Evaluating Your Plan’s Features

Studies show that a 401(k) plan’s design can have a significant influence on both participation and contributions. One way you can evaluate the effectiveness of your plan design is to compare the plan’s features to a benchmark, such as the Profit Sharing/401(k) Council of America’s (PSCA) Annual Survey of Profit Sharing and 401(k) Plans. The most recent survey* published reflects 2005 plan year experience.

Contributions and Participation

The first things an employer should consider are the plan’s participation and participant deferral rates. The PSCA survey’s average participation rate for all 401(k) plans is 77.7%. Participation is greatest in plans that offer both a fixed and discretionary match (89% average participation rate) and — not surprisingly — lowest in plans with no employer match (66.1%). The average deferral of lower paid participants, as the ADP tests define them, is 5.4% of pretax pay, while higher paid participants defer 6.9%.

Company 401(k) contributions average 2.8% of pay (5.8% in combination profit sharing/401(k) plans). The most common matching formula is a fixed match (31.9% of plans). Among plans with company matches, 19.1% offer a graded match based on the percentage of pay deferred. The most common fixed-match contribution (33.6%) is 50 cents per dollar of the first 6% of pay deferred. A dollar-for-dollar match of up to 4% of pay is the choice for 8.6% of plans, and 8.4% offer a 50-cents-per-dollar match of the first 4% deferred.

If you find that your participation and participant deferral rates vary significantly from other similarly sized 401(k) plans, you may want to investigate why. A good place to start is by looking at the rates and plan features offered by similarly sized plans (see the table on page two).

Plan Investments

The number of funds that plans offer continues to increase. The average number of funds available for participant contributions is 19, up from 18 in 2004 and 10 in 1998. Among large plans, however, the average number of investment options is down to 17 from 20 in 2004. Among all plans, the most common investment option for participant contributions is actively managed domestic equity funds (80%). Actively managed international equity funds are second (74.8%), and indexed domestic equity funds are third (71.3%).

For plans surveyed that offer automatic enrollment, the most popular default investment choice is a lifestyle or target date fund (37%), followed by stable value funds (30.3%), balanced funds (17%), and money market funds (9.7%). Employers that currently have a stable value or money market fund as their default investment should be aware (continued on page 2)
that the Pension Protection Act of 2006 generally requires default investments to be U.S. Department of Labor (DOL) approved, and currently neither stable value nor money market funds are on the DOL’s initial list. At press time, final regulations are expected to be issued soon. The final rules may or may not sanction these funds.

**Plan Loans**

The vast majority of 401(k) plans (85.2%) allow loans. Most charge some type of loan fee to participants — loan origination fees being the most common. Fewer than half of the plans allow multiple loans, and nearly all have a minimum loan amount. In 82% of the plans surveyed, this minimum loan amount is between $500 and $1,000.

While different employers have different plan objectives and employee demographics vary, a look at the PSCA’s survey results can give employers a good idea of what similar plans offer.

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**How Does Your 401(k) Plan Compare?**

<table>
<thead>
<tr>
<th>Plan Rates and Features Offered</th>
<th>Plan Size by Number of Participants</th>
<th>1-49</th>
<th>50-199</th>
<th>200-999</th>
<th>All Plans*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average employee participation rate</td>
<td></td>
<td>84.6%</td>
<td>81.1%</td>
<td>76.6%</td>
<td>77.7%</td>
</tr>
<tr>
<td>Average pretax deferral for nondiscrimination testing</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Higher paid employees</td>
<td></td>
<td>7.3%</td>
<td>7.1%</td>
<td>6.8%</td>
<td>6.9%</td>
</tr>
<tr>
<td>Lower paid employees</td>
<td></td>
<td>6.1%</td>
<td>5.9%</td>
<td>5.2%</td>
<td>5.4%</td>
</tr>
<tr>
<td>Type of match (where offered)</td>
<td></td>
<td>76.9%</td>
<td>87.8%</td>
<td>84.5%</td>
<td>79.3%</td>
</tr>
<tr>
<td>Fixed</td>
<td></td>
<td>22.2%</td>
<td>12.2%</td>
<td>14.4%</td>
<td>19.1%</td>
</tr>
<tr>
<td>Graded</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plans permitting catch-up contributions for participants age 50 and older</td>
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<td>97.5%</td>
<td>98.5%</td>
<td>98.4%</td>
<td>98.0%</td>
</tr>
<tr>
<td>Plans matching catch-up contributions (when permitted)</td>
<td></td>
<td>38.7%</td>
<td>31.3%</td>
<td>29.6%</td>
<td>27.9%</td>
</tr>
<tr>
<td>Participants making catch-up contributions</td>
<td></td>
<td>39.7%</td>
<td>24.7%</td>
<td>15.3%</td>
<td>23.3%</td>
</tr>
<tr>
<td>Plans permitting loans</td>
<td></td>
<td>73.3%</td>
<td>71.6%</td>
<td>91.1%</td>
<td>85.2%</td>
</tr>
<tr>
<td>Plans allowing multiple loans</td>
<td></td>
<td>25.0%</td>
<td>40.8%</td>
<td>43.4%</td>
<td>45.8%</td>
</tr>
</tbody>
</table>

* Includes larger sized plans.

Source: 49th Annual Survey of Profit Sharing and 401(k) Plans, Profit Sharing/401(k) Council of America; copies available online at www.psca.org.

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**The Latest on Plan Loans**

Many 401(k) plans offer participant loans as a way to encourage employees to participate. The reasoning is that, if employees — particularly younger, lower paid employees — know they can access the money in their plan accounts if they really need to, they will be more comfortable contributing to the plan. And this reasoning is solid. Plans that offer loans generally have high participation rates.

But some employers have concerns that employees will overuse the loan option, causing extra administrative work for the employer and possibly hampering the employees’ ability to successfully save for retirement. Information from two recent studies may alleviate this concern.

Surveys from the Employee Benefit Research Institute/Investment Company Institute (EBRI/ICI) and the Profit Sharing/401(k) Council of America (PSCA)* both show that, while about 85% of the plans/employers surveyed have a plan loan feature, fewer than a quarter of employees who are eligible for a loan actually had outstanding loans. The surveys also revealed that average outstanding loan balances were relatively low ($6,821 and $7,407 respectively).

The PSCA study also found that many employers implement restrictions to control plan loans. For example, 84.5% of employers surveyed charged borrowers some kind of loan fee; 94.7% imposed a minimum loan amount (most commonly between $500 and $1,000); and fewer than half (47.9%) allowed employees to have more than one plan loan outstanding at a time.

Now that the provisions allowing employees to make designated Roth contributions to 401(k) plans are permanent, more employers are considering adding this feature to their plans. If your plan offers Roth contributions or you are thinking about offering them, you’ll want to be familiar with the recently issued final regulations on distributions from Roth 401(k) accounts. Here are some key points made in the regulations.

**How are Roth 401(k) account distributions taxed?** The tax treatment depends on whether the distribution is “qualified.” With a qualified distribution, the employee does not include any amount in income for federal tax purposes. Generally, a distribution is qualified if it is made (1) after the employee reaches age 59½ or on account of disability or death and (2) after a five-year period has elapsed. If a distribution is not qualified, the portion of the distribution allocable to account earnings is subject to income tax and possibly to a 10% early withdrawal penalty.

**Do the regulations address how the five-year period is determined?** As with the proposed regulations issued in early 2006, the final regulations say the five-year period begins on the first day of the employee’s tax year in which the employee first makes a designated Roth contribution to the employer’s plan and ends when five consecutive tax years have passed. A contribution that is returned as an excess deferral, excess contribution, or “permissible withdrawal” from an automatic contribution arrangement (after 2007) does not begin the five-year period.

**What about rollovers?** Employees may make tax-free rollovers of eligible rollover distributions from a designated Roth account to either a designated Roth account with another employer’s plan or to a Roth IRA. However, rollovers of otherwise nontaxable amounts to another designated Roth account must be accomplished through a direct rollover. If an eligible rollover distribution is instead paid to the employee, the employee could still roll over the entire amount (or any portion of it) to a Roth IRA within 60 days.

If a nonqualified distribution is paid to the employee and less than the entire amount is rolled over, the part that is rolled over is deemed to consist first of the portion of the distribution attributable to account earnings. It is possible for an employee to roll over the taxable portion of a distribution from a designated Roth account into a designated Roth account under another plan within 60 days. However, the recipient plan would have additional reporting requirements.

New Guidance on Roth Distributions

With rollovers to Roth IRAs, the starting date depends on whether the employee has an existing Roth IRA. If the employee does not, the five-year period begins with the year the rollover is completed. If the employee already has a Roth IRA, the five-year period for the amounts attributable to the rollover contribution is the same as the period for the previously established Roth IRA.

**When do the new regulations take effect?** They are effective April 30, 2007, and generally apply to tax years beginning on or after January 1, 2007.
Recent Developments

■ Update on Deduction Rules.
Employers maintaining both defined benefit (DB) and defined contribution (DC) plans are subject to the 25% combined plan deduction limit for 2006 and 2007. However, they may make a contribution of up to 6% of compensation to their DC plan without the amount being counted toward the 25% limit. Recent IRS guidance clarified that when the plan year and the employer’s taxable year are not the same, the employer has three alternatives for determining the allowable deduction: the plan year beginning in the taxable year, the plan year ending in the taxable year, or a weighted average of the two.

Effective for plan years starting in 2008, employers with DB plans covered by the Pension Benefit Guaranty Corporation (PBGC) are no longer subject to the 25% combined DB/DC deduction limit. They may take a deduction for the minimum DB funding amount (even when it exceeds 25% of compensation) and a deduction of up to 25% of compensation for the DC plan. Plans not covered by the PBGC will remain under the combined limit plus the 6% in effect as of 2006 and 2007.

Note: With limited exceptions, most DB plans are covered by Title IV of ERISA and the PBGC. The exceptions are plans of “professional service employers” with 25 or fewer active participants and plans covering only substantial owners and no common-law employees.

“...employers with DB plans covered by the Pension Benefit Guaranty Corporation (PBGC) are no longer subject to the 25% combined DB/DC deduction limit.”

■ Schedule P Discontinued. For years, filers of Form 5500 could attach a Schedule P, which started a three-year statute of limitations for the return. The form was unusual in that the institution holding the assets for the plan had to sign it and often actually completed it for the employer. Schedule P has been eliminated. The statute of limitations will now automatically be set at three years.

■ Final 409A Regulations Issued. The long awaited final 409A regulations for nonqualified plans have been issued. These regulations bring together interim guidance from the last 2 ½ years. The 397 pages of regulations are being pored over by practitioners. Documents will need to be compliant before the effective date of January 1, 2008.

Can We Help?
Our firm offers a broad range of employee benefit plan services. If we can be of service to you, please call.

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