Correcting Excess 401(k) Contributions

**SITUATION:** When conducting its annual actual deferral percentage (ADP) nondiscrimination testing, Employer found that several highly compensated employees had contributed disproportionately more to its 401(k) plan than lower paid employees, causing the plan to fail the ADP test.

**QUESTION:** What can Employer do to correct these excess contributions?

**ANSWER:** Employer has three choices: (1) the plan can return the excess contributions and related earnings to the highly compensated employees, (2) the plan can recharacterize the excess contributions as after-tax or catch-up contributions (if the employee qualifies), or (3) the employer can make additional qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs) to nonhighly compensated employees that will be treated as elective contributions for ADP testing purposes until the plan satisfies the nondiscrimination test.

**DISCUSSION:** Under the ADP test, the percentage of compensation deferred by highly compensated employees is compared to the percentage deferred by nonhighly compensated employees. The percentage contributed by the highly compensated employees generally can’t exceed the percentage contributed by the nonhighly compensated employees by more than an amount specified in the tax law. A similar test applies to employer matching contributions.

When the amount contributed by highly compensated employees exceeds the limits, the IRS can assess an excise tax against the plan sponsor equal to 10% of the excess contributions. In addition, the plan risks disqualification.

**Refunding option.** An employer can avoid the 10% excise tax by refunding the excess contributions and any plan income attributable to those contributions to the appropriate employees within 2½ months of the close of the plan year. The refunds will be taxable to the employees and must be reported by the employer on IRS Form 1099-R. Alternatively, an employer may be able to recharacterize the excess contributions as after-tax contributions by the highly compensated employee to the plan or as catch-up contributions if the highly compensated employee is eligible to make catch-up contributions. To recharacterize the contributions as after-tax contributions, the plan must have a provision allowing after-tax contributions. Amounts recharacterized as after-tax contributions will be includable in the highly compensated employee’s income for federal income-tax purposes and are subject to additional nondiscrimination testing.

**Additional contributions option.** For employees who are age 50 or older, excess contributions may be recharacterized as catch-up contributions if the plan allows catch-up contributions and the employee hasn’t already made the maximum allowable catch-up contribution for the year. It’s possible that part of an employee’s excess contributions could be recharacterized as a catch-up contribution, with the remainder refunded to the employee or recharacterized as an after-tax contribution.

The goal in making QNECs or QMACs to a plan is to achieve a more favorable ratio between contributions for nonhighly compensated employees and contributions for highly compensated employees so the

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Asset Investment Trends

The Profit Sharing/401(k) Plan Council of America’s 46th Annual Survey of Profit Sharing and 401(k) Plans offers some interesting insights into plan investment provisions that may prompt some plan sponsors to reconsider their investment offerings. The survey reflects 2002 plan year experience. Here are some of the asset investment trends noted.

- The number of funds offered to plan participants continues to increase, with 80.8% of plans offering 10 or more funds for participant contributions, up from 69.8% in 2001 and 61.5% in 2000.
- The average number of funds available for participant contributions also is on the upswing.
- Plans’ average allocations to equity investments are declining, while investments in company stock are holding steady.
- Some plans seem to be pulling back on allowing participants to direct the investment of their own and company contributions.
- The percentage of plans permitting participants to make daily funds transfers is on the rise.

We can help you review your investment offerings and plan provisions to make sure they continue to meet your company’s and plan participants’ needs.

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<th>Tracking the Trends</th>
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<tr>
<td>Average number of fund investment options</td>
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<td>Plan allocations to equity investments</td>
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<td>Plans letting participants direct investment of</td>
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<td>— their own contributions</td>
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<td>— company contributions</td>
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<td>Plans permitting daily fund transfers</td>
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Retirement Plan Limits Change for 2004

The IRS recently announced 2004 cost-of-living adjustments to several retirement plan limits. Various other limits are scheduled to change for 2004 due to provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Below, we answer some questions employers may have about the new limits.

What is the maximum catch-up contribution permitted by law in 2004?

Participants age 50 and over can make catch-up contributions of up to $3,000 in 2004, assuming their plans allow them. The $3,000 limit applies to 401(k) plans, SAR-SEPS, 403(b) plans, and 457 plans.

As with regular salary deferrals, the maximum catch-up contribution will increase $1,000 a year through 2006 and subsequently be adjusted for inflation.

Do different deferral limits apply to a SIMPLE plan?

Yes. With a SIMPLE plan, the maximum regular salary deferral is $9,000 for 2004, up from $8,000 for 2003. The 2004 catch-up limit is $1,500, up from $1,000 for 2003.

Additional increases of $1,000 (regular) and $500 (catch-up) are scheduled for 2005. In 2006, the regular deferral limit
Studies show that 401(k) plan design can have a significant influence on plan participation and contributions. For instance, researchers at the Center for Retirement Research at Boston College (CRR) recently concluded that the apparent trend to suspending employer matches will have an adverse impact on both participation and contributions. Combined with a report from the U.S. Census Bureau that plan participation declined again in 2002, the CRR findings may point to a need for employers to review their 401(k) plan features.

One way an employer can begin this review is to compare its plan 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 reflects 2002 plan year experience.*

Contributions and Participation

The first things an employer should consider are its plan’s participation rate and participant deferrals. The accompanying chart provides comparison figures. Overall, 80.3% of eligible employees have balances in their 401(k) plan accounts. Participation is greatest in plans that offer both a fixed and discretionary employer match (87.1%) and lowest in plans with no employer match (68.9%). Employers that find that their participation rates and participant deferral rates vary significantly from other similarly sized 401(k) plans may want to investigate why. A good place to start is by looking at plan features offered by similarly sized plans.

Plan Investments

The number of funds offered to plan participants continues to increase. The average number of funds available for participant contributions is 15.3, with 80.8% of plans offering 10 or more funds — up from 69.8% in 2001 and 61.5% in 2000.

Be wary of this trend, though. Another recent study done at Columbia University Business School** found that participation rates are lower in plans that offer more investment funds. It seems that some employees are intimidated by too many choices. Contributions seem to be unaffected by the number of funds available.

Among plans with up to 999 participants, the funds offered most often are balanced funds, actively managed and indexed domestic stock funds, actively managed international stock funds, and cash equivalents (CDs or money market funds), not necessarily in that order.

Plan Loans

The vast majority of 401(k) plans (86.2%) allow loans. Most use the prime rate to determine the interest rate on loans and charge some type of loan fee to participants — loan origination fees being the most common. Fewer than half of the 401(k) plans allow multiple loans. About 80% of plans require a minimum loan amount of $501 to $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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* 46th Annual Survey of Profit Sharing and 401(k) Plans, Profit Sharing/401(k) Council of America; copies available by calling 312-441-8550 or online at www.psca.org


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### 401(k) Rates and Features at a Glance

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<tr>
<th>Plan Rates and Features Offered</th>
<th>Plan Size by Number of Participants</th>
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<tbody>
<tr>
<td></td>
<td>1–49</td>
</tr>
<tr>
<td>Average employee participation rate</td>
<td>88.2%</td>
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<tr>
<td>Average pretax deferral for nondiscrimination testing</td>
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<tr>
<td>Higher paid employees</td>
<td>6.9%</td>
</tr>
<tr>
<td>Lower paid employees</td>
<td>6.2%</td>
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<tr>
<td>Plans with a fixed employer match</td>
<td>85.1%</td>
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<tr>
<td>Plans with a graded employer match</td>
<td>14.9%</td>
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<tr>
<td>Plans permitting catch-up contributions for participants age 50 and older</td>
<td>89.7%</td>
</tr>
<tr>
<td>Plans matching catch-up contributions (when permitted)</td>
<td>23.4%</td>
</tr>
<tr>
<td>Participants making catch-up contributions</td>
<td>41.9%</td>
</tr>
<tr>
<td>Plans permitting loans</td>
<td>74.0%</td>
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<tr>
<td>Plans allowing multiple loans</td>
<td>36.1%</td>
</tr>
<tr>
<td>Plans permitting hardship withdrawals</td>
<td>76.7%</td>
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</tbody>
</table>

*Includes larger sized plans
GUST Reprieve

September 30, 2003, marked the deadline for Master and Prototype (M&P) plans and volume submitter plans to be amended to reflect recent tax law changes (known collectively as “GUST”). This date also was the deadline for requesting IRS determination letters for GUST changes other than those allowed by the M&P adoption agreement or options permitted under the volume submitter document. Now, the IRS has given these plans a reprieve and extended the determination letter deadline to January 31, 2004. GUST amendments must have been adopted by the September 30 deadline and become effective immediately upon receipt of a favorable determination letter. Other plans that missed the deadline for amending their plans also can apply for a determination letter by January 31, 2004, pay a $250 compliance fee, and extend the plan’s GUST remedial amendment period through the 91st day following the issuance of a favorable determination letter (Revenue Procedure 2003-72 IRB 578).

Correcting Excess 401(k) Contributions
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An employer should take care when using this remedy. Newly proposed regulations would prohibit QNECs if less than half of all nonhighly compensated employees receive them or the QNECs paid on behalf of certain “targeted” nonhighly compensated employees are more than double what other nonhighly compensated employees are receiving (expressed as a percentage of compensation). Plans that limit QNECs to 5% of compensation or less wouldn’t be affected by the proposed change. A similar prohibition would apply to QMACs. Talk with us if you have concerns about failing the nondiscrimination tests. We can advise you on the steps to take to avoid or correct any excess contributions.

Retirement Plan Limits
Change for 2004
(continued from page 2)

of $10,000 will be adjusted for inflation and the catch-up limit will be $2,500.

Is the 25%-of-compensation deduction limit that applies to profit-sharing plans going up?

No, the 25% percentage limitation is not adjusted for inflation. Thus, for 2004, an employer’s maximum tax-deductible contribution remains 25% of the total compensation paid to covered employees. In addition, if a plan includes a 401(k) salary deferral feature, employees’ elective deferrals are fully tax deductible by the employer.

How much can be added to a defined contribution plan account for 2004?

Annual additions are capped at $41,000 for 2004. This is a $1,000 increase from 2003’s limit of $40,000.

Annual additions include employer and employee contributions to the plan and allocated forfeitures. Plans that will be affected by this change include 401(k) plans, profit-sharing plans, SEPs, and money purchase pension plans, among others.

What about defined benefit plans? Can a larger benefit be funded in 2004?

Yes. The limit on the annual benefit that can be funded under a defined benefit plan increases from $160,000 to $165,000.

Should employers be aware of any other 2004 cost-of-living adjustments?

There is one potentially important adjustment we haven’t mentioned. The maximum amount of an employee’s compensation that can be considered for purposes of computing contributions and benefits to a qualified retirement plan increases from $200,000 for 2003 to $205,000 for 2004.

Note that the dollar limits used in the tax law’s definitions of highly compensated employee ($90,000) and key employee ($130,000) stay the same.