let's assume, for example, that a life insurance contract has an FMV of $100,000 (without regard to any debt). The policy serves as collateral for a policy loan of $30,000 (borrowed by the employer, who then lends the $30,000 to the employee) prior to the distribution or transfer of the contract. If the loan to the employee no longer exists after the distribution or transfer so that the amount distributed is $70,000 ($100,000-$30,000), the entire $100,000 must be considered by the employee. If a participant receives a loan from a life insurance contract held by a qualified plan (or another plan subject to the rules of IRC § 72(p)) and the contract is subsequently distributed to the participant in satisfaction of the participant's benefit under the plan, the reduction in the value of the distribution in order to repay the participant's loan from the plan constitutes a plan loan offset amount, which is treated as a distribution from the plan.

The bottom line is that, by introducing a minimum of 0.7 for the ASF and by measuring the ASFs for a period of 10 years beginning in the year of the sale or distribution, most, if not all, gimmicks will be eliminated. In addition, the IRS has strengthened the "fair market value" standard by targeting three "innovative" techniques (exchanging the existing policy for a new springing cash value policy, refunding mortality charges, and waiving surrender charges) and by not allowing the rules to be interpreted in a way that would understate fair value.

The Treasury regulations provide that FMV is determined by applying the "willing buyer-willing seller" rule for estate and gift tax purposes. Before 2000, there was no secondary market for the sale of life insurance policies. Even with the advent of this new market, it's often limited to sales of policies by older, less healthy insureds; this market is generally unavailable to many insureds.

The estate and gift tax regulations indicate that the value of a policy is based on the cost of a hypothetical "comparable contract." For newly issued policies, the value is the cost of the policy (that is, premiums paid). For one-time, single premium policies that are "paid up," the value is the carrier’s current cost for an identical policy. For policies in force for some time on which additional premiums are due, the regulations say that the FMV of the policy can be “approximated” by using the ITR amount plus unearned premiums unless this method isn’t reasonably close to full value (for example, the insured is terminally ill).

Unisex Rates

If there is any situation where sex discrimination seems to be justified, it is in the pricing of life insurance and related products. Women live longer than men on average. Therefore, it is cheaper for an insurance company to insure a woman's life because the benefits will be paid out later, and the present value of the payoff is lower. Thus, the insurance industry and numerous commentators have argued that to charge men and women of the same age the same price for life insurance would constitute a subsidy running from women (who would pay too much) to men (who would pay too little). As a result, men would buy too much insurance, and women would buy too little.

Similarly, an annuity should cost more for a woman than for a man because the longer an annuitant is likely to live, the more costly it is for the insurance company to pay the annuity. Women would buy too much in annuities with unisex pricing and men would buy too little. Or so the argument goes.

Despite this compelling argument, the Supreme Court of the United States (SCOTUS) has held that gender-based insurance rates constitute illegal sex discrimination in connection with employer-sponsored pension programs. First in 1978, with *City of Los Angeles, Department of Water and Power v. Manhart* (435 U.S. 702), and then in 1983, *Arizona Governing Committee for Tax Deferred Annuity and Deferred Compensation Plans v. Norris* (463 U.S. 1073).

Both SCOTUS rulings prohibit insurance companies from taking into consideration gender when developing insurance classifications, rates or types of coverage for certain types of insurance. When unisex rates apply, all people, regardless of gender, must be given the same rates and types of coverage.

Prohibited Transaction Rules

Another important issue involves prohibited transactions. ERISA generally prohibits transactions between a qualified plan and a party in interest even if the transaction is at arm’s length and for fair market value. A party in interest includes the following:

- The Employer;
- The Participant;
- A fiduciary of the plan; or
- A relative of any of the above or a corporation or other entity owned more than 50 percent of any of the above.

Fortunately, the DOL (which administers ERISA) has granted several exemptions to the prohibited transactions rule.

In 1977 an exemption was granted for sales of individual life insurance policies owned by the plan. This exemption was updated and clarified in Private Transaction Exemptions (PTE) 92-6. This exception permits the sale of a policy by a qualified plan if several conditions are met:

- Policy must first be offered to the participant before it can be sold to any other party;
- Plan can only sell the policy if it would otherwise be surrendering it;
- Sale must produce cash proceeds to the plan at least equal to what it would have realized upon a surrender of the policy; and
- Sale must be to:
    - Plan participant insured under the policy;
    - Relative of such participant who is a beneficiary under the policy;
    - Employer whose employees are covered by the plan; or
    - Another employee benefit plan.

PTE 92-6 has been updated in Advisory Opinion 98-07A and Advisory Opinion 2006-03A. These updates permit the sale of a second-to-die policy insuring the participant and their spouse to an ILIT created by the participant.

Bottom Line

Life insurance in a DC plan is not for everyone, but it can be for those clients (especially small business owners) needing large amounts of life insurance; the cost can be made more affordable with tax-deductible dollars.

Chapter 11
Review Questions

1. What is the table used to determine the taxable portion of the premium paid for an individual life insurance contract inside a 401(k) plan?

( ) A. P.S. 38
( ) B. P.S. 58
( ) C. P.S. 68
( ) D. P.S. 28

2. According to the IRS, the percentage test of the "*incidental death benefit rule*" requires premiums for life insurance to be less than what percent of the contributions for the participant?

( ) A. 25%
( ) B. 70%
( ) C. 40%
( ) D. 50%

3. To be considered incidental, the aggregate total premiums paid for a term or universal life insurance policy must be what percent or less of the aggregate employer contributions and forfeitures allocated to the account over time?

( ) A. 25%
( ) B. 50%
( ) C. 75%
( ) D. 40%

4. The Average Surrender Factor (ASF) is the unweighted average of the applicable surrender factors over how many years, beginning with the policy year of the distribution or sale?

( ) A. Five
( ) B. Ten
( ) C. Two
( ) D. Seven

5. Which of the following would NOT be considered "a party in interest"?

( ) A. The Employer
( ) B. The Participant
( ) C. Accountant who is not a fiduciary of the plan
( ) D. A fiduciary of the plan

CHAPTER 12

REPORTING AND DISCLOSURE REQUIREMENTS

Overview

Under ERISA § 101 through 111, employers (plan sponsors) with extensive reporting and disclosure requirements to be made to plan participants and beneficiaries and report plan information to governmental agencies. Some of the reporting and disclosure requirements provide that certain materials must be disseminated or made available to participants and beneficiaries at reasonable times and places. Other requirements arise only upon the written request of a plan participant or beneficiary or the occurrence of a specific event.

This chapter will examine those required reporting and disclosure documents. It will begin with the types of disclosures required and then list the various documents that must be disclosed to participants and beneficiaries. The end of the chapter will discuss the specific reporting requirements for plans sponsors to report to the government.

Learning Objectives

Upon completion of this chapter, you will be able to:

- List the reporting and disclosure requirements required by plans sponsors as set forth by the DOL and IRS; and
- Describe the required plan sponsor reporting requirements to governmental agencies as set forth in Title I of ERISA.

Reporting and Disclosure

ERISA § 2(b) states that it is the policy of ERISA:

> "…*to protect. the interests of plan participants and their beneficiaries by requiring disclosure and reporting of financial and other information*."

ERISA requires three different types of disclosures. First, certain material must be provided to participants at stated times or if certain events occur. Second, the plan administrator must provide certain material to participants upon request. Finally, the plan administrator must make certain material available to participants for inspection at reasonable times and places.
Below is a list of documents required to be made available to participants and beneficiaries at a stated time or upon certain events. They are:

- Summary Plan Description (SPD);
- Summary of Material Modification (SMM);
- Summary of Annual Report (SAR);
- Notice of Preretirement Survivor Benefit;
- Notice of Joint and Survivor Benefit;
- Notice of Terminated Vested Participants; and
- Notice of Freedom to Divest Employer Securities.

Plan disclosure documents keep participants informed about the basics of plan operation, alert them to changes in the plan's structure and operations, and provide them a chance to make decisions and take timely action about their accounts (Table 12.1).

Methods of Complying with the Disclosure Requirements

If reports, statements, notices, and other documents are required to be furnished, either automatically or upon request, the documents must be current, readily accessible, and clearly identified. Sufficient copies must be available to accommodate the expected number of inquiries.

The documents do not have to be maintained at each employer establishment, union hall, or office but must be available at any such location within ten (10) calendar days after the day on which a request for disclosure is made. A plan administrator that sets out a procedure to request such plan documents and communicates it to plan participants does not have to comply with requests that do not follow that procedure. The procedure must allow requests to be made reasonably convenient to the plan administrator and at each location where the documents must be made available. Under DOL Reg. § 2520.104b-1(b) (3), if a reasonable procedure has not been established, a good faith effort to request examination of plan documents will be considered a request to the plan administrator.

For other documents required to be furnished to plan participants and beneficiaries, the plan administrator must use measures reasonably calculated to ensure actual receipt of the material by the plan participants, beneficiaries, and other specified individuals. Material required to be furnished to all participants and beneficiaries receiving benefits must be sent by a method likely to result in full distribution. In-hand delivery to an employee at their worksite is sufficient, while simply placing copies in a location frequented by participants is not [DOL Reg. § 2520.104b-1(b) (1)]. If a participant or beneficiary makes a written request for materials, they must be mailed to an address provided by the requesting participant or beneficiary or personally delivered to the participant or beneficiary [DOL Reg. § 2520.104b-1(b) (2)].

Electronic Delivery

The Department of Labor (DOL) and the Internal Revenue Service (IRS) have separate rules for disclosing certain retirement plan information. The DOL has established safe-harbor rules for all retirement plans covered by ERISA.

The DOL safe-harbor rules apply to the following:

- Summary plan descriptions (SPDs).
- Summary of material modifications (SMMs).
- Summary annual reports (SARs).
- Notices required by the Sarbanes-Oxley Act when a blackout – defined as a suspension of participants' and beneficiaries' rights to diversify or direct investments, or obtain a loan or distribution – will last for three consecutive business days or more.
- Individual benefit statements.
- Investment-related information in participant-directed individual account plans that intend to comply with ERISA section 404(c).
- Qualified domestic relations order (QDRO).
- Notifications Information that ERISA requires to be furnished or made available upon participant or beneficiary request; and
- Participant fee disclosures are intended to comply with ERISA section 404(a)(5).

The DOL requirements for electronic delivery are:

- Style, format, and content.
- Delivery.
- Notice.
- Confidentiality; and
- Consent.

As you can see, the electronic delivery of notices, reports, and documents involves more than sending to a participant as an email with an attachment. It is important that plan sponsors have adequate procedures and processes to ensure they satisfy these requirements.

Summary Plan Description (SPD)

As a mechanism for informing plan participants of the terms of the plan and its benefits, ERISA requires that plan administrators furnish a *summary plan description* (SPD). An SPD is a written summary of the provisions of an employee benefit plan that contains the terms of the plan and the benefits offered. Under ERISA § 102(a), the SPD must be written in a manner that can be understood by the average plan participant and be sufficiently accurate and comprehensive to reasonably apprise participants and beneficiaries of their rights and obligations under the plan.

Contents of the SPD

The SPD must include the following information:

- The name of the plan and, if different, the name by which the plan is commonly known by its participants and beneficiaries [DOL Reg. § 2520.102-3(a)].
- The name and address of the employer or employee organization maintaining the plan [DOL Reg. § 2520.102-3(b)].

- The name, business address, and business phone number of the plan administrator [DOL Reg. § 2520.102-3(f)].
- For a collectively bargained plan established or maintained by one or more employers and one or more employee organizations, detailed information about the employers and organizations involved and that additional information will be provided upon written request and is available for inspection [DOL Reg. § 2520.102-3(b)(3)].
- In the case of a plan established or maintained by two or more employers, the association, committee, joint board of trustees, parent or most significant employer of a group of employers all of which contribute to the same plan, or other similar representative of the parties who established or maintain the plan, and how additional information can be obtained [DOL Reg. § 2520.102-3(b)(4)].
- The plan's Employer Identification Number (EIN) and the plan number assigned by the plan sponsor [DOL Reg. § 2520.102-3(c)].
- The type of pension plan [DOL Reg. § 2520.102-3(d)].
- The type of administration of the plan, e.g., contract administration, insurer administration, etc. [DOL Reg. § 2520.102-3(e)].
- The plan's designated agent for service of legal process, and the address at which process may be served on such person, and a statement that service of legal process may be made upon a plan trustee or the plan administrator [DOL Reg. § 2520.102-3(g)].
- The name, title, and address of the principal place of business of each trustee of the plan [DOL Reg. § 2520.102-3(h)].
- If a plan is maintained pursuant to one or more collective bargaining agreements, a statement that the plan is so maintained, and how a copy of any such agreement may be obtained or examined by participants and beneficiaries [DOL Reg. § 2520.102-3(i)].
- The plan's requirements for eligibility for participation and for benefits, including any condition that must be met before a participant is eligible to receive benefits and circumstances that could result in the participant not receiving benefits, they might expect based on the SPDs description of benefits [DOL Reg. § 2520.102-3(j)].
- Any joint and survivor benefits provided under the plan, including any requirements that an election is required to select or reject the joint and survivor annuity [DOL Reg. § 2520.102-3(k)].
- The participant's rights to self-direct the investment of their account and whether the plan is designed to qualify for the exception to the ERISA fiduciary duties for accounts directed by the participant [DOL Reg. § 2550.404c-1(b)(2)(i)(B)].
- A statement that the plan benefits are not insured by the Pension Benefit Guaranty Corporation and the reason why [DOL Reg. § 2520.102-3(m)].
- A description and explanation of the plan provisions for determining years of service for eligibility to participate, vesting and breaks in service, and years of participation for benefit accrual. It must include the service required to accrue full benefits and the manner in which accrual of benefits is prorated for employees failing to complete full service for a year [DOL Reg. § 2520.102-3(n)].
- The source of contributions to the plan–for example, employer, employee organization, employees–and the method by which the amount of contribution is calculated [DOL Reg. § 2520.102-3(p)].

- The identity of any funding medium used for the accumulation of assets through which benefits are provided. The SPD must identify any insurance company, trust fund, or any other institution, organization, or entity that maintains a fund on behalf of the plan or through which the plan is funded, or benefits are provided [DOL Reg. § 2520.102-3(q)].
- The date that the plan's fiscal year ends [DOL Reg. § 2520.102-3(r)].
- The procedures governing claims for benefits, including filing claim forms, providing notification of benefits determinations, and reviewing denied claims, time limits, and remedies for appealing denied claims [DOL Reg. § 2520.102-3(s)]; and
- A statement of ERISA rights, containing information included in a model statement provided in the regulations. It may include an explanatory and descriptive provision in addition to the model statement provisions. The statement must comply with the SPD style and format rules. The plan may mention certain rights elsewhere in the SPD, but the statement of ERISA rights must appear as one consolidated statement [DOL Reg. § 2520.102-3(t)(1)].

A plan may delete any item that does not apply [DOL Reg. § 2520.102-3(t) (2)].

Timely Delivery of the SPD

The SPD must be provided to each participant and beneficiary of the plan on or before the later of:

- 90 days after an employee becomes a participant or a beneficiary first receives benefits; or
- Within 120 days after the plan becomes subject to ERISA's reporting and disclosure requirements [DOL Reg. § 2520.104b-2(a) (3)]. This is generally the first day an employee is credited with an hour of service. Special rules apply to plans that have prospective or retroactive effective dates [DOL Reg. § 2520.104b-2(a)(3)].

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Under DOL Reg. § 2520.104b-2(b)(1), an updated SPD must be provided every five years if any plan amendments were made since the last SPD was provided. Even if no amendments were made to the plan, a new SPD must be provided every 10 years [DOL Reg. § 2520.104b-2(b)(2)].

Summary of Material Modification

Under ERISA § 104(b) (1), a plan administrator must provide a S*ummary of Material Modification* (SMM) in the terms of the plan as well as any change in the information required to be included in the SPD. This summary must be provided, in most cases, within 210 days after the close of the plan year in which the modification was adopted and also must be furnished to the Labor Department upon request. Similar to the SPD, the materials must be written in a manner that can be understood by the average plan participant [DOL Reg. § 2520.104b-3(a)]. While ERISA does not define "material modification" and does not specifically cover what changes warrant an SMM, courts have addressed this issue. Courts have held plan amendments such as the establishment and elimination of benefits are material modifications. However, as courts have also pointed out, not all plan amendments are material modifications.

Timely Delivery of the SMM

The SMM is required to be provided to participants and beneficiaries of the plan within 210 days after the close of the plan year in which the modification or change occurred, regardless of the change's effective date. Changes that are retroactive to a prior year do not affect the disclosure date. Under DOL Reg. § 2520.104b-3(a), an SMM is not required if the material modification or change does not take effect, whether it is rescinded or otherwise.

No SMM is required if a plan incorporates the material modification or changes in a timely SPD [DOL Reg. § 2520.104b-3(b)]. However, when an SPD is furnished, it must be accompanied by all SMMs that are required to be included in the SPD but that are not reflected in the SPD furnished [DOL Reg. § 2520.104b-3(c)].

Summary Annual Report (SAR)

ERISA § 103 provides that certain employee benefit plans must file an annual report with the Department of Labor. The annual report is considered a primary source of information concerning employee benefit plans' operation, funding, assets, and investments. It is regarded as a compliance and research tool for the DOL and a source of information and data for other federal agencies, Congress, and private groups to assess employee benefit, tax, and economic trends and policies. While the SAR can also be an important disclosure document for plan participants and beneficiaries, participants and beneficiaries must request a copy from the plan administrator.

Contents of the SAR

The SAR must include a detailed financial statement containing information on the plan's assets and liabilities, an actuarial statement, and other information, depending on the type of the plan and the number of participants. Plan administrators must make copies of the annual report available at the principal office of the plan administrator and at other places as may be necessary to make pertinent information readily available to plan participants.

Obligation to Furnish

The SAR must be filed within nine months after the close of a plan's year. The annual report is filed with the DOL on Form 5500 series. In 2006, the DOL published a rule requiring electronic filing of Form 5500 series reports for plan years beginning after January 1, 2008.

Under DOL Reg. § 2520.104b-10(c), if the IRS has granted the plan an extension to file its Form 5500 series with the DOL, the SAR must be filed within two months after the end of the extended filing period.

Individual Benefit Statements

Under ERISA § 105, plan administrators are required to periodically furnish an *individual benefit statement* (IBS) to participants and beneficiaries.

Contents of IBS

An *individual benefit statement (IBS)* shows the total plan benefits earned by a participant, vested benefits, the value of each investment in the account, information describing the ability to direct investments, and (for plans with participant direction) an explanation of the importance of a diversified portfolio.

For plans that allow participants to direct the investments in their accounts, plan and investment information, including information about fees and expenses, must be provided to participants before they can first direct investments and periodically thereafter–primarily on an annual basis with information on the fees and expenses actually paid provided at least quarterly The initial plan-related information may be distributed as part of the SPD provided when a participant joins the plan as long as it is provided before the participant can first direct investments. The information provided quarterly may be included with the IBS.

Timely Delivery of IBS

For 401(k) (and other defined contribution) plans, an IBS must be provided:

- Every calendar quarter to participants and beneficiaries who have the right to direct the investments of the account, or
- Once each calendar year for participants and beneficiaries who have accounts with the plan but do not have control over the investment in the account.

Automatic Enrollment Notice

If a plan automatically enrolls employees, the *Automatic Enrollment Notice* (AEN) details the plan's automatic enrollment process and participant's rights. The notice must specify the deferral percentage, the participant's right to change that percentage or not make automatic contributions, and the plan's default investment. The participant generally must receive an initial notice at least 30 days before they can participate in the plan. Employers that provide for immediate eligibility can provide this initial notice on an employee's first day of employment if they allow participants to withdraw contributions within 90 days of their first contribution. An annual notice also must be provided to participants at least 30 days prior to the beginning of each subsequent plan year.

Blackout Period Notice

The *Blackout Period Notice* requires at least 30 days (but not more than 60 days) advance notice before a 401(k) or profit-sharing plan is closed to participant transactions. During blackout periods, participants (and beneficiaries) cannot direct investments, take loans, or request distributions. Typically, blackout periods occur when plans change.

Notice of Freedom to Divest Employer Securities

The PPA amended the disclosure provisions of ERISA to require plan administrators to provide participants with a notice of their eligibility to divest employer securities held in a defined contribution plan. ERISA § 101(m) requires plan administrators to provide this notice to applicable individuals at least 30 days before the date on which the individual is eligible to divest these securities. The notice must inform the participants that they have the right to direct divestment of the employer securities and be informed of the importance of diversifying the investment of retirement account assets. The notice must be written in a manner that the average plan participant can understand. It may be delivered in written, electronic, or other appropriate form that is reasonably accessible to the recipient.

Reporting to Government Agencies

In addition to the disclosure documents that provide information to participants, plans must also report certain information to government entities.

Annual Return/Report of Employee Benefit Plans

Under IRC § 6058(a) and Treas. Regs. §§§ 101(b)(1), 103, 104, plans are required to file an annual return/report with the federal government, in which information about the plan and its operation is disclosed to the IRS and to the Department of Labor. These reports are made available to the public.

Depending on the number and type of participants covered, the plan must file one of the following forms:

- *Form 5500*, Annual Return/Report of Employee Benefit Plan is generally used for 401 (k) plans that have 100 or more participants.
- *Form 5500-SF*, Short Form Annual Return/Report of Small Employee Benefit Plan can be used by plans that meet the following requirements:
    - Qualify as a small plan; a plan qualifies if it had less than 100 participants at the beginning of the current plan year.
    - Not hold any employer securities at any time during the year;
    - Not be required to have an annual audit.
    - All of its assets held for investment purposes were invested in assets that have a readily determinable market value; and
    - Is not a multi-employer plan.
- *Form 5500-EZ*, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan is generally used by plans that cover only the business owner and their spouse or only

partners and their spouses and does not provide benefits for anyone else. If the total plan assets of the plan and any other one-participant plan maintained by the employer are less than $250,000 at the end of the plan year and it is not the plan's final plan year, no return needs to be filed. If the total assets exceed $250,000, Form 5500-EZ must be filed for all of the employer's one-participating plans, regardless of the amount of a plan's assets.

Form 5500

Under DOL Reg. § 2520.103-1(a) a 401(k) plan covering 100 or more participants can elect a limited exemption or alternative method of compliance. If a plan does not elect a limited exemption or alternative method of compliance, the following information must be provided:

- Financial statements, providing the detail specified in ERISA § 103(b)(3) and an accountant's opinion [ERISA § 103(a)(1)(B)]. Under ERISA § 103(b)(2), the financial statements must include the following:
  - A statement of assets and liabilities;
  - A statement of changes in net assets available for plan benefits, including details of revenues and expenses and other changes aggregated by general source and applications; and
  - In the notes, ERISA directs the accountant to consider disclosures concerning such things as significant changes to the plan during the period and their impact on benefits; the funding policy and any changes to the policy; contingent liabilities; agreements and transactions with persons know to be parties of interest; whether a tax ruling or determination letter has been obtained; and any other matters necessary to present the financial statements fully and fairly.
- The number of employees covered by the plan [ERISA § 103(c)(1)].
- The name and address of each fiduciary [ERISA § 103(c)(2)].
- The name of each person who rendered services to the plan and received compensation from the plan directly or indirectly, the amount of the compensation, and details about the services provided, the relationship to the employer or covered, and any other relationship with any party in interest [ERISA § 103(c)(3)].
- The reason for any change in plan trustee, accountant, insurance carrier, administrator, investment manager, or custodian [ERISA § 103(c)(4)].
- Any financial and actuarial information that the Secretary requires, including the financial statement information described above [ERISA § 103(c)(5)].
- 401(k) and other profit-sharing plans do not have to provide actuarial information [ERISA § 103(d)(A)]; and
- If any benefits under the plan are purchased or guaranteed by an insurance company, the insurer must provide a report with specific information [ERISA § 103(e)].

Plans that elect the limited exemption or alternative method of compliance must include the following information:

- Form 5500 and any statement or schedules to be attached, including:
  - Schedule A (Insurance Information).
  - Schedule C (Service Provider Information).

- Schedule D (Direct Filing Entity (DFE)/Participating Plan Information;
- Schedule G (Financial Transaction Schedules);
- Schedule H ((Financial Information);
- The following financial schedules [(DOL Reg. § 2520-103-10(b)]:
  - Assets held in investments;
  - Assets acquired and disposed within plan year;
  - Party in interest transactions.
  - Obligations in default.
  - Leases in default; and
  - Reportable transactions.
- Separate financial statements (in addition to those described above) if any are prepared for the audit and notes to the financial statement, complying with the requirement of DOL Reg. § § 2520.103-1(b)(3) and 2520.103-1(b)(4) [(DOL Regs. §§ 2520-103-1(b)(2), 2520.103-1(b)(3)].
- Financial statements for the account or trust (if some or all of the plan's assets are held in a pooled separate account maintained by an insurance company or a common or collective trust) [DOL Reg. § 2520-103-1(b)(4)]; and
- The opinion of an independent qualified accountant [DOL Reg. § 2520-103-1(b)(5)] that states:
  - if the audit was made in accordance with generally accepted auditing standards [DOL Reg. § 2520-103-1(b)(5)(ii)];
  - any omitted auditing procedures deemed necessary and the reason for their omission [DOL Reg. § 2520-103-1(b)(5)(ii)];
  - whether the accounting principles were consistently applied between the current year and the preceding year [DOL Reg. § 2520-103-1(b)(5)(iii)];
  - any changes in principles that have a material effect on the financial statements [DOL Reg. § 2520-103-1(b)(5)(iii)]; and
  - a clear identification of any matters to which the accountant takes exception clearly specifying the exception and the effect of the matters subject to the exception on the financial statements, and whether the matters are the result of DOL regulations or otherwise [DOL Reg. § 2520-103-1(b)(5)(iv)].

Form 5500-SF

401(k) plans that qualify to file Form 5500-SF must complete that form and attach any required statements and schedules. One participant plans can file a Form 5500-SF instead of a Form 5500-EZ if they meet the following requirements:

- The plan is a one-participant plan. This means either:
  - The plan only covers the owner (or the owner and their spouse), and the owner (or the owner and their spouse) own the entire business (which may be incorporated or unincorporated; or
  - The plan only covers one or more partners (or partner(s) and spouse(s)) in a business partnership.
- The plan does not provide benefits for anyone except the owner or the owner and their spouse, or one or more partners and their spouses.

- The plan covered fewer than 100 participants at the beginning of the plan year; and
- A plan that does not meet ALL the listed conditions is not a one-participant plan filer eligible to file Form 5500-SF instead of Form 5500-EZ. It must file a paper Form 5500-EZ with the IRS if it meets the first two conditions but does not meet the third condition.

Eligible one-participant plans need to complete only the basic questions about the plan, finances, and operation.

Filing Requirements and Timing

Under IRC § 6058, the plan must file Form 5500, 5500-SF, or 5500-EZ by the last day of the seventh calendar month following the end of the plan year. The plan may be allowed a 2 ½ month extension by filing Form 5558, Application for Extension of Time to File Certain Employee Plan Returns with the IRS [Treas. Reg. § 1.6081-11(a)]; failure to do so subjects the plan to a $25 per day penalty, up to a maximum of $15,000 per return [IRC § 6652 (e)]. In addition, the DOL can impose a penalty of $1,100 per day for failure to file appropriate Form 5500 [ERISA § 502(c)(2) and DOL Reg. §2575.502c-2].

Under DOL Reg. § 2520-104a-2, for plan years beginning on or after January 1, 2009, Form 5500 or 5500-SF and all statements and schedules must be filed electronically using the ERISA Filing Acceptance System (EFAST2). Filers may file online using EFAST2's web-based IFILE filing system, or filers may file through an EFAST2-approved vendor. All delinquent and amended filings of Title 1 plans (includes 401(k) plans) must also be submitted electronically through EFAST2.

Form 5500-EZ cannot be submitted electronically through EFAST2. However, a one-participant plan eligible to file the Form 5500-EZ may elect to file the Form 5500-EZ electronically with EFAST2 rather than filing a Form 500-EZ on paper with the IRS.

IRS Form 1099-R

Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* is used to report distributions (including rollovers) from a retirement plan. It is given to both the IRS and recipients of distributions from the plan during the year.

Table 12.1
Key Information Plan Administrator Must Provide Automatically

What	Description	When
Summary Plan Description (SPD)	A summary version of the plan document and other important plan information, in easier-to-understand language.	Within 90 days of becoming a participant in the plan; and An updated copy every 10 years (5 years if the plan has been amended).
Automatic Enrollment Notice	For plans with automatic enrollment, a description of the automatic enrollment process, the percentage of salary being deferred, the default investment used for automatic contributions, the right to opt out of the plan, the right to change deferral percentage and investments, and how to find information about the plan's other investments.	Generally, at least 30 days before you are eligible to participate; and 30 days before the beginning of each subsequent plan year.
Individual Benefit Statement	Statement providing information about your account balance and vested benefits. Depending on the type of plan you have, the statement may also include the value of the investments in the account and information describing your right to direct investments.	At least quarterly for participant-directed defined contribution plans; At least annually for non-participant-directed defined contribution plans; or At least every 3 years for defined benefit plans.
Plan and Investment Information for Participant-Directed Plans	Plan and investment related information, including information about fees and expenses, so participants can make informed decisions to manage their individual accounts. The investment related information must be provided in a format, such as a chart, that allows for comparison among the plan's investment options.	Before a participant can direct investments for the first time; At least annually thereafter; and At least quarterly for fees and expenses actually paid.
Summary of Material Modifications	A summary of significant plan changes or changes in the information required to be in the SPD.	Within 7 months of the end of the plan year in which the changes were made.

What	Description	When
Summary Annual Report	A summary of financial information filed by the plan on its Form 5500 Annual Return/Report. If your plan is required to provide an annual funding notice, your plan is not required to provide this report.	Within 9 months after the end of the plan year or 2 months after the annual report filing deadline.
Notice of Significant Reduction in Future Benefit Accruals	Notice of any significant reduction in the rate of future benefit accruals, or the elimination of or significant reduction in an early retirement benefit or retirement-type subsidy. Applies to defined benefit plans and certain defined contribution plans.	At least 45 days before the effective date of the plan amendment.
Blackout Notice	Notice of a period of more than 3 consecutive business days when there is a temporary suspension, limitation, or restriction on directing or diversifying plan assets, obtaining loans, or obtaining distributions. Applies to most 401(k) or other individual account plans.	Generally, at least 30 days before the blackout date.
Annual Report (Form 5500)–most recent report	Financial information about the plan that most plans are required to file with the government within 7 months of the end of the plan year.	Reasonable copying charge

Chapter 12
Review Questions

1. Documents do not have to be maintained at each employer establishment, union hall, or office but must be available at any such location within how many calendar days after the day on which a request for disclosure is made?

( ) A. 7 days
( ) B. 10 days
( ) C. 20 days
( ) D. 30 days

2. The Summary Annual Report (SAR) must be within how many months after the close of the plan's year?

( ) A. 3 months
( ) B. 6 months
( ) C. 9 months
( ) D. 12 months

3. The *Blackout Period Notice* requires at least how many days advance notice before a 401(k) is closed to participant transactions?

( ) A. 30 days
( ) B. 45 days
( ) C. 90 days
( ) D. 180 days

4. The *Automatic Enrollment Notice* (AEN) must be provided to the eligible participant at least within how many days before they are eligible to participate in the plan?

( ) A. 7 days
( ) B. 10 days
( ) C. 20 days
( ) D. 30 days

5. Identify which of the following are required to file Form 5500

( ) A. Plans with 100 or more participants at the beginning of the plan years
( ) B. Plans with fewer than 100 participants
( ) C. Solo 401(k) plans
( ) D. All Participant Plans

CHAPTER 13

SECURE 2.0 ACT of 2022

Overview

On December 29, 2022, President Biden signed into law the "Consolidated Appropriations Act (CAA) of 2023, which included a major package (4,155 pages) of retirement savings provisions known as "SECURE 2.0 Act".

As expected, the $1.7 trillion dollar spending bill made its way through the Senate with a final vote of 68-2. The core of the bill consists of provisions needed to fund the operations of the federal government, but Division T is the text of the Setting Every Community Up for Retirement Enhancement (SECURE 2.0) Act., a 358-page package of over 90 retirement and general financial security provisions. Some of these changes will be effective immediately, while other changes will take effect in 2024 or beyond.

In this chapter we will examine some of the key provisions that will affect retirement plans, IRAs, and Roth IRAs.

Learning Objective

Upon completion of this chapter, you will be able to:

- Identify some of the key provisions that will make changes to retirement plans, IRAs, and Roth IRAs.
- Describe the new provisions in Title I of the SECURE 2.0 Act that will expand coverage and increase retirement savings.
- List the new provisions in Title II of the SECURE 2.0 Act that are designed to preserve retirement income.
- Explain the new provisions in Title III of the SECURE 2.0 Act that will simplify and clarify new and existing retirement rules; and
- Describe the new provisions in Title VI of the SECURE 2.0 Act that are designed are revenue producers.

Background

Congress does seem to enjoy unique naming conventions. SECURE Act 2.0 borrows its name from a similar retirement savings initiative former President Donald Trump signed into law in 2019—the Setting Every Community Up for Retirement Enhancement Act (Pub L. 116-94).

The first SECURE Act of 2019 focused mostly on two things: increasing the minimum age when retirement savers must start drawing down on their accounts, and coming up with new, creative ways for retirement plans to pool their resources to reduce the overall cost of setting up and maintaining a workplace plan.

SECURE 2.0 Act of 2022 includes over 92 provisions intended to expand coverage, increase retirement savings, and simplify and clarify retirement plan rules. The retirement package is a consolidation of three bills – the Senate Health, Education, Labor and Pensions Committee's Retirement Improvement and Savings Enhancement to Supplement Healthy Investments for the Nest Egg Act (the RISE & SHINE Act), the Senate Finance Committee's Enhance America's Retirement Now (EARN) Act, and the House Ways and Means Committee's Securing a Strong Retirement Act (the only included bill without a creative acronym).

SECURE 2.0 is intended to build on the Setting Every Community Up for Retirement Enhancement Act of 2019 (the original SECURE Act). The SECURE Act is the less expansive predecessor to SECURE 2.0, ushering in quieter revisions to retirement plan rules, such as raising the age of required minimum distributions (RMDs) and eliminating age limits for traditional IRA contributions. Bolstered by the overwhelming bipartisan support of the SECURE Act, SECURE 2.0 makes even more aggressive changes to retirement plan governance, including key provisions.

Title I: Expanding Coverage and Increasing Retirement Savings

Section 101, Expanding Automatic Enrollment in Retirement Plans

One of the main reasons many Americans reach retirement age with little, or no savings is that too few workers are offered an opportunity to save for retirement through their employers. However, even for those employees who are offered a retirement plan at work, many do not participate. But automatic enrollment in 401(k) plans – providing for people to participate in the plan unless they take the initiative to opt out – significantly increases participation. Since first defined and approved by the Treasury Department in 1998, automatic enrollment has boosted participation by eligible employees generally, and particularly for Black, Latinx, and lower-wage employees. An early study found that adoption of automatic enrollment increased participation in a 401(k) plan by short-tenure Latinx employees from 19 percent to 75 percent. An Ariel/Aon-Hewitt study found that, in plans using automatic enrollment, "[t]he most dramatic increases in enrollment rates are among younger, lower-paid employees, and the racial gap in participation rates is nearly eliminated among employees subject to auto-enrollment." Section 101 requires 401(k) and 403(b) plans to automatically enroll participants in the respective plans upon becoming eligible (and the employees may opt out of coverage). The initial automatic enrollment amount is at least 3 percent but not more than 10 percent. Each year thereafter that amount is increased by 1 percent until it reaches at least 10 percent, but not more than 15 percent. All current 401(k) and 403(b) plans are grandfathered. There is an exception for small businesses with 10 or fewer employees, new businesses (i.e., those that have been in business for less than 3 years), church plans, and governmental plans. Section 101 is effective for plan years beginning after December 31, 2024.

Section 102 Modification of Startup Tax Credit

The 3-year small business startup credit is currently 50 percent of administrative costs, up to an annual cap of $5,000. Section 102 makes changes to the credit by increasing the startup credit from 50 percent to 100 percent for employers with up to 50 employees. Except in the case of defined benefit plans, an additional credit is provided. The amount of the additional credit generally will be a percentage of the amount contributed by the employer on behalf of employees, up to a per-employee cap of $1,000. This full additional credit is limited to employers with 50 or fewer employees and phased out for employers with between 51 and 100 employees. The applicable percentage is 100 percent in the first and second years, 75 percent in the third year, 50 percent in the fourth year, 25 percent in the fifth year – and no credit for tax years thereafter. Section 102 is effective for taxable years beginning after December 31, 2022.

Section 103 Saver's Match

Current law provides for a nonrefundable credit for certain individuals who make contributions to individual retirement accounts ("IRAs"), employer retirement plans (such as 401(k) plans), and ABLE accounts. Section 103 repeals and replaces the credit with respect to IRA and retirement plan contributions, changing it from a credit paid in cash as part of a tax refund into a federal matching contribution that must be deposited into a taxpayer's IRA or retirement plan. The match is 50 percent of IRA or retirement plan contributions up to $2,000 per individual. The match phases out between $41,000 and $71,000 in the case of taxpayers filing a joint return ($20,500 to $35,500 for single taxpayers and married filing separate; $30,750 to $53,250 for head of household filers). Section 103 is effective for taxable years beginning after December 31, 2026.

Section 104 Promotion of Saver's Match

Section 104 directs the Treasury Department to increase public awareness of the Saver's Match to increase use of the match by low- and moderate-income taxpayers. The promotion will make clear that the Saver's Match cannot be withdrawn without incurring penalties, including repayment to the Treasury Department in some cases where the Saver's Match is withdrawn from an individual retirement account before retirement. Taxpayers will have an election to designate a retirement account to receive the repaid Saver's Match. The Treasury Secretary must report to Congress on the Treasury Department's anticipated promotion efforts no later than July 1, 2026.

Section 105, Pooled Employer Plan Modification

Section 105 clarifies that a pooled employer plan ("PEP") may designate a named fiduciary (other than an employer in the plan) to collect contributions to the plan. Such fiduciary would be required to implement written contribution collection procedures that are reasonable, diligent, and systematic. Section 105 is effective for plan years beginning after December 31, 2022.

Section 106, Multiple Employer 403(b) Plans

Multiple employer plans ("MEPs") provide an opportunity for small employers to band together to obtain more favorable retirement plan investment results and more efficient and less expensive management services. The Setting Every Community Up for Retirement Enhancement Act of 2019 ("SECURE Act") made MEPs more attractive by eliminating outdated barriers to the use of MEPs and improving the quality of MEP service providers. Section 106 allows 403(b) plans, which are generally sponsored by charities, educational institutions, and non-profits, to participate in MEPs and PEPs, including relief from the one bad apple rule so that the violations of one employer do not affect the tax treatment of employees of compliant employers. Section 106 is effective for plan years beginning after December 31, 2022.

Section 107, Increase in Age for Required Beginning Date

Under current law, participants are generally required to begin taking distributions from their retirement plans at age 72. The policy behind this rule is to ensure that individuals spend their retirement savings during their lifetime and not use their retirement plans for estate planning purposes to transfer wealth to beneficiaries. The SECURE Act of 2019 increased the required minimum distribution age to 72. Section 107 further increases the required minimum distribution age further to 73 starting on January 1, 2023 – and increases the age further to 75 starting on January 1, 2033.

Section 108, Indexing IRA Catch-Up Limit

Under current law, the limit on IRA contributions is increased by $1,000 (not indexed) for individuals who have attained age 50. Section 108 indexes such limit and is effective for taxable years beginning after December 31, 2023.

Section 109, Higher Catch-Up Limit to Apply at Age 60, 61, 62, and 63

Under current law, employees who have attained age 50 are permitted to make catch-up contributions under a retirement plan more than the otherwise applicable limits. The limit on catch-up contributions for 2025 is $7,500, except in the case of SIMPLE plans for which the limit is $3,500. Section 109 increases these limits to the greater of $10,000 or 50 percent more than the regular catch-up amount in 2025 for individuals who have attained ages 60, 61, 62 and 63. The increased amounts are indexed for inflation after 2025. Section 109 is effective for taxable years beginning after December 31, 2024.

Section 110 Treatment of Student Loan Payments

Section 110 is intended to assist employees who may not be able to save for retirement because they are overwhelmed with student debt, and thus are missing out on available matching contributions for retirement plans. Section 110 allows such employees to receive those matching contributions by reason of repaying their student loans. Section 110 permits an employer to make matching contributions under a 401(k) plan, 403(b) plan, or SIMPLE IRA with respect to "qualified student loan payments." A qualified student loan payment is broadly defined as any indebtedness incurred by the employee solely to pay qualified higher education expenses of the employee. Governmental employers are also permitted to make matching contributions in a section 457(b) plan or another plan with respect to such repayments. For purposes of the nondiscrimination test applicable to elective contributions, Section 110 permits a plan to test separately the employees who receive matching contributions on student loan repayments. Section 110 is effective for contributions made for plan years beginning after December 31, 2023.

Section 111 Application of Credit for Small Employer Pension Plan

Section 111 ensures the startup tax credit is available for 3 years for employers joining a MEP, regardless of how long the MEP has been in existence. Under both pre- and post-SECURE Act law, the startup tax credit only applies for the first 3 years that a plan is in existence. For example, if a small business joins a MEP that has already been in existence for 3 years, the startup credit is not available. If, for example, the MEP has been in existence for 1 or 2 years when a small business joins, the small business may be able to claim the credit for 1 or 2 years, respectively. Section 111 fixes this issue so that employers joining a MEP (which includes PEPs) are eligible for the credit for all 3 years. Section 111 is effective retroactively for taxable years beginning after December 31, 2019.

Section 112 Military Spouse Retirement Plan Eligibility Credit

Military spouses often do not remain employed long enough to become eligible for their employer's retirement plan or to vest in employer contributions. Section 112 provides small employers a tax credit with respect to their defined contribution plans if they (1) make military spouses immediately eligible for plan participation within two months of hire, (2) upon plan eligibility, make the military spouse eligible for any matching or nonelective contribution that they would have been eligible for otherwise at 2 years of service, and (3) make the military spouse 100 percent immediately vested in all employer contributions. The tax credit equals the sum of (1) $200 per military spouse, and (2) 100 percent of all employer contributions (up to $300) made on behalf of the military spouse, for a maximum tax credit of $500. This credit applies for 3 years with respect to each military spouse – and does not apply to highly compensated employees. An employer may rely on an employee's certification that such employee's spouse is a member of the uniformed services. Section 112 is effective for taxable years beginning after the date of enactment of this Act.

Section 113 Small Immediate Financial Incentives for Contributing to a Plan

Under current law, employers may provide matching contributions as a long-term incentive for employees to contribute to a 401(k) plan. However, immediate financial incentives (like gift cards in small amounts) are prohibited even though individuals may be especially motivated by them to join their employers' retirement plans. Section 113 enables employers to offer de minimis financial incentives, not paid for with plan assets, such as low-dollar gift cards, to boost employee participation in workplace retirement plans by exempting de minimis financial incentives from section 401(k)(4)(A) and from the corresponding rule under section 403(b). Section 113 is effective for plan years beginning after the date of enactment of this Act.

Section 114 Deferral of Tax for Certain Sales of Employer Stock to ESOP Sponsored by S Corporation.

Under section 1042 of the Internal Revenue Code ("Code"), an individual owner of stock in a non-publicly traded C corporation that sponsors an employee stock ownership plan ("ESOP") may elect to defer the recognition of gain from the sale of such stock to the ESOP if the seller reinvests the sales proceeds into qualified replacement property, such as stock or other securities issued by a U.S. operating corporation. After the sale, the ESOP must own at least 30 percent of the employer corporation's stock. Section 114 expands the gain deferral provisions of Code section 1042 with a 10 percent limit on the deferral to sales of employer stock to S corporation ESOPs. Section 114 is effective for sales made after December 31, 2027.

Section 115 Withdrawals for Certain Emergency Expenses

Generally, an additional 10 percent tax applies to early distributions from tax-preferred retirement accounts, such as 401(k) plans and IRAs, unless an exception applies. Section 115 provides an exception for certain distributions used for emergency expenses, which are unforeseeable or immediate financial needs relating to personal or family emergency expenses. Only one distribution is permissible per year of up to $1,000, and a taxpayer has the option to repay the distribution within 3 years. No further emergency distributions are permissible during the 3-year repayment period unless repayment occurs. Section 115 is effective for distributions made after December 31, 2023.

Section 116 Allow Additional Nonelective Contributions to SIMPLE Plans

Current law requires employers with SIMPLE plans to make employer contributions to employees of either 2 percent of compensation or 3 percent of employee elective deferral contributions. Section 116 permits an employer to make additional contributions to each employee of the plan in a uniform manner, provided that the contribution may not exceed the lesser of up to 10 percent of compensation or $5,100 (indexed). Section 116 is effective for taxable years beginning after December 31, 2023.

Section 117 Contribution Limit for SIMPLE Plans

Under current law, the annual contribution limit for employee elective deferral contributions to a SIMPLE IRA plan is $16,500 (2025) and the catch-up contribution limit beginning at age 50 is $3,500. A SIMPLE IRA plan may only be sponsored by a small employer (100 or fewer employees), and the employer is required to either make matching contributions on the first 3 percent of compensation deferred or an employer contribution of 2 percent of compensation (regardless of whether the employee elects to make contributions). Section 117 increases the annual deferral limit and the catch-up contribution at age 50 by 10 percent, as compared to the limit that would otherwise apply in the first year this change is effective, in the case of an employer with no more than 25 employees. An employer with 26 to 100 employees would be permitted to provide higher deferral limits, but only if the employer either provides a 4 percent matching contribution or a 3 percent employer contribution. Section 117 makes similar changes to the contribution limits for SIMPLE 401(k) plans. Section 117 is effective for taxable years beginning after December 31, 2023. The Secretary of Treasury shall report to Congress on data related to SIMPLE IRAs by December 31, 2024, and annually thereafter.

Section 118 Tax Treatment of Certain Nontrade or Business SEP Contributions

Section 118 permits employers of domestic employees (e.g., nannies) to provide retirement benefits for such employees under a Simplified Employee Pension ("SEP"). Section 118 is effective for taxable years beginning after the date of enactment of this Act.

Section 119 Application of Section 415 Limit for Certain Employees of Rural Electric Cooperatives

Under current law, section 415 generally limits the amount that may be paid by a pension plan in annual benefits to a participant to the lesser of $245,000 (2022) or 100 percent of the participant's average compensation. Section 119 eliminates the compensation-based limit for participants who are non-highly compensated employees and participate in a rural electric cooperative retirement plan. Section 119 is effective for limitation years ending after the date of enactment of this Act.

Section 120 Exemption for Certain Automatic Portability Transactions

Under current law, an employer is permitted to distribute a participant's account balance without a participant's consent if the balance is under $5,000 and the balance is immediately distributed (e.g., after a termination of employment). Current law also requires an employer to roll over this distribution into a default IRA if the account balance is at least $1,000 and the participant does not affirmatively elect otherwise. Section 120 permits a retirement plan service provider to provide employer plans with automatic portability services. Such services involve the automatic transfer of a participant's default IRA (established in connection with a distribution from a former employer's plan) into the participant's new employer's retirement plan, unless the participant affirmatively elects otherwise. Section 120 is effective for transactions occurring on or after the date which is 12 months after the date of enactment of this Act.

Section 121 Starter 401(k) Plans for Employers with No retirement Plan

Section 121 permits an employer that does not sponsor a retirement plan to offer a starter 401(k) plan (or safe harbor 403(b) plan). A starter 401(k) plan (or safe harbor 403(b) plan) would generally require that all employees be default enrolled in the plan at a 3 to 15 percent of compensation deferral rate. The limit on annual deferrals would be the same as the IRA contribution limit, which for 2023 is $6,500 with an additional $1,000 in catch-up contributions beginning at age 50. Section 121 is effective for plan years beginning after December 31, 2023.

Section 122 Assist States in Locating Owners of Applicable Savings Bonds

To facilitate efforts to locate the owners of matured and unredeemed savings bonds, Section 122 requires the Treasury Secretary to share certain relevant information with a state that relates to an applicable savings bond registered to an owner with a last known or registered address in that state.

The state is permitted to use that information to locate the registered owner in accordance with the state's standards for recovery of abandoned property. Section 122 further requires the Treasury Secretary to develop guidance as may be necessary to carry out the proper disclosure and protection of such information. The Treasury Secretary also is required to submit to the Senate Appropriations and Finance Committees and House Appropriations and Ways and Means Committees an annual report assessing its efforts to provide states with information on unclaimed savings bonds. Section 122 is effective on the date of enactment of this Act.

Section 123 Certain Securities Treated as Publicly Traded in Case of Employee Stock Ownership Plans

Section 123 updates certain ESOP rules related to whether a security is a "publicly traded employer security" and "readily tradeable on an established securities market." Section 123 allows certain non-exchange traded securities to qualify as "publicly traded employer securities" so long as the security is subject to priced quotations by at least four dealers on a Securities and Exchange Commission-regulated interdealer quotation system, is not a penny stock and is not issued by a shell company and has a public float of at least 10 percent of outstanding shares. For securities issued by domestic corporations, the issuer must publish annual audited financial statements. Securities issued by foreign corporations are subject to additional depository and reporting requirements. The updated definitions in Section 123 will allow highly regulated companies with liquid securities that are quoted on non-exchange markets to treat their stock as "public" for ESOP purposes, thus making it easier for these companies to offer ESOPs to their U.S. employees. Section 123 is effective for plan years beginning after December 31, 2027.

Section 124 Modification of Age for Qualified ABLE programs

Current law allows states to create qualified ABLE programs, which are tax-advantaged savings programs for certain people with disabilities. Distributions from an ABLE account are tax-free if used for qualified disability expenses of the account's designated beneficiary. Section 124 increases the age by which blindness or disability must occur for an individual to be an eligible individual by reason of such blindness or disability for an ABLE program. Section 124 is effective for taxable years beginning after December 31, 2025.

Section 125 Improving Coverage for Part-Time Workers

The SECURE Act requires employers to allow long-term, part-time workers to participate in the employers' 401(k) plans. The SECURE Act provision provides that – except in the case of collectively bargained plans – employers maintaining a 401(k) plan must have a dual eligibility requirement under which an employee must complete either 1 year of service (with the 1,000-hour rule) or 3 consecutive years of service (where the employee completes at least 500 hours of service). Section 125 reduces the 3-year rule to 2 years, effective for plan years beginning after December 31, 2024. Section 125 also provides that pre-2021 service is disregarded for vesting purposes, just as such service is disregarded for eligibility purposes under current law, effective as if included in the SECURE Act to which the amendment relates. This provision also extends the long-term part-time coverage rules to 403(b) plans that are subject to ERISA.

Section 126 Distributions from Qualified Tuition Programs to Roth IRAs

Section 126 amends the Internal Revenue Code to allow for tax and penalty free rollovers from 529 accounts to Roth IRAs, under certain conditions. Beneficiaries of 529 college savings accounts would be permitted to rollover up to $35,000 over the course of their lifetime from any 529 account in their name to their Roth IRA. These rollovers are also subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years. Must be a direct, trustee-to-trustee transfer to a Roth IRA account maintained for the benefit of the 529 plan beneficiary. Rollover limited to $6,000 contribution limit per year. Families and students have concerns about leftover funds being trapped in 529 accounts unless they take a non-qualified withdrawal and assume a penalty. This has led to hesitating, delaying, or declining to fund 529s to levels needed to pay for the rising costs of education. Section 126 eliminates this concern by providing families and students with the option to avoid the penalty, resulting in families putting more into their 529 account. Families who sacrifice and save in 529 accounts should not be punished with tax and penalty years later if the beneficiary has found an alternative way to pay for their education. They should be able to retain their savings and begin their retirement account on a positive note. Section 126 is effective with respect to distributions after December 31, 2023.

Section 127 Emergency Savings Accounts

Though individuals can save on their own, far too many fail to do so. According to a report by the Federal Reserve, almost half of Americans would struggle to cover an unexpected $400 expense. Many are forced to tap into their retirement savings. A recent study found that, in the past year, almost 60 percent of retirement account participants who lack emergency savings tapped into their long-term retirement savings, compared to only 9 percent of those who had at least a month of emergency savings on hand. Separating emergency savings from one's retirement savings account will provide participants a better understanding that one account is for short-term emergency needs and the other is for long-term retirement savings, thus empowering employees to handle unexpected financial shocks without jeopardizing their long-term financial security in retirement through emergency hardship withdrawals. Section 127 provides employers the option to offer to their non-highly compensated employees' pension-linked emergency savings accounts. Employers may automatically opt employees into these accounts at no more than 3 percent of their salary, and the portion of an account attributable to the employee's contribution is capped at $2,500 (or lower as set by the employer). Once the cap is reached, the additional contributions can be directed to the employee's Roth defined contribution plan (if they have one) or stopped until the balance attributable to contributions falls below the cap. Contributions are made on a Roth-like basis and are treated as elective deferrals for purposes of retirement matching contributions with an annual matching cap set at the maximum account balance – i.e., $2,500, or lower as set by the plan sponsor. The first four withdrawals from the account each plan year may not be subject to any fees or charges solely based on such withdrawals. At separation from service, employees may take their emergency savings accounts as cash or roll it into their Roth defined contribution plan (if they have one) or IRA.

Section 128 Enhancement of 403(b) Plans

Under current law, 403(b) plan investments are generally limited to annuity contracts and publicly traded mutual funds. This limitation cuts off 403(b) plan participants – generally, employees of charities and public schools, colleges, and universities– from access to collective investment trusts, which are often used by 401(a) plans to expand investment options for plan participants at a lower overall cost. Section 128 would permit 403(b) custodial accounts to participate in group trusts with other tax-preferred savings plans and IRAs and would be effective after date of enactment.

Title II – Preservation of Income

Section 201 Remove Required Minimum Distribution Barriers of Life Annuities

Section 201 eliminates certain barriers to the availability of life annuities in qualified plans and IRAs that arise under current law due to an actuarial test in the required minimum distribution regulations. The test is intended to limit tax deferral by precluding commercial annuities from providing payments that start out small and increase excessively over time. In operation, however, the test commonly prohibits many important guarantees that provide only modest benefit increases under life annuities. For example, guaranteed annual increases of only 1 or 2 percent, return of premium death benefits, and period certain guarantees for participating annuities are commonly prohibited by this test. Without these types of guarantees, many individuals are unwilling to elect a life annuity under a defined contribution plan or IRA. Section 201 is effective for calendar years ending after the date of enactment of this Act.

Section 202 Qualifying Longevity Annuity Contracts (QLACs)

In 2014, the Treasury Department published final regulations on qualifying longevity annuity contracts ("QLACs"). QLACs are generally deferred annuities that begin payment at the end of an individual's life expectancy. Because payments start so late, QLACs are an inexpensive way for retirees to hedge the risk of outliving their savings in defined contribution plans and IRAs. The minimum distribution rules were an impediment to the growth of QLACs in defined contribution plans and IRAs because those rules generally require payments to commence at the required beginning date, before QLACs begin payments. The 2014 regulations generally exempted QLACs from the minimum distribution rules until payments commence. However, due to a lack of statutory authority to provide a full exemption, the regulations imposed certain limits on the exemption that have prevented QLACs from achieving their intended purpose in providing longevity protection. Section 202 addresses these limitations by repealing the 25 percent limit and allowing up to $200,000 (indexed) to be used from an account balance to purchase a QLAC. Section 202 also facilitates the sales of QLACs with spousal survival rights – and clarifies that free-look periods are permitted up to 90 days with respect to contracts purchased or received in an exchange on or after July 2, 2014. Section 202 is effective for contracts purchased or received in an exchange on the date of enactment of this Act, and the Treasury Secretary must update the relevant regulations within 18 months of the date of enactment of this Act.

Section 203 Insurance-Dedicated Exchange-Traded Funds

Exchange-traded funds ("ETFs") are pooled investment vehicles that are traded on stock exchanges. They are similar to mutual funds, except the shares can be traded throughout the day on the stock market, rather than having to be held until after the market closes. ETFs are widely available through retirement plans, IRAs, and taxable investment accounts. However, outdated Treasury Department regulations have prevented ETFs from being widely available through individual variable annuities. Simply because the regulations were written before ETFs existed, ETFs cannot satisfy the regulatory requirements to be "insurance dedicated." Section 203 directs the Treasury Department to update the regulations to reflect the ETF structure to provide that ownership of an ETF's shares by certain types of institutions that are necessary to the ETF's structure would not preclude look-through treatment for the ETF, as long as it otherwise satisfies the current-law requirements for look-through treatment. This essentially would facilitate the creation of a new type of ETF that is "insurance dedicated." Section 203 is effective for segregated asset account investments made on or after 7 years after the date of enactment of this Act and directs the Treasury Secretary to update the relevant regulations by that time.

Section 204 Eliminating a Penalty on Partial Annuitization

If a tax-preferred retirement account also holds an annuity, current law requires that the account be bifurcated between the portion of the account holding the annuity and the rest of the account for purposes of applying the required minimum distribution rules. This treatment may result in higher minimum distributions than would have been required if the account did not hold an annuity. Section 204 permits the account owner to elect to aggregate distributions from both portions of the account for purposes of determining minimum distributions and is effective on the date of enactment of this Act. The Treasury Secretary is to update the relevant regulations accordingly.

Title III – Simplification and Clarification of Retirement Plan Rules

Section 301 Recovery of Retirement Plan Overpayments

Sometimes retirees mistakenly receive more money than they are owed under their retirement plans. These mistakes cause problems when they occur over time, and plan fiduciaries later seek to recover the overpayments from unsuspecting retirees. When an overpayment has lasted for years, plans often compel retirees to repay the amount of the overpayment, plus interest, which can be substantial. Even small overpayment amounts can create a hardship for a retiree living on a fixed income. Section 301 allows retirement plan fiduciaries the latitude to decide not to recoup overpayments that were mistakenly made to retirees. If plan fiduciaries choose to recoup overpayments, limitations and protections apply to safeguard innocent retirees. This protects both the benefits of future retirees and the benefits of current retirees. Rollovers of the overpayments also remain valid. Section 301 is effective on the date of enactment of this Act, and further outlines how plan fiduciaries may proceed with respect to determinations made prior to the date of enactment of this Act to seek or not to seek recovery of overpayments.

Section 302 Reduction in Excise Tax for Failure to Take RMDs

Section 302 reduces the penalty for failure to take required minimum distributions from 50 to 25 percent. Further, if a failure to take a required minimum distribution from an IRA is corrected in a timely manner, as defined under this Act, the excise tax on the failure is further reduced from 25 percent to 10 percent. Section 302 is effective for taxable years beginning after the date of enactment of this Act.

Section 303, Retirement Savings Lost and Found

Every year, thousands of people approach retirement but are unable to find and receive the benefits that they earned often because the company they worked for moved, changed its name, or merged with a different company. Similarly, every year there are employers around the country ready to pay benefits to retirees, but they are unable to find the retirees because the former employees changed their names or addresses. Section 303 creates a national online searchable lost and found database for Americans' retirement plans at the Department of Labor ("DOL"). The database will enable retirement savers, who might have lost track of their pension or 401(k) plan, to search for the contact information of their plan administrator. Section 303 directs the creation of the database no later than 2 years after the date of enactment of this Act.

Section 304 Updating Dollar Limit for Mandatory Distributions

Under current law, employers may transfer former employees' retirement accounts from a workplace retirement plan into an IRA if their balances are between $1,000 and $5,000. Section 307 increases the limit from $5,000 to $7,000, effective for distributions made after December 31, 2023.

Section 305 Expansion of Employee Plans Compliance Resolution System

Because of the ever-growing complexity of retirement plan administration, Section 305 expands the Employee Plans Compliance Resolution System ("EPCRS") to (1) allow more types of errors to be corrected internally through self-correction, (2) apply to inadvertent IRA errors, and (3) exempt certain failures to make required minimum distributions from the otherwise applicable excise tax. For example, Section 305 allows for correction of many plan loan errors through self-correction, which are a frequent area of error and can be burdensome to correct a single loan error through the Internal Revenue Service. Section 305 is effective on the date of enactment of this Act. Any guidance or revision of guidance required by Section 305 shall be promulgated no later than 2 years after the date of enactment of this Act. Revenue Procedure 2021–30 (or any successor guidance) shall be updated to consider the provisions of this section no later than 2 years after the date of enactment of this Act.

Section 306 Eliminate the "First Day of the Month" Requirement for 457(b) Plans

Under current law, participants in a governmental 457(b) plan must request changes in their deferral rate prior to the beginning of the month in which the deferral will be made. This rule does not exist for other defined contribution plans. Section 306 allows such elections to be made at any time prior to the date that the compensation being deferred is available. Section 306 is effective for taxable years beginning after the date of enactment of this Act.

Section 307 Qualified Charitable Distribution to Split-Interest Entity

One-time election for qualified charitable distribution to split-interest entity; increase in qualified charitable distribution limitation. Section 307 expands the IRA charitable distribution provision to allow for a one-time, $50,000 distribution to charities through charitable gift annuities, charitable remainder unitrusts, and charitable remainder annuity trusts, effective for distributions made in taxable years beginning after the date of enactment of this Act. Section 307 also indexes for inflation the annual IRA charitable distribution limit of $100,000, effective for distributions made in taxable years ending after the date of enactment of this Act.

Section 308 Distribution to Firefighters

Under current law, if an employee terminates employment after age 55 and takes a distribution from a retirement plan, the 10 percent early distribution tax does not apply. However, there is a special rule for "qualified public safety employees" in governmental plans, under which age 50 is substituted for age 55 for purposes of this exception from the 10 percent tax. This exemption applies to public sector firefighters, but not private sector firefighters. Section 308 extends the age 50 rule to private sector firefighters, who merit the same treatment for distributions. Section 308 is effective for distributions made after the date of enactment of this Act.

Section 309 Exclusion of Certain Disability-Related First Responder Treatment Payments

Section 309 permits first responders to exclude service-connected disability pension payments from gross income after reaching retirement age. Section 309 is effective for amounts received in taxable years beginning after December 31, 2026.

Section 310 Application of Top-Heavy Rules Covering Excludable Employees

Under current law, qualified retirement plans must pass the top-heavy test, in addition to other nondiscrimination tests. Plans that are deemed top-heavy are required to provide employees with a minimum of a 3 percent of pay non-elective contribution, which is a significant cost to small businesses. Other nondiscrimination tests that apply to 401(k) plans allow an employer to test otherwise excludable employees (e.g., those who are under age 21 and have less than 1 year of service) separately. This was intended to encourage plan sponsors to permit employees to defer earlier than the minimum age and service conditions permitted under the law because it reduces the situations where plans would fail the nondiscrimination tests if these employees were included when performing the test. However, this separate testing is not allowed for the top-heavy test. Small business retirement plans often do not cover excludable employees because, if the plan is or becomes top heavy, the employer may be required to contribute a top-heavy employer contribution for all employees who are eligible to participate in the plan, straining the budget for these small businesses. Section 310 allows an employer to perform the top-heavy test separately on the non-excludable and excludable employees. This removes the financial incentive to exclude employees from the 401(k) plan and increase retirement plan coverage to more workers. Section 310 is effective for plan years beginning after December 31, 2023.

Section 311 Repayment of Qualified Birth or Adoption Distribution Limited to 3-Years

The SECURE Act included a provision that allows individuals to receive distributions from their retirement plan in the case of birth or adoption without paying the 10 percent additional tax under Code section 72(t) (known as a qualified birth or adoption distribution, or "QBAD"). The distributions can be recontributed to a retirement plan at any time and are treated as rollovers. The problem with current law is the allowance of recontributions at any time. Code section 6511 prevents a refund from being provided to a taxpayer after the period of limitations for the return has closed, which is generally a 3-year period. Thus, there would not be a mechanism under the Code allowing someone who took a birth/adoption distribution to recontribute the distribution more than 3 years later and amend their return to receive a refund for the taxes that were paid in the year of the withdrawal. Section 311 amends the QBAD provision to restrict the recontribution period to 3 years. Section 311 is effective to distributions made after the date of the enactment of this Act and retroactively to the 3-year period beginning on the day after the date on which such distribution was received.

Section 312 Employee Certifying Deemed Hardship Distribution

Section 312 provides that, under certain circumstances, employees are permitted to self-certify that they have had an event that constitutes a hardship for purposes of taking a hardship withdrawal. This is a logical step considering the success of the corona virus related distribution self-certification rules and the current hardship regulations that already permit employees to self-certify that they do not have other funds available to address a hardship. Section 312 is effective for plan years beginning after the date of enactment of this Act.

Section 313 Individual Retirement Plan Statute of Limitations for Excise Tax on Excess Contributions and Certain Accumulations

Under current law, the statute of limitations for excise taxes imposed on excess contributions or required minimum distribution failures start running as of the date that a specific excise tax return (Form 5329) is filed for the violation. Individuals often are not aware of the requirement to file Form 5329, and this can lead to an indefinite period of limitations that can cause hardship for taxpayers due to the accumulation of interest and penalties (see Paschall v. C.I.R., 137 T.C. 8 (2011)). In order to provide finality for taxpayers in the administration of these excise taxes, Section 313 provides that a 3-year period of limitations begins when the taxpayer files an individual tax return (Form 1040) for the year of the violation, except in the case of excess contributions, in which case the period of limitations runs 6 years from the date Form 1040 is filed. There is a further exception from this 6-year rule for taxes that arise out of a bargain sale to the IRA. In general, these changes are intended to ensure that there is a reasonable period of limitations for violations of which taxpayers were not aware and thus did not file an excise tax return, while retaining existing law in fact scenarios that involve a bargain sale. Section 313 is effective on the date of enactment of this Act.

Section 314 Penalty-Free Withdrawal from Retirement Plans for Domestic Abuse

A domestic abuse survivor may need to access his or her money in their retirement account for various reasons, such as escaping an unsafe situation. Section 314 allows retirement plans to permit participants that self-certify that they experienced domestic abuse to withdraw a small amount of money (the lesser of $10,000, indexed for inflation, or 50 percent of the participant’s account). A distribution made under Section 314 is not subject to the 10 percent tax on early distributions. Additionally, a participant can repay the withdrawn money from the retirement plan over 3 years and will be refunded income taxes on money that is repaid. Exception limited to the lessor of $10,000 or 50% of the account value. Self-certification process Section 318 is effective for distributions made after December 31, 2023.

Section 315 Reform of Family Attribution Rule

Under the Code, certain related businesses must be aggregated when performing the coverage and nondiscrimination tests. The aggregation rules are generally based on the degree of common ownership of the businesses. In determining the level of ownership in a business, the tax laws have certain attribution rules whereby an individual is deemed to own stock held by other individuals or entities. Section 315 updates two stock attribution rules. The first update addresses inequities where spouses with separate businesses reside in a community property state when compared to spouses who reside in separate property states. The second update modifies the attribution of stock between parents and minor children. Section 315 is effective for plan years beginning after December 31, 2023.

Section 316 Amendments to Increase Benefit Accruals

The SECURE Act permits an employer to adopt a new retirement plan by the due date of the employer’s tax return for the fiscal year in which the plan is effective. Current law, however, provides that plan amendments to an existing plan must generally be adopted by the last day of the plan year in which the amendment is effective. This precludes an employer from adding plan provisions that may be beneficial to participants. Section 316 amends these provisions to allow discretionary amendments that increase participants’ benefits to be adopted by the due date of the employer’s tax return. Section 316 is effective for plan years beginning after December 31, 2023.

Section 317 Retroactive First Year Elective Deferrals for Sole Proprietors

Under the SECURE Act, an employer may establish a new 401(k) plan after the end of the taxable year, but before the employer’s tax filing date and treat the plan as having been established on the last day of the taxable year. Such plans may be funded by employer contributions up to the employer’s tax filing date. Section 317 allows these plans, when they are sponsored by sole proprietors or single member LLCs, to receive employee contributions up to the date of the employee’s tax return filing date for the initial year. Section 317 is effective for plan years beginning after the date of enactment of this Act.

Section 318 Performance Benchmarks for Asset Allocation Funds

The DOL’s participant disclosure regulation requires that each designated investment alternative’s historical performance be compared to an appropriate broad-based securities market index. However, the rule does not adequately address increasingly popular investments like target date funds that include a mix of asset classes. Section 318 directs the Labor Secretary to update the DOL’s regulations so that an investment that uses a mix of asset classes can be benchmarked against a blend of broad-based securities market indices, provided (a) the index blend reasonably matches the fund’s asset allocation over time, (b) the index blend is reset at least once a year, and (c) the underlying indices are appropriate for the investment’s component asset classes and otherwise meet the rule’s conditions for index benchmarks. This change in the disclosure rule allows better comparisons and aids participant decision-making. The DOL is to update its regulations no later than two years after enactment of this Act. Section 318 also requires DOL to report to Congress on the effectiveness of its benchmarking requirements no later than 3 years after the applicability date of the regulations.

Section 319 Review, and Report to Congress Relating to Reporting and Disclosure Requirements

Section 319 directs the Treasury Department, DOL, and Pension Benefit Guaranty Corporation to review reporting and disclosure requirements for pension plans as soon as practicable after enactment of this Act. Section 319 further directs the agencies to make recommendations to Congress to consolidate, simplify, standardize, and improve such requirements no later than 3 years after the date of enactment of this Act.

Section 320 Eliminating Unnecessary Plan Requirements Related to Unenrolled Participants

Under current law, employees eligible to participate in a retirement plan are required to receive a broad array of notices that are intended to inform them of their various options and rights under the plan. In the case of eligible employees who have not elected to participate in the plan (“unenrolled participants”), these notices – such as notices regarding the different investment options available under the plan – are generally unnecessary and can even have adverse effects on savings and coverage. Section 320 no longer requires employers to provide certain intermittent ERISA or Code notices to unenrolled participants who have not elected to participate in a workplace retirement plan. However, to further encourage participation of unenrolled participants, the plan is required to send (1) an annual reminder notice of the participant’s eligibility to participate in the plan and any applicable election deadlines, and (2) any otherwise required document requested at any time by the participant. This rule applies only with respect to an unenrolled participant who received the summary plan description, in connection with initial eligibility under the plan, and any other notices related to eligibility under the plan required to be furnished. Section 320 is effective for plan years beginning after December 31, 2022.

Section 321 Review of Pension Risk Transfer Interpretive Bulletin

Section 321 requires the DOL to review the current interpretive bulletin governing pension risk transfers to determine whether amendments are warranted and to report to Congress its finding, including an assessment of any risk to participant, no later than 1 year after enactment of this Act.

Section 322 Tax Treatment of IRA Involved in a Prohibited Transaction

When an individual engages in a prohibited transaction with respect to their IRA, the IRA is disqualified and treated as distributed to the individual, irrespective of the size of the prohibited transaction. Section 322 clarifies that if an individual has multiple IRAs, only the IRA with respect to which the prohibited transaction occurred will be disqualified. Section 322 is effective for taxable years beginning after the date of enactment of this Act.

Section 323 Clarification of Substantially Equal Periodic Payment Rule

Current law imposes a 10 percent additional tax on early distributions from tax-preferred retirement accounts, but an exception applies to substantially equal periodic payments that are made over the account owner's life expectancy. Section 323 provides that the exception continues to apply in the case of a rollover of the account, an exchange of an annuity providing the payments, or an annuity that satisfies the required minimum distribution rules. Section 323 is effective for transfers, rollovers, exchanges after December 31, 2023, and effective for annuity distributions on or after the date of enactment of this Act.

Section 324 Treasury Guidance on Rollovers

Section 324 requires the Treasury Secretary to simplify and standardize the rollover process by issuing sample forms for direct rollovers that may be used by both the incoming and outgoing retirement plan or IRA. Development and release of the sample forms must be completed no later than January 1, 2025.

Section 325 Roth Plan Distribution Rules

Under current law, required minimum distributions are not required to begin prior to the death of the owner of a Roth IRA. However, pre-death distributions are required in the case of the owner of a Roth designated account in an employer retirement plan (e.g., 401(k) plan). Section 325 eliminates the pre-death distribution requirement for Roth accounts in employer plans, effective for taxable years beginning after December 31, 2023. Section 325 does not apply to distributions which are required with respect to years beginning before January 1, 2024, but are permitted to be paid on or after such date.

Section 326 Exception to Penalty for Individuals with a Terminal Illness

Under current law, an additional 10 percent tax applies to early distributions from tax-preferred retirement accounts. Section 326 provides an exception to the tax in the case of a distribution to a terminally ill individual and would be effective for distributions made after the date of enactment of this Act.

Section 327 Surviving Spouse Election to be Treated as Employee

Section 327 allows a surviving spouse to elect to be treated as the deceased employee for purposes of the required minimum distribution rules. Section 327 is effective for calendar years beginning after December 31, 2023.

Section 328 Repeal of Direct Payment Requirement on Exclusion from Gross Income of Distributions from Governmental Plans for Health and Long-Term Care Insurance

Current law provides an exclusion from gross income ($3,000) for a distribution from a governmental retirement plan to a public safety officer to pay for their health insurance premiums. The exclusion requires that the plan directly pay the insurance premiums. Section 328 repeals the direct payment requirement and is effective for distributions made after the date of enactment of this Act.

Section 329 Modification of Eligible Age for Exemption from Early Withdrawal Penalty

The 10 percent additional tax on early distributions from tax preferred retirement savings plans does not apply to a distribution from a governmental plan to a public safety officer who is at least age 50. Section 329 extends the exception to public safety officers with at least 25 years of service with the employer sponsoring the plan and is effective for distributions made after the date of enactment of this Act.

Section 330 Exemption from Early Withdrawal Penalty for Certain State and Local Government Corrections Employees

Section 330 extends the public safety officer's exception to the 10 percent early distribution tax to corrections officers who are employees of state and local governments, effective for distributions made after the date of enactment of this Act.

Section 331 Special Rules for Use of Retirement Funds in Connection with Qualified Federally Declared Disasters

Section 331 provides permanent rules relating to the use of retirement funds in the case of a federally declared disaster. The permanent rules allow up to $22,000 to be distributed from employer retirement plans or IRAs for affected individuals. Such distributions are not subject to the 10 percent additional tax and are considered as gross income over 3 years. Distributions can be repaid to a tax preferred retirement account. Additionally, amounts distributed prior to the disaster to purchase a home can be recontributed, and an employer is permitted to provide for a larger amount to be borrowed from a plan by affected individuals and for additional time for repayment of plan loans owed by affected individuals. Section 331 is effective for disasters occurring on or after January 26, 2021.

Section 332, Employers Allowed to Replace SIMPLE Retirement Accounts with Safe Harbor 401(k) Plans During a Year

Section 332 allows an employer to replace a SIMPLE IRA plan with a SIMPLE 401(k) plan or other 401(k) plan that requires mandatory employer contributions during a plan year and is effective for plan years beginning after December 31, 2023.

Section 333, Elimination of Additional Tax on Corrective Distributions of Excess Contributions

Current law requires a distribution if too much is contributed to an IRA. The corrective distribution includes the excessive contribution and any earnings allocable to that contribution. Section 333 exempts the excess contribution and earnings allocable to the excess contribution from the 10 percent additional tax on early distributions, and is effective for any determination of, or affecting, liability for taxes, interest, or penalties which is made on or after the date of enactment of this Act, without regard to whether the act (or failure to act) upon which the determination is based occurred before such date of enactment.

Section 334 Long-Term Care Contracts Purchased with Retirement Plan Distributions

Section 334 permits retirement plans to distribute up to $2,500 per year for the payment of premiums for certain specified long term care insurance contracts. Distributions from plans to pay such premiums are exempt from the additional 10 percent tax on early distributions. Only a policy that provides for high quality coverage is eligible for early distribution and waiver of the 10 percent tax. Section 334 is effective 3 years after the date of enactment of this Act.

Section 335 Corrections of Mortality Tables

Section 335 generally requires that for purposes of the minimum funding rules, a pension plan is not required to assume beyond the plan’s valuation date future mortality improvements at any age greater than 0.78 percent. The Treasury Secretary shall amend the relevant regulation on the matter within 18 months, though Section 335 shall be deemed to take effect on the date of enactment of this Act.

Section 336 Report to Congress on Section 402(f) Notices

Section 402(f) notices are given by employer retirement plans in the case of a distribution to a participant that is eligible for rollover to another tax preferred retirement account and describes distribution options and tax consequences. Section 336 requires the Government Accountability Office to issue a report to Congress on the effectiveness of section 402(f) notices within 18 months after the date of enactment of this Act.

Section 337 Modification of RMD Rules for Special Needs Trust

The SECURE Act placed limits on the ability of beneficiaries of defined contribution retirement plans and IRAs to receive lifetime distributions after the account owner's death. Special rules apply in the case of certain beneficiaries, such as those with a disability. Section 337 clarifies that, in the case of a special needs trust established for a beneficiary with a disability, the trust may provide for a charitable organization as the remainder beneficiary. Section 337 is effective for calendar years beginning after the date of enactment of this Act.

Section 338 Requirement to Provider Paper Statements

Section 338 amends ERISA to generally provide that, with respect to defined contribution plans, unless a participant elects otherwise, the plan is required to provide a paper benefit statement at least once annually. The other three quarterly statements required under ERISA are not subject to this rule (i.e., they can be provided electronically). For defined benefit plans, unless a participant elects otherwise, the statement that must be provided once every 3 years under ERISA must be a paper statement. The Labor Secretary must update the relevant sections of their regulations and corresponding guidance by December 31, 2024, and the annual paper statement is effective for plan years beginning after December 31, 2025.

Section 339 Recognition of Tribal Government Domestic Relations Orders

Section 339 adds Tribal courts to the list of courts authorized under federal law to issue qualified domestic relations orders. Section 339 is effective to domestic relations orders received by plan administrators after December 31, 2022, including any such order which is submitted for reconsideration after such date.

Section 340 Defined Contribution Plan Fee Disclosure Improvements

Section 340 builds on recommendations recently made to the DOL by the Government Accountability Office and requires the agency to review its fiduciary disclosure requirements in participant-directed individual account plan regulations. A report must be submitted to Congress within 3 years on such findings, including recommendations for legislative changes.

Section 341 Consolidation of Defined Contribution Plan Notices

Current law requires certain retirement plan notices to be provided to participants as individual notices. Section 341 directs the Treasury and DOL Secretaries within 2 years to amend regulations to permit a plan to consolidate certain required plan notices.

Section 342 Information Needed for Financial Options Risk Mitigation Act

Section 342 requires pension plan administrators to provide plan participants and retirees with critical information that would allow people considering what is best for their financial futures to compare between benefits offered under the plan and the lump sum, and would explain how the lump sum was calculated, the ramifications of accepting a lump sum, such as the loss of certain federal protections, details about the election period, where to follow up with questions, and other information. The DOL Secretary must issue regulations implementing this provision not earlier than 1 year after enactment. Such regulations must be applicable not earlier than the issuance of a final rule and not later than 1 year after issuance of a final rule.

Section 343 Defined Benefit Annual Funding Notices

Section 343 aims to identify defined benefit pension plan funding issues more clearly on a plan's annual funding notice. Section 343 is effective for plan years beginning after December 31, 2023.

Section 344 Report on Pooled Employer Plans

Section 344 requires the DOL Secretary to conduct a study on the new and growing pooled employer plan industry. A report on the findings of the study must be completed within 5 years, with subsequent reports completed every 5 years thereafter.

Section 345 Annual Audits for Group of Plans.

Under current law, generally, a Form 5500 for a defined contribution plan must contain an opinion from an independent qualified public accountant as to whether the plan's financial statements and schedules are fairly presented. However, no such opinion is required with respect to a plan covering fewer than 100 participants. Section 345 clarifies that plans filing under a Group of Plans need only to submit an audit opinion if they have 100 participants or more. In other words, DOL and Treasury would continue to receive full audit information on at least the number of plans as under current law. Section 345 is effective on the date of enactment of this Act.

Section 346 Worker Ownership, Readiness, and Knowledge (WORK) Act

Section 346 boosts employee ownership programs through the DOL, which may make grants to promote employee ownership through existing and new programs. Funds are authorized to be appropriated for the purpose of making grants for fiscal years 2025 to 2029.

Section 347 Report by the Secretary of Labor in the impact of Inflation on Retirement Savings

Section 347 directs the DOL Secretary, in consultation with the Treasury Secretary, to study the impact of inflation on retirement savings and submit a report to Congress within 90 days on the findings of the study.

Section 348 Cash Balance Plans

Section 348 clarifies the application of the Code and ERISA's rules, prohibiting the backloading of benefit accruals, as they relate to hybrid plans that credit variable interest. Specifically, Section 348 clarifies that, for purposes of the applicable Code and ERISA rules, the interest crediting rate that is treated as in effect and as the projected interest crediting rate is a reasonable projection of such variable interest rate, subject to a maximum of 6 percent. This clarification will allow plan sponsors to provide larger pay credits for longer older service workers. Section 346 is effective for plan years beginning after the date of enactment of this Act.

Section 349 Termination of Variable Rate Premium Indexing

Section 349 removes the “applicable dollar amount” language in the rules for determining the premium fund target for purposes of unfunded vested benefits and replaces it with a flat $52 for each $1,000 of unfunded vested benefits. Section 349 is effective on the date of enactment of this Act.

Section 350 Safe Harbor for Corrections of Employee Elective Deferral Failures

Under current law, employers that adopt a retirement plan with automatic enrollment and automatic escalation features could be subject to significant penalties if even honest mistakes are made. The Internal Revenue Service has issued guidance on the correction of failures relating to default enrollment of employees into retirement plans. This guidance includes a safe harbor, which expires December 31, 2023, that permits correction if notice is given to the affected employee, correct deferrals commence within certain specified time periods, and the employer provides the employee with any matching contributions that would have been made if the failure had not occurred. Employers are concerned about the lapse of the safe harbor at the end of 2023. Section 350 eases these concerns by allowing for a grace period to correct, without penalty, reasonable errors in administering these automatic enrollment and automatic escalation features. Errors must be corrected prior to 9 ½ months after the end of the plan year in which the mistakes were made. Section 350 is effective to errors after December 31, 2023.

Title VI – Revenue Provisions

Section 601 SIMPLE and SEP Roth IRAs

Generally, all plans that allow pre-tax employee contributions are permitted to accept Roth contributions with one exception – SIMPLE IRAs. 401(k), 403(b), and governmental 457(b) plans are allowed to accept Roth employee contributions. Section 601 allows SIMPLE IRAs to accept Roth contributions too. In addition, aside from grandfathered salaried reduction simplified employee pension plans, under current law, simplified employee pension plans (“SEPs”) can only accept employer money and not on a Roth basis. Section 601 allows employers to offer employees the ability to treat employee and employer SEP contributions as Roth (in whole or in part). The provisions in Section 601 are effective for taxable years beginning after December 31, 2022.

Section 602, Hardship Withdrawal Rules for 403(b) Plans

Under current law, the distribution rules for 401(k) and 403(b) are different in certain ways that are historical anomalies for varied reasons. For example, for 401(k) plans, all amounts are available for a hardship distribution. For 403(b) plans, in some cases, only employee contributions (without earnings) are available for hardship distributions. Section 602 conforms the 403(b) rules to the 401(k) rules, effective for plan years beginning after December 31, 2023.

Section 603 Elective Deferrals Generally Limited to Regular Contribution Limit

Under current law, catch-up contributions to a qualified retirement plan can be made on a pre-tax or Roth basis (if permitted by the plan sponsor). Section 603 provides all catch-up contributions to qualified retirement plans that are subject to Roth tax treatment, effective for taxable years beginning after December 31, 2023. An exception is provided for employees with compensation of $145,000 or less (indexed).

Section 604 Optional Treatment of Employer Matching or Nonelective Contributions as Roth Contributions

Under current law, plan sponsors are not permitted to provide employer matching contributions in their 401(k), 403(b), and governmental 457(b) plans on a Roth basis. Matching contributions must be on a pre-tax basis only. Section 604 allows defined contribution plans to provide participants with the option of receiving matching contributions on a Roth basis, effective on the date of enactment of this Act.

Section 605 Charitable Conservation Easements

The tax deduction for charitable contributions of conservation easements has long played a crucial role in incentivizing the preservation of critical habitat, open spaces, and historically important areas and structures. However, since 2016 IRS has identified certain syndicated conservation easement transactions involving pass-through entities as “listed transactions” carrying a high potential for abusive tax avoidance. Section 605 disallows a charitable deduction for a qualified conservation contribution if the deduction claimed exceeds two- and one-half times the sum of each partner’s relevant basis in the contributing partnership, unless the contribution meets a 3-year holding period test, substantially all the contributing partnership is owned by members of a family, or the contribution relates to the preservation of a certified historic structure. In the case of a contribution for the preservation of a certified historic structure, a new reporting requirement applies. Section 605 also provides taxpayers the opportunity to correct certain defects in an easement deed (excluding easements involved in abusive transactions) and makes certain changes to the statute of limitations and penalty provisions. Section 605 is generally effective for contributions made after the date of enactment of this Act.

Section 606 Enhancing Retiree Health Benefits in Pension Plans

Under current law, an employer may use assets from an overfunded pension plan to pay retiree health and life insurance benefits. These rules sunset at the end of 2025. Section 606 extends the sunset date to the end of 2032 and would permit transfers to pay retiree health and life insurance benefits provided the transfer is no more than 1.75 percent of plan assets and the plan is at least 110 percent funded. Section 606 is effective for transfers made on or after the date of enactment of this Act.

Chapter 13
Review Questions

1. SECURE 2.0 Act, Section 102, makes changes to the startup tax credit by increasing the startup credit from 50 percent to 100 percent for employers with up to how many employees?

( ) A. 100
( ) B. 50
( ) C. 75
( ) D. 500

2. SECURE Act 2.0, Section 107, further increases the required minimum distribution age further to age 75 starting on what date?

( ) A. January 1, 2033
( ) B. January 1, 2024
( ) C. January 1, 2026
( ) D. January 1, 2030

3. Identify the SECURE 2.0 Act, Section 311

( ) A. Section 311 of the SECURE Act 2.0 establishes a recontribution period of three years.
( ) B. Access to the funds is delayed for 3 years
( ) C. Incurs a 10% penalty for early withdrawals
( ) D. There is no specific time limit for recontributing the QBAD

4. SECURE 2.0 Act, Section 302, reduces the penalty for failure to take required minimum distributions from 50 percent to what percent?

( ) A. 6%
( ) B. 25%
( ) C. 50%
( ) D. 15%

5. SECURE Act 2.0, Section 331 provides which of the following?

( ) A. A penalty for withdrawals up to $22,000
( ) B. Permanent rules for the use in the case of federally declared disaster
( ) C. Any payment requires repayment within 5 years
( ) D. Any and all payments are taxed at ordinary income tax rates

CHAPTER REVIEW ANSWERS

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GLOSSARY OF KEY TERMS

401(k) Plan: A retirement savings plan sponsored by an employer that allows employees to save and invest a portion of their paycheck before taxes are taken out. Taxes are paid when the money is withdrawn from the account.

Administrator: The person or entity responsible for managing the 401(k) plan. Duties include ensuring the plan complies with legal requirements and managing the plan's assets.

Actual Contribution Percentage (ACP) Test: A nondiscrimination test similar to the ADP test, but it focuses on matching contributions and employee after-tax contributions. It compares the contribution percentages of HCEs to those of NHCEs to ensure fairness

Actual Deferral Percentage (ADP) Test: A nondiscrimination test that compares the average deferral rates of highly compensated employees (HCEs) to those of non-highly compensated employees (NHCEs). The goal is to ensure HCEs do not disproportionately benefit from the plan.

Automatic Enrollment: A feature that allows employers to enroll employees in the 401(k) plan automatically, with the option for employees to opt-out if they choose.

Automatic Rebalancing: You've heard the saying, "Buy low, sell high." While you can micromanage your retirement savings, doing so isn't practical. Automatic rebalancing is a retirement feature that rebalances your account automatically. This involves adjusting your portfolio's percentage of stocks, bonds, cash, and other investments back to your original target.

Beneficiary: The person designated by a 401(k)-plan participant to receive the account balance upon the participant's death.

Catch-Up Contribution: Additional contributions that participants aged 50 and over can make to their 401(k) plans above the standard contribution limits.

Compound Earnings: Think of compound earnings as the "earnings on the earnings" that your investments earn. If you invest $100 and get a 10% return each year, you'll have $110 to invest in the second year, $121 in the third, and so on. In this example, if you continue receiving 10% of earnings every year, you will double your money in seven years. Sometimes called "compounding," this effect makes it possible for even a modest retirement account to grow significantly over a career.

Cliff Vesting: While some companies allow 401(k) plan participants to vest in their full employer contributions account gradually, others prefer a more abrupt formula. In cliff vesting, employees remain 0% vested in their employer contributions account until they complete a minimum number of years of service when they become 100% vested. In most 401(k) plans, a cliff vesting schedule cannot require more than three years of service.

Contribution Limits: The maximum amount that employees and employers can contribute to a 401(k) plan each year, as set by the IRS.

Deferral: The portion of an employee's wages that is contributed to a 401(k) plan on a pre-tax basis. Also called employee contributions, deferrals are the portion of an employee's paycheck that's set aside for their retirement account. Deferrals might be expressed as either a set dollar amount or a percentage. Sometimes, a company might assign an employee a default deferral rate (see automatic enrollment). Even then, employees can typically update their deferrals at any time.

Defined Benefit Plan: Commonly referred to as a pension, this arrangement is where retired employees are typically paid a guaranteed monthly income from their employers who choose the plan's investments.

Defined Contribution Plan: This is a retirement plan in which contributions are defined and allocated to the individual accounts of each employee. The benefits depend on the investment performance. 401(k) plans are defined contribution plans where participants can contribute a percentage or set amount from their paychecks every pay period. Employer contributions in a 401(k) plan are optional.

Distribution: The withdrawal of funds from a 401(k) plan, which may be subject to taxes and penalties depending on the participant's age and the reason for the withdrawal.

Distribution Event: While you can take your money out of your IRA at any time, the IRS limits when you can take your money out of an employer-sponsored plan. Individuals can only take money out of their retirement account when specific events (such as death, termination of employment, at age 59 ½ or when a financial hardship) occur. The plan sponsor chooses these events and will be specified in the plan document.

Employee Contribution Limits: The IRS caps how much individuals can set aside in their retirement accounts per year. These contribution limits vary depending on the kind of account. As of 2024, the 401(k)-contribution limit for individuals is $23,000. If you turn 50 (or older) during 4 you can contribute an additional $7,500. IRA account holders are limited to much smaller contribution limits. In either case, it's important to note that employer contributions do not count towards this cap.

Employer Matching: Contributions made by an employer to an employee's 401(k). Employer contributions are tax-deductible for employers up to applicable deduction limits, making them a popular way for companies to reward their employees.

Employee Retirement Income Security Act (ERISA): Call it the closest thing to a 401(k) rulebook. While the federal government doesn't require companies to offer retirement plans, it does set minimum standards for those that do. The Employee Retirement Income Security Act (ERISA) outlines the conduct, responsibilities, and obligations 401(k) providers have to their employees. It also requires most retirement plans to pass stringent nondiscrimination testing to ensure that top executives aren't disproportionately benefiting compared to other employees.

Employer-Sponsored Retirement Plan: While individuals can open retirement accounts independently, employers can also offer their employees access to a plan, usually with the help of a third-party provider. A 401(k) plan is one of the most popular employer-sponsored retirement plans.

Expense Ratio: Most 401(k) plans offer participants control over the investment of their accounts by selecting from among a menu of mutual funds. Each mutual fund in a participant's portfolio comes with an administrative and operating charge, taken from the participant's invested funds as a percentage of the assets invested in that fund. This charge is called the fund's expense ratio. A fund's expense ratio measures how much of a fund's assets are taken by the fund's manager for these purposes, and it can vary widely from fund to fund. Some funds charge an expense ratio loaded with high fees.

Fiduciary: Fiduciaries are individuals or entities entrusted with handling funds or other assets belonging to someone else, or exercising discretion in administrative activities. When it comes to retirement plans, there are a few different kinds of fiduciaries — but generally speaking, they're the ones managing your company's 401(k) plan, making benefit determinations, interpreting the plan document, selecting the plan's fund menu, and/or providing investment advice to those who make those decisions. Fiduciaries are legally obligated to make decisions solely in the interest of plan participants and their beneficiaries.

Form 5500: Each year, 401(k) plan sponsors must file a Form 5500 with the federal government. This annual report outlines basic information about the sponsor's business, retirement plans, total participants, and other details. The document is typically accompanied by secondary forms or "schedules" with additional detail. Sponsors with at least 100 participants must attach an audited financial statement, while sponsors with fewer than 100 participants may be able to fill out a shorter version of the form.

Graded Vesting: Employers may gradually allow 401(k) plan participants to vest in the employer's contributions over time (e.g., 20% after one year, 40% after two years). This approach is called graded vesting. Federal law mandates that it can't take longer than six years for employees to vest 100% of their employer contributions

Hardship Withdrawal: A provision that allows participants to withdraw funds from their 401(k) in cases of immediate and heavy financial need, subject to specific IRS rules and potential penalties.

Highly Compensated Employee (HCE) The IRS defines a highly compensated, or "key," employee according to the following criteria: Officers making over $225,000 in 2024. Owners holding more than 5% of the stock or capital. Owners earning over $155,000 in 2024, not adjusted for inflation, and holding more than 1%. The annual limit on compensation that can be taken into account for contributions and deductions increased to $345,000 in 2024

Individual Retirement Account (IRA): A tax-advantaged retirement savings account that individuals can set up independently of their employer. IRAs offer many of the same tax benefits as conventional employer-sponsored plans, though participants can only contribute a much smaller amount. Still, IRAs are an excellent option for those without access to an employer-sponsored plan.

Investment Options: The various mutual funds, stocks, bonds, and other financial instruments available for investment within a 401(k) plan.

Liquidity: In short, liquidity refers to the immediate usability of an asset. If you've got cash in your wallet, that's "liquid" — you could easily spend that money if you wanted to. Retirement accounts aren't considered liquid until you reach distribution age because you can't take distributions while employed, unless your plan allows for hardship withdrawals, loans or other special circumstances.

Loan: Individuals can sometimes borrow and gradually repay money from their 401(k) account. Rules and eligibility requirements vary from plan to plan, but unlike hardship withdrawals, IRS taxes and penalties don't apply to 401(k) loans unless you default on them.

Loan Provision: A feature that allows participants to borrow money from their 401(k) accounts, with the requirement to repay the loan with interest.

Multiple Employer Plan (MEP): Retirement plans of unrelated businesses, under the coordination of a third party, can be bundled together under one retirement plan. This arrangement might give them more competitive pricing but typically provides less room for plan customization.

Mutual Fund: A mutual fund is a pool of investors' money that's subsequently invested in stocks, bonds, and other securities and is managed by someone else, like a fund manager. A mutual fund is structured to achieve certain investment objectives. Mutual funds don't put investors' eggs into one basket — meaning if one specific investment does not perform, the damage to the overall investment portfolio of the fund may be limited.

Nondiscrimination Testing: By law, a company's 401(k) plan can't overly favor owners, executives, or those making the most money. Annual nondiscrimination tests look at employee participation, employer contributions, and other factors to determine if the plan complies with those requirements. Certain retirement plans, like Safe Harbor, automatically satisfy some nondiscrimination testing rules

Payroll Deduction IRA: As an alternative to a 401(k) plan, companies can help their employees enroll in a payroll deduction IRA. Individuals establish an IRA and the employer's only responsibility is to facilitate the transfer of the employees' contributions from their paychecks to their IRA account.

Plan Sponsor: Typically, the employer who establishes and maintains the 401(k) plan for the benefit of the employees.

Pooled Employer Plan (PEP): A PEP is a particular type of open MEP set up for multiple unrelated employers. A PEP requires a pooled plan provider to be a named fiduciary and plan administrator for the PEP and to register with the Department of Labor.

Portability: The ability to transfer 401(k) assets from one employer's plan to another or to a personal retirement account without tax penalties, usually upon changing jobs.

Pre-Tax Contributions: Depending on the plan, employees can either contribute to their retirement account before or after federal and state taxes are taken out of their paycheck. As the name suggests, pre-tax 401(k) contributions are taken out before, thus they reduce the employee's gross income in that year, potentially lowering income taxes.

Profit Sharing: In the context of retirement, profit sharing (sometimes referred as nonelective contributions) involves an employer making tax-deductible contributions that are allocated to employees' 401(k) accounts. Think of it as a bonus deposited directly into employees' retirement accounts. Profit-sharing comes with a slew of benefits for employers and employees.

Portfolio: This term simply represents your overall collection of investments. A diverse retirement portfolio features of stocks, bonds, commodities, mutual funds, and other investments. The mix of these reflects how aggressive or conservative an investment strategy.

Qualified Distributions: The amount contributed to a Roth 401(k) or Roth IRA, commonly referred to as the "basis" is always distributed tax free. However, the earnings on those contributions are subject to taxation unless certain requirements are met. When the requirements are met, you have a qualified distribution, and the entire distribution is tax free. Additionally, distributions from a Roth 401(k) will be subject to a 10% early withdrawal penalty tax unless you qualify for an exemption.

Required Minimum Distribution (RMD): The minimum amount that must be withdrawn from a retirement account each year, starting at age 73, as mandated by the IRS.

Rollover: When you move your retirement savings from one plan to another (as might be the case when switching employers), that's called a rollover. If the old and new employers share the same third-party 401(k) plan provider, the transfer is a simple one. In all other cases, the old provider will likely directly transfer the value of the account in cash to the new plan.

Roth 401(k): A type of 401(k) plan where contributions are made with after-tax dollars, and qualified withdrawals in retirement are tax-free.

Roth 401(k) Deferrals: Roth 401(k) deferrals allow employees to contribute to their retirement accounts on an "after-tax" basis, meaning they won't owe taxes on that money, or the investment income on that money, when they retire. Roth accounts tend to be a popular option for younger employees since they have more time for their earnings to compound.

Roth IRA Roth IRAs allow individuals to contribute to their retirement accounts on an "after-tax" basis, meaning they won't owe taxes on qualified distributions (including any earnings) that are withdrawn from the IRA when they retire. Unlike 401(k) plans, IRAs are not necessarily employer sponsored.

Safe Harbor 401(k) Plan: A type of 401(k) plan that automatically satisfies certain IRS nondiscrimination requirements, making it easier for employers to ensure compliance.

Salary Deferral: Another term for elective deferral, where employees choose to have a portion of their salary contributed to their 401(k) plan.

Simplified Employee Pension (SEP): SEP Plan stands for simplified employee pension plan, which is a type of IRA where contributions are made by the employer only. SEPs are tax-deferred retirement plans that may be established by businesses of any size. They are generally popular with entrepreneurs and small business owners due to larger contribution limits, greater flexibility, and fewer administration requirements compared to other retirement plans. If you own a company without many employees and want a low-stress, flexible way to contribute to retirement, a SEP IRA may be a good fit..

Summary Plan Description (SPD): By law, companies with retirement plans are required to provide employees with an overview of the program that is written in language designed to be understood by the average participant. How the plan works, eligibility requirements, vesting details, and other important details need to be included.

Target Date Fund: Mutual funds designed to invest funds in a manner to help achieve the investor's investment objectives at a specific point in time are called target-date funds. In the context of retirement, a target date fund's strategy typically gets more conservative the closer an individual gets to retirement age.

Tax-deferred: If you have a 401(k) account, your investment earnings are growing on a "tax-deferred" basis. This means that, unlike in a normal taxable investment account, you won't pay taxes on earnings in your account every year. When it comes time to take a distribution, you'll just owe income taxes on what you take out.

Tax Penalty: If you take out retirement funds before turning 59½ years old, you'll do so at a cost. The IRS will assess a 10% fee, a tax penalty, in addition to federal and state income taxes unless you meet one of the penalty exemptions.

Traditional 401(k) Deferrals: Traditional 401(k) deferrals allow participants to set aside a share of their paycheck on a pre-tax basis. This means that generally the IRS will only tax these funds when the individual receives a distribution from the plan.

Traditional IRA: Traditional IRAs are tax-advantaged accounts at a bank, insurance company or other regulated financial institution that allow individuals to contribute money on a pre-tax basis. This means that the IRS will only tax these funds when the individual receives a distribution from the account. Unlike 401(k) plans, IRAs are not necessarily employer sponsored.

Vesting: The process by which a participant earns the right to keep the employer's contributions to their 401(k) plan after a certain period of service.

Withdrawals: The act of taking money out of a 401(k) plan, which can be subject to income taxes and early withdrawal penalties if taken before age 59½ without qualifying exceptions

Workplace retirement plan: Companies often offer their employees access to a retirement account as a benefit. A traditional 401(k) plan is the most popular example of a workplace retirement plan.