Administrative Retirement Services, Inc.
2 S. 545 IL Route 53
Glen Ellyn, IL 60137-7175
Phone: (630) 942-0010, Fax: (630) 942-0020

What All 401(k) Plan Sponsors Should Know For 2008

Whether you are setting up a 401(k) plan for your company or a plan has been in place for several years, Administrative Retirement Services, Inc. (ARS) strongly recommends that you take the time to read and understand some basic plan requirements.

Note that this is a brief overview of some very detailed concepts which should help avoid future problems because the reader will have a basic understanding of what is required to have a qualified 401(k) plan.

Maintaining a qualified status means the plan is drafted according to IRS rules, and that all necessary tests are performed and passed annually. If the tests do not pass, corrective action such as ADP refunds or top-heavy minimum contributions are taken to have these tests deemed passed.

SELECTING A TPA

Most companies retain the services of a third party administrator (TPA) to assist in setting up and administering a 401(k) plan. Not all TPAs are the same.

Things to consider when selecting a TPA firm include:

- the staff's experience and qualifications
- staff communication skills
- plan design suggestions and implementation
- document sponsorship
- amendment capability
- ability of the firm to represent your plan before the Internal Revenue Service and Department of Labor
- problem solving abilities

TPA independence is also important because this may impact the quality of work and fees incurred. TPA qualifications to look for are CPA, MST, JD, ESQ, EA, QPA, QKA and CEBS, to name a few. ARS retains CPAs, an MST, a CEBS and an enrolled actuary. The entire staff has, or is working toward the Qualified 401(k) Administrator (QKA) designation.

Selecting the right TPA is paramount to the success of the plan. In most cases, the bundled approach is not the best approach since you cannot choose with whom you work, and whether they have sufficient qualifications to make ongoing plan recommendations.

Most companies evolve, as does the Internal Revenue Code relating to retirement plans. Most plans would be served best by a firm which specializes only in retirement plans, has no vested interest in selling additional services or investments, and which only cares about the success of the plan.

WRITTEN REQUIREMENTS

Written Plan Document

In order to have a qualified 401(k) plan, the Internal Revenue Code requires that a plan sponsor have a written plan and trust. The plan document lists all of the plan provisions, including but not limited to:

- plan name, sponsor, number, year end, trustees
- eligibility requirements
- entry dates
- definition of compensation
- profit sharing and matching contribution allocation method
- discrimination testing methods
- vesting
- loan provisions
- distribution requirements
- normal retirement age

See Administrative Retirement Services, Inc.'s August 2003 newsletter, located on our web site at www.ars401k.com, for a complete discussion on plan provisions and plan types.

Most companies choose to use a prototype plan document because it provides all the necessary plan options, is inexpensive and is pre-approved by the IRS. In addition, it is easier to read than an individually drafted document and probably better written, since the document drafter normally practices solely in the ERISA area.

ARS sponsors plan documents, which means we have submitted plan documents to IRS for approval and are a document sponsor. Document sponsorship shows our commitment to the qualified plan area.

Summary Plan Description

Plan sponsors must provide all plan participants and beneficiaries a Summary Plan Description which summarizes plan provisions in layman's terms. The Employee Retirement Income Security Act (ERISA) requires a number of additional disclosures of plan and benefit information to participants and beneficiaries, such as an annual participant statement and an annual Summary Annual Report (SAR).

ANNUAL TESTING

Nondiscrimination Testing (ADP/ACP)

A 401(k) plan qualifies under the tax code and employee deferrals are not currently taxed if a retirement plan satisfies a nondiscrimination test, which compares employee contributions of eligible highly compensated employees (HCE) to those of eligible non-highly compensated employees (NHCE).

An employee is considered an HCE if in 2008 they earned $105,000 or more in the prior year, or if they own more than five percent of the business in the current or preceding year. Ownership is also attributable to spouses and lineal ascendants and descendants (i.e., parents and children) of each owner. Employers can limit the HCEs to the top 20 percent of employees meeting the plan eligibility requirements and earning $105,000 or more in 2008.

The nondiscrimination test which applies to employee deferrals is the Actual Deferral Percentage (ADP) test, and for the employer matching contributions is the Actual Contribution Percentage (ACP) test.

The ADP test is satisfied if the average ADP (employee contributions divided by wages) for HCEs does not exceed the ADP for NHCEs multiplied by 1.25, or if the ADP for the HCEs does not exceed the ADP for the NHCEs by more than 2 percentage points and the ADP for the HCEs is not more than twice the ADP for the NHCEs. The ACP test must also pass by similar rules.

Plan sponsors can elect to use the prior year's NHCE ADP in performing the current year's nondiscrimination test. This alleviates unwanted refunds to HCEs by providing an exact percent HCEs may contribute for the current year.

The process of performing the ADP and ACP tests are as follows:

- Determine the HCEs and NHCEs.

- Calculate an ADP or ACP ratio for each employee by dividing their applicable contributions by their compensation. Eligible participants not contributing to a plan have a ratio of zero, which is averaged with other eligible participants.

- Calculate the averages for the HCEs and NHCEs by totaling the contribution percentages for all eligible participants, and dividing this by the number of employees in each group.

- Compare the averages for the HCEs and NHCEs.

Top-Heavy Testing

Another important test for a 401(k) plan is the top-heavy test.

Under IRC 416, if the key employee(s) adjusted account balances are greater than 60 percent of adjusted plan assets at the beginning of the plan year, the plan is considered top-heavy. The account balances are adjusted by subtracting the account balances of participants terminated in prior plan years, subtracting rollover balances, adding distributions to participants employed in the previous year and adding in-service distributions made during the last four years.

In order for the key employees to contribute to a top-heavy 401(k) plan, a top-heavy minimum contribution equal to the largest deferral percentage made by a key employee, up to 3 percent, must be contributed by the employer.

Definition of a Key Employee:

- An officer having annual compensation in excess of 50 percent of the annual dollar limitation for defined benefit plans in effect for such plan year ($150,000 for 2008 testing).
- A more than five percent owner.
- A more than one percent owner whose annual compensation exceeds $150,000.

Ownership is also attributable to spouses and lineal ascendants and descendants (i.e., parents and children).

To avoid nondiscrimination and top-heavy testing, a plan sponsor can elect 30 days prior to the beginning of the plan year or initial plan set-up to utilize Safe Harbor provisions which are described on page 6.

Coverage Testing

A plan is not qualified unless it benefits a certain percentage of employees. IRC section 410(b) requires that all plans pass either a ratio percentage test (RPT) or average benefits test (ABT). A RPT must be performed for each contribution type of a plan (salary reduction, profit sharing, matching).

To perform a RPT, the number of NHCEs benefiting in the plan contribution is divided by the number of NHCEs eligible for the plan contribution. Then the number of HCEs benefiting from the plan contribution are divided by the number of HCEs eligible for the plan contribution. The NHCE ratio must be at least 70% of the HCE ratio to pass the RPT. If the RPT fails, the plan can be tested to see if it passes an ABT.

Under the ABT, the plan may benefit employer-defined classes of employees which are reasonable, and do not discriminate in favor of HCEs. The classifications must be found to be nondiscriminatory based on either a safe harbor rule or a facts and circumstances test.

The ABT compares the ratio percentage calculated in the RPT to the safe harbor percentages and to the unsafe harbor percentages. The test automatically passes if the ratio percentage is equal to or greater than the safe harbor percentage.

EMPLOYER CONTRIBUTIONS

Match Contribution

Match contributions allow the plan sponsor to allocate contributions only to participants who make a salary deferral contribution. Matching formulas can be stated in the plan or can be discretionary each year. We recommend making the match discretionary so that it can be changed each year based on business conditions. The match is usually a percentage of each employee’s salary deferral. The salary deferrals which are matched may be limited to a percentage of the participants compensation.

Profit Sharing Contribution

Profit Sharing contributions can be allocated proportionate to salary, integrated with social security (participants who earn more than the social security wage base can receive an extra contribution based on the wages above the base), cross-tested, or assigned a certain dollar amount per hour of service or a flat dollar amount per participant.

Profit sharing and match contributions may be calculated and deposited each payroll period or at the end of the year.

Plan sponsors can allocate this contribution to all participants or can limit it to all participants employed at the end of the year who have completed 1,000 hours of service during the year, subject to the coverage testing rules. If employer contributions are limited to participants employed at the end of the year, we recommend that the contributions not be made until the end of the year.

CONTRIBUTION DEPOSIT RULES

Employer Contributionss

In order for employer contributions to qualified plans to be deductible, they must be deposited by the employer's federal tax return due date, according to Internal Revenue Code section 404(a)(6).

If the tax return is extended, the taxpayer is given additional time to deposit the employer's contribution. This rule applies to both cash and accrual basis taxpayers.

Employer contributions include profit sharing, money purchase, defined benefit and matching contributions.

Example 1

A calendar year C or S corporation sponsors a 401(k) profit sharing plan, which offers both profit sharing and matching contributions. The 2008 corporate tax return (1120 or 1120S) is due by March 15, 2009. Profit sharing and matching contributions must be deposited by March 15, 2009 in order to be deductible, regardless of whether the taxpayer is under the cash or accrual basis of accounting.

If the corporate tax return is extended before March 15, 2009 using form 7004, the corporation has until September 15, 2009 to deposit the 2008 profit sharing and matching contributions. These dates would also apply for defined benefit and money purchase contributions.

Example 2

Sole proprietors are unincorporated businesses. They are normally calendar year taxpayers and file form 1040 and report their business activity on schedule C.

Calendar year 2008 1040s are due by April 15, 2009. For Employer contributions to be deductible, they must be deposited by April 15, 2009. The sole proprietor's tax return can be extended for six months to October 15, 2009 by completing form 4868. If the return is extended, the date by which the employer's contribution must be deposited is also extended.

Note that even if both extensions are filed and granted, money purchase and defined benefit contributions for 2008 must be deposited by September 15, 2009 due to minimum funding requirements. Employer contributions are considered deposited timely if they are mailed by the due date of the taxpayers tax return.

401(k) Contributions

401(k) contributions which an employer withholds from employees, must be deposited as soon as administratively feasible, but no later than the 15th day of the following month. 401(k) contributions deposited after this deadline are subject to a fifteen percent (15%) IRS penalty. The employer is also required to make up any lost earnings to the participants. For more details see Volume 2, Issue 2-April 2001 newsletter located at www.ars401k.com.

FILING & BONDING REQUIREMENTS

Form 5500 Filing Requirements

All qualified plans are required to file Form 5500, which is due seven months after the plan year end and can be extended 2 ½ months. Calendar year plan Form 5500s are due July 31 and can be extended until October 15 using Form 5558. Failure to file a timely Form 5500 can result in a $25 per day penalty up to $15,000.

One-participant plans do not have to file Form 5500EZ until they have more than $250,000 in plan assets. However, by filing the form, the statute of limitations begins and runs three years from the date of filing. Thus, filing tax forms is always prudent.

Distributions & 1099-R Reporting

Distributions normally take place upon attainment of a distributable event, such as retirement, severance from employment or death. Terminated participants can rollover their funds into another plan or IRA or take a lump sum distribution. Form 1099-R must be distributed to participants who have received a retirement plan distribution by January 31 of the year following the year in which the distribution took place. 1099s report the taxable status of a distribution. If funds are rolled over from one plan to another plan or IRA, the funds are not taxable, but do require the filing of a 1099-R.

1099-Rs may be created by the employer, the TPA, or the investment firm. It is the responsibility of the employer to ensure that participants receive the 1099-R by the January 31 deadline. Failure to file a timely Form 1099-R may result in penalties ranging from $15 - $50 per day, up to $100,000.

Fidelity Bonding Requirements

According to Section 412 of ERISA, all Trustees (Fiduciaries) of Corporate Retirement and Welfare Funds must obtain a Fidelity Bond. The amount of the bond required is 10% of the Plan assets, with a maximum bond of $500,000. If your company already carries Fidelity Bond coverage, you can contact the person who wrote this coverage and have them add the retirement plan as an additional named insured. If your company does not have a Fidelity Bond at present, you should obtain a Commercial Blanket Fidelity Bond for your retirement plan.

PLAN LIMITS

Employee Contribution Limit

For 2008, plan participants can contribute 100% of wages or self-employment income up to $15,500. This is known as the 402(g) limit. If the participant will attain the age of 50 during the plan year, they can contribute an additional $5,000. For various plan limits, see Annual Dollar Limits on our website at www.ars401k.com.

Employer Contribution Limit

Employers may contribute profit sharing or matching contributions up to 25% of eligible compensation for the entire company. For 2008, eligible compensation includes W-2 wages or income subject to self- employment taxes up to $230,000. The contributions can be discretionary or have a set formula, and must be deposited by the taxpayer's tax return due date with extension.

Annual Additions Limit

A qualified plan must limit the annual additions, or total benefits, that are allocated to a participant's account for a limitation year. Defined contribution annual additions are limited to the lesser of 100% of the participant's section 415 compensation or $46,000 in 2008. Defined benefit annual additions are limited to $185,000 in 2008.

PLAN DESIGN IDEAS

Cross-Testing

Cross-testing a profit sharing contribution allows a plan sponsor to define classes of employees and contribute a specific percentage per class subject to an average benefits test. A plan must satisfy a minimum allocation gateway where either each NHCE in the plan has an allocation rate that is at least one-third of the allocation rate of the HCE with the highest allocation rate, or, each NHCE receives an allocation of at least 5% of the NHCE's compensation (within the meaning of section 415(c)(3)).

In a typical cross-tested plan, HCEs (who tend to be older than a majority of NHCES) receive high allocation rates (often 20% to 25% of compensation), while NHCEs, regardless of their age or years of service, receive comparatively lower allocation rates (e.g., 5% of compensation).

In the typical case, there are a sufficient number of young NHCEs to enable the employer to demonstrate compliance with the nondiscrimination standards, by comparing the actuarially projected value of the small allocations for those young NHCEs with the actuarially projected value of the substantially larger allocations for older HCEs.

Safe Harbor 401(k) Plan

Safe Harbor plans automatically pass nondiscrimination and top-heavy testing. A Safe Harbor 401(k) Plan requires that the plan sponsor contribute either 3% of compensation to all eligible participants, or match 100% of the first 3% plus 50% of the next 2% of employee contributions. Both contributions are 100% vested immediately.

The above rules and tests provide many planning opportunities. For assistance in understanding or implementing any of these concepts, contact Administrative Retirement Services, Inc.