ERISA Basics National Institute: Section 401(k) Plans

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401(k) Plan Definition

A 401(k) plan has a qualified cash or deferred arrangement that is part of a profit sharing plan or stock bonus plan I.R.C. Sec. 401(k)(2)

- Under which a covered employee may elect to make contributions to the plan I.R.C. Sec. 401(k)(2)(A)
- Under which the covered employee's contributions are not distributable before severance from employment, disability, death, attainment of age 59½, financial hardship, or termination of the plan I.R.C. Sec. 401(k)(2)(B)
- Under which the covered employee's contributions are nonforfeitable I.R.C. Sec. 401(k)(2)(C)

401(k) Presentation Objectives

- ✓**Who** gets the money?
- ✓**What** money do they receive?
- ✓**Where** does the money go?
- ✓**When** do they get the money?
- ✓**How** is the money administered?

Who Gets the Money?

A plan sponsor determines its eligible employees, but a 401(k) plan must cover specified employees who meet the statutory age requirement of 21 ***and*** the statutory service requirement of 1 year I.R.C. Sec. 410(a)(1)(A)

- A 401(k) plan cannot impose a maximum age limit on participation I.R.C. Sec. 410(a)(2)
- A 401(k) plan can impose a 2-year service requirement if all contributions are nonforfeitable under the 401(k) plan I.R.C. Sec. 410(a)(1)(B)(i)

Who Gets the Money?

A 401(k) plan must measure the completion of the required service on either an ***hours basis*** or ***elapsed time basis*** under Treas. Reg. Sec. 1.410(a)-7(a)(1)

- ***Hours basis*** – must complete 1,000 hours of service in first 12 months of employment or in any plan year that begins during this period I.R.C. Sec. 410(a)(3)
  - Generally any *paid* hour of employment must be counted, including vacation, holiday, sick leave, jury duty, layoff, and back pay awards 29 C.F.R. Sec. 2530.200b-2
- ***Elapsed time basis*** –must work 12 months measured from the employee's date of hire until he has severed by quit, discharge, retirement, death, or the first anniversary of absence for any other reason Treas. Reg. Sec. 1.410(a)-7(a)(2)

Who Gets the Money?

- A 401(k) plan may exclude certain employees, including collectively bargained employees and non-resident alien employees with no U.S. earned income I.R.C. Sec. 410(b)(3)
- Although not prohibited by statute, the IRS scrutinizes any exclusion that is based on anything other than the statutory service or age restrictions IRS Quality Assurance Bulletin (Feb. 14, 2006). Common coverage exclusions subject to IRS' scrutiny include:
  - Seasonal employees
  - Temporary employees
  - Part-time employees

Who Gets the Money?

Coverage testing applies to a 401(k) plan to ensure that its availability does not discriminate in favor of highly compensated employees. The 401(k) plan must either:

- Benefit 70% of all the employer's non-highly compensated employees I.R.C. Sec. 410(b)(1)(A)
- Benefit a percentage of non-highly compensated employees that is at least 70% of the benefitting percentage of highly compensated employees I.R.C. Sec. 410(b)(1)(B)
- Meet the average benefit percentage test I.R.C. Sec. 410(b)(2)

What Money Do They Receive?

Contributions are chosen by the plan sponsor and must be specified in the plan's legal document:

- ***Employee pre-tax contributions***, like 401(k) under I.R.C. Sec. 401(k), catch-up under I.R.C. Sec 414(v), or rollover under I.R.C. Sec. 402(c)
- ***Employee post-tax contributions***, like after-tax under I.R.C. 414(h), Roth 401(k) under I.R.C. Sec 402A, or Roth catch-up under I.R.C. Sec 402A and 414(v)
- ***Employer pre-tax contributions***, like matching under I.R.C. Sec. 401(m) or profit sharing under I.R.C. Sec 401(a)(1)

What Money Do They Receive?

401(k) contributions are pre-tax contributions made by a covered employee in lieu of receiving taxable wages. A covered employee may make 401(k) contributions under an election or by default under automatic enrollment. Treas. Reg. Sec. 1.401(k)-1(a)(3)

- 401(k) contributions by an election must precede the employee's services and must precede the availability of cash wages. Treas. Reg. Sec. 1.401(k)-1(a)(3)(iii)
- 401(k) contributions can be automatic if an employee fails to decline enrollment. ERISA Sec. 514(e).

What Money Do They Receive?

A ***contribution based safe harbor*** and an ***automatic enroll-ment safe harbor*** escape certain nondiscrimination testing

- ***Contribution based safe harbor*** – qualified employer nonelective contributions of 3% of a covered employee's pay ***or*** matching contributions of 100% on up to 3% of the covered employee's pay and of 50% on next 2% of pay I.R.C. Sec. 401(k)(12)
- ***Automatic enrollment safe harbor*** – unless declined, a covered employee must automatically make specified levels of 401(k) contributions ***and*** either receive qualified employer nonelective contributions of 3% of a covered employee's pay ***or*** receive matching contributions of 100% on up to 1% of the employee's pay and of 50% on next 5% of pay I.R.C. Sec. 401(k)(13)

What Money Do They Receive?

Another type of contribution is a Roth 401(k) contribution, which is a hybrid contribution.

- Some features like an after-tax contribution where Roth 401(k) contributions are taxed when contributed to the plan I.R.C. Sec. 402A(c)(1)
- Some features like a pre-tax contribution where Roth 401(k) contributions are subject to the same contribution limits and nondiscrimination testing as other 401(k) contributions I.R.C. Sec. 402A(c)(2)
- Some unique features unlike other contributions, such as distribution and rollover rules I.R.C. Sec. 402A(c) and (d)

What Money Do They Receive?

Contributions under a 401(k) plan normally are based on compensation. Compensation used in calculating contributions must meet certain statutory requirements

- Compensation used to calculate benefits cannot exceed the statutory maximum as periodically adjusted by IRS ($265,000 for 2016) I.R.C. Sec. 401(a)(17)
- Compensation used in nondiscrimination testing must either be based on an approved regulatory definition or must not favor highly compensated employee by more than a de minimis amount Treas. Reg. Sec. 1.414(s)-1(a)(3)

What Money Do They Receive?

401(k), Roth 401(k), after-tax and matching contributions must meet numerous nondiscrim-ination requirements.

- 401(k), Roth 401(k), catch-up, and Roth catch-up contributions must not exceed periodically adjusted statutory maximums ($18,000 for 401(k) and Roth 401(k) and $6,000 for catch-up and Roth catch-up in 2016) I.R.C. Sec. 402(g)
- 401(k) and Roth 401(k) contributions as a percentage of pay for highly compensated employees cannot exceed those of non-highly compensated employees by more than the statutory amount I.R.C. Sec. 401(k)(3)
- After-tax and matching contributions as a percentage of pay for highly compensated employees cannot exceed those of non-highly compensated employees by more than the statutory amount I.R.C. Sec. 401(m)(1) and(2)

What Money Do They Receive?

All contributions under a 401(k) plan must meet additional nondiscrimination requirements

- All contributions cannot discriminate in amount in favor of highly compensated employees Treas. Reg. Sec. 1.401(a)(4)-2
- All contributions and forfeitures allocated to a participant each year, except rollover contributions, cannot exceed a periodically adjusted statutory maximum ($53,000 in 2016) I.R.C. 415(c)
- If a plan is top heavy with 60% or more of aggregate benefits provided to key employees (certain officers or owners with compensation above periodically adjusted statutory amounts), then employer contributions to non-key employees must equal the lesser of: 3% of pay or the same as the highest key employee contribution percentage I.R.C. Sec. 416

What Money Do They Receive?

An employee receives only contributions and earnings in the employee's vested accounts. All non-vested amounts are forfeited.

- 401(k), Roth 401(k), catch-up, Roth catch-up, after-tax, or rollover contributions, or qualified employer nonelective contributions or matching contributions under a contributions based safe harbor, must be 100% vested I.R.C. Secs. 401(k)(2)(C), 401(k)(12)(E), and 411(a)(1)
- Qualified employer nonelective contributions or matching contributions under an automatic enrollment safe harbor must fully vest after 2 years I.R.C. Sec. 401(k)(13)(D)(iii)
- All other employer contributions must fully vest after 3 years ***or*** vest 20% each year beginning after 2 years with full vesting after 6 years I.R.C. Sec. 411(a)(2)(B)

Where Does the Money Go?

ERISA requires that 401(k) plan assets go to a trust or to an insurance contract or company

- Under ERISA Sec. 403(a), all assets of an employee benefit plan must be held in ***trust*** unless an exception applies.
- ERISA Sec. 403(b) provides an exception from the trust requirement for any plan assets that consist of ***insurance contracts*** or that are held by an ***insurance company***.

Where Does the Money Go?

Plan assets must be timely contributed by the employer.

- Under DOL Reg. Sec. 2510.3-102(a)(1), employee contributions are plan assets as soon as they can be segregated from the employer's general assets.
- DOL Reg. Sec. 2510.3-102(b) provides that the latest date on which employee contributions can be segregated is the 15th business day of the month following the month in which the employee contributions are deducted. If the participant contributions are deposited ***after*** the earliest date they can be segregated, the contributions are "delinquent."
- Examples in DOL Reg. Sec. 2510.3-102(f) indicate that if an employer can transmit participant contributions to a 401(k) plan within 3 business days after paychecks are issued, the participant contributions become plan assets after 3 business days from the date that paychecks are issued.

Where Does the Money Go?

I.R.C. Sec. 401(a) sets forth qualification requirements for a trust funding a retirement plan, including a 401(k) plan.

- I.R.C. Sec. 401(a)(2) requires that the 401(k) plan assets must be held in the ***trust*** until distributed to the employees or their beneficiaries according to the plan's provisions.
- I.R.C. Sec. 401(a)(2) provides that the assets of the trust ***cannot be used by the employer*** sponsoring the plan or by any other party.
- Under I.R.C. Sec. 401(a), Plan assets must be used for the ***exclusive benefit*** of 401(k) plan participants and beneficiaries.

Where Does the Money Go?

Most 401(k) plans permit participants to direct the investment of their accounts. Fiduciaries generally are responsible for the **prudent** selection and monitoring of investment options. However, ERISA Sec. 407 limits investments in "employer securities" and "employer real property".

- Under ERISA Sec. 407(a)(1)(A), plans may invest in employer securities only if they are "**qualifying employer securities**" (defined in ERISA Sec. 407(c)(4) as employer stocks or "marketable obligations")
- Under ERISA Sec. 407(a)(1)(A), plans may invest in employer real property only if it is "**qualifying employer real estate**" (defined in ERISA Sec. 407(c)(5) as several parcels that are geographically dispersed and suitable for more than one use).

Where Does the Money Go?

Under **ERISA Sec. 404(c)**, plan fiduciaries are not liable for losses that result from a participant's investment directions if certain requirements are satisfied. Participants must be given an opportunity to:

- Choose from a ***broad range*** of investment alternatives (at least 3 diversified investment funds with a broad range of risk and return) (DOL Reg. Sec. 2550.404c-1(b)(3));
- ***Change*** investment elections at least once every **3 months** (frequency must be appropriate for volatility) (DOL Reg. Sec. 2550.404c-1(b)(2)(ii)(C)); and
- Obtain ***sufficient information*** to make informed investment decisions (DOL Reg. Sec. 2550.404c-1(b)(2)(i)(B)) .

Where Does the Money Go?

- DOL Reg. Sec. 2550.404c-5 provides fiduciary relief for "qualified default investment alternatives." ("**QDIAs**"). QDIAs are investments made in the absence of instructions from a plan participant.
- DOL Reg. Sec. 2550.404c-5(e) defines QDIAs to include the following:
  - An investment fund that seeks long-term appreciation and capital preservation through a mix of equity and fixed income investments based on the participant's age, target retirement date or life expectancy (***target date funds***). DOL Reg. Sec. 2550.404c-5(e)(4)(i).
  - An investment fund that is diversified and designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income investments with a target level of risk for the plan participants as a whole (***balanced funds***). DOL Reg. Sec. 2550.404c-5(e)(4)(ii).
  - An investment management service for a plan participant's individual account that seeks long-term appreciation and capital preservation through a mix of equity and fixed income investments (***managed account***). DOL Reg. Sec. 2550.404c-5(e)(4)(iii).

Where Does the Money Go?

DOL Reg. Sec. 2550.404a-5 requires ***fees*** paid by the 401(k) plan to be disclosed to participants so they know what the plan costs.

- DOL Reg. Sec. 2550.404a-5(c)(2) requires disclosure of the fees for administering the plan, such as recordkeeping fees.
- DOL Reg. Sec. 2550.404a-5(c)(3) requires disclosure of expenses charged against a participant's account on an individual basis, such as when a participant invests through an open brokerage window.

DOL Reg. Sec. 2550.404a-5 contains other disclosure requirements, including identifying the 401(k) investment options and providing performance data and benchmarks.

When Do they Get the Money?

Under Treas. Reg. Sec. 1.401(k)-1(d)(1), 401(k) contributions can be distributed while the participant is still working only under certain limited circumstances.

- 401(k) plans are not required to permit in-service distributions.
- 401(k) plans may permit in-service withdrawals any time after the employee reaches **age 59-1/2**. Treas. Reg. Sec. 1.401(k)-1(d)(1)(ii).

When Do they Get the Money?

Treas. Reg. Sec. 1.401(k)-1(d)(1)(ii) allows 401(k) plans to provide in-service withdrawals on account of "**hardship**" defined in Treas. Reg. Sec. 1.401(k)-1(d)(3)(iii) as:

- Purchase of the participant's primary home.
- Post-secondary educational fees for the next 12 months for the participant or the participant's spouse, children or dependents.
- Unreimbursed medical expenses, for the participant or the participant's spouse, children or dependents.
- Preventing eviction from or foreclosure on the participant's primary home.
- Burial expenses for the participant's deceased parent, spouse, children or dependents.
- Expenses to repair damages to the participant's primary home that would qualify as a casualty deduction.

When Do they Get the Money?

A plan sponsor can choose whether its 401(k) plan may allow participants to take ***loans*** from the plan.

- In order for a loan not to be treated as a distribution from the plan, I.R.C. Sec. 72(p) requires that the loan amount not exceed the lesser of (a) $50,000 reduced by the participant's highest plan loan balance in the last 12 months, *and* (b) the greater of (i) $10,000 ; and 50% of the account value .
- A participant loan is a prohibited transaction under I.R.C. Sec. 4975 and ERISA unless the conditions of I.R.C. Sec. 4975(d)(1) are satisfied.
- DOL Reg. Sec. 2550.408(b)-1 sets forth these conditions, including that the loan bear a reasonable interest rate and be "adequately secured."
- Under I.R.C. Sec. 401(a)(13), which generally prohibits the assignment of plan benefits, use of a 401(k) plan account balance as security for a loan is not a prohibited assignment.

When Do they Get the Money?

- Treas. Reg. Sec. 1.401(k)-1(d)(1)(i) permits distributions upon the employee's ***death, disability or severance from employment***.
- I.R.C. Sec. 401(a)(9) contains ***minimum distribution rules*** that require:
  - Annuity distributions to be evenly spread over the life of the employee or over the lives of the employee and a designated beneficiary (I.R.C. Sec. 401(a)(9)(A)(ii)).
  - The distribution to begin by April 1 of the year following the later of (a) the employer's termination of employment and (b) the year in which the employee reaches age 70½ (I.R.C. Sec. 401(a)(9)(A)(ii)). Special rules apply to 5% owners.

When Do they Get the Money?

- I.R.C. Sec. 411(a)(11) permits plans to distribute account balances of $5,000 or less immediately after termination of employment.
- If the balance exceeds $5,000, the 401(k) plan can't force a participant to take a distribution before the later of (a) normal retirement age under the plan (usually age 65), and (b) age 62. Treas. Reg. Sec. 1.411(a)-11(c)(4).
- I.R.C. Sec. 401(a)(31) requires plans to provide participants with the right to directly transfer "**eligible rollover distributions**" to another plan that accepts such distributions.
  - Eligible rollover distributions are defined in I.R.C. Sec. 402(c)(4) as any plan distribution other than (a) a distribution consisting of a series of payments over the life expectancy or for a period of 10 years or more, (b) a required minimum distribution under I.R.C. Sec. 401(a)(9) or (c) a hardship distribution.

When Do they Get the Money?

Treas. Reg. Sec. 1.401(k)-1(d)(1)(iii) permits distributions upon ***termination of the 401(k) plan***. Under Treas. Reg. Sec. 1.401(k)-1(d)(4), distribution upon plan termination is permitted only if the employer does not have an "alternative defined contribution plan" defined as a defined contribution plan:

- That exists at any time during the 12 month period after termination of the 401(k) plan;
- In which 2% or more of the terminated 401(k) plan participants are eligible to participate; and
- Which is not an ESOP, SIMPLE, SEP, 457 plan or 403(b) plan.

How is the Money Administered?

- ERISA Sec. 402(a)(1) requires that every plan have one or more “**named fiduciaries**” who have authority to control and manage the operation and administration of the plan.
- It is common practice for a 401(k) committee to be the “named fiduciary” responsible for the day to day operation of a 401(k) plan.
  - The committee could be named in the 401(k) plan document or could be selected by the plan sponsor’s board of directors or other governing body.
  - The committee may have sole responsibility and authority for selecting investment options for the 401(k) plan.

How is the Money Administered?

- **Other Fiduciaries:** Anyone who exercises ***discretion*** in administering and managing the plan or controlling the plan's assets.
  - Ordinarily includes the trustee and investment advisors or consultants
  - Attorneys, accountants and actuaries are generally *not* fiduciaries when acting solely in their professional capacities
- **New DOL Rule** (Apr. 2017): Fiduciary test for financial advisors based on ***relationships*** that give rise to fiduciary responsibilities and ***communications*** that constitute investment advice.
- **Duty to Monitor:** Fiduciaries have a continuing duty to regularly monitor trust investments and remove imprudent ones. *Tibble v. Edison International*, 135 S. Ct. 1823 (2015).

How is the Money Administered?

ERISA Sec. 412 requires individuals who handle plan assets to be **bonded** to protect the plan from losses due to fraud or dishonesty, but not from other fiduciary breaches.

- Every administrator, officer and employee of an ERISA-covered plan who handles funds or other property must be bonded
- Under ERISA Sec. 412(a), the amount of bond must be 10% of funds handled, but not less than $1,000 and no more than $500,000 ($1,000,000 if the plan holds “employer securities”).
- ERISA Sec. 412(a) provides that the value of bond is computed by using the amount of plan assets handled for the previous year.
- Coverage may be paid from plan assets or by the employer.

How is the Money Administered?

Mistakes can occur in the administration of 401(k) plans. Both the IRS and the DOL provide correction programs.

- IRS Rev. Proc. Rev. Proc. 2016-51 contains the Employee Plans Compliance Resolution System ("**EPCRS**") for corrections of qualification errors. The IRS recently updated this guidance to reflect the elimination of the determination letter program.
  - Appendix A to Rev. Proc. 2016-51 sets forth acceptable corrections for 401(k) errors.
- The DOL issued a notice, 71 Fed. Reg. 20262 (4/19/06), that contains the Voluntary Fiduciary Correction Program ("**VFCP**").
  - Section 7.1 of the notice provides a correction method for delinquent participant contributions.

Presentation Summary

- ✓**Who** gets the money? Selected by plan sponsor but subject to statutory eligibility and coverage testing requirements
- ✓**What** money do they receive? Selected by plan sponsor but subject to statutory nondiscrimination and vesting requirements
- ✓**Where** does the money go? Into a trust or insurance policy within statutory timing requirements and with investments selected by either the plan's fiduciary or participants
- ✓**When** do they get the money? Unless the plan permits loans, limited availability during employment and normally available only after separation from employment
- ✓**How** is the money administered? By a fiduciary in accordance with the plan's legal documents unless governmental correction procedures are utilized

QUESTIONS?