What is a Plan Document?

In order for a business to sponsor a qualified retirement plan, a representative of the sponsor must adopt a written plan document, notify participants, and set up a qualified retirement trust. So what is the plan document?

The plan document defines the terms of the plan. This includes stating who is eligible to participate, when eligible employees enter the plan, how and when participants earn or accrue benefits, when and how the benefits are payable from the plan and various other factors relating to benefits. This is a legal, binding document. You should have assistance from a professional to draft your plan document.

Plan documents come in various forms – prototype, volume submitter, and individually designed documents.

A *prototype* document has been preapproved by the IRS. It generally consists of two parts – the adoption agreement and the basic plan document. The adoption agreement is generally a "check box" listing that allows the plan sponsor to choose from a limited number of options. The basic plan document contains all of the definitions and rules / limits imposed by applicable laws and regulations. This is the least flexible type of plan document. The number and types of options for plan design are limited. The IRS approval is evidenced by an "Opinion Letter" issued to the company that submitted the language to the IRS for approval. Individual plan sponsors may rely on the Opinion Letter as proof that the plan is qualified. Prototype documents are often provided by mutual fund companies, insurance companies, and third party administrators.

A *volume submitter* plan document also has language that has been preapproved by the IRS. This type of document generally reads more like a book. Only the sections of the preapproved language that the plan sponsor elects will appear in the document. The plan sponsor is limited to the options already preapproved; if the document language is changed beyond those options, the plan may fall out of volume submitter status. The IRS approval is evidenced by an "Advisory Letter" issued to the company that submitted the language to the IRS for approval. Generally, individual plan sponsors may rely on the Advisory Letter as proof that the plan is qualified. However, if the preapproved document language is altered, the plan document must be submitted to the IRS for a "Favorable Determination Letter" (see below) to ensure reliance on its qualified status. Volume submitter plan documents are often available from attorneys and third party administrators.

Individually designed plan documents are generally written by attorneys. They must contain certain definitions, provisions and references to regulations to comply with applicable laws and regulations. However, they also offer the most flexibility in plan design. Because the IRS has not preapproved the language, the individually designed plan document must be submitted to the IRS to demonstrate the plan complies with the law and regulations. This is done by requesting a "Favorable Determination Letter". There is a filing fee payable to the IRS to request the favorable determination letter, as well as fees for services to prepare the filings and required notices.

A "Favorable Determination Letter" is a letter issued by the IRS to a plan sponsor indicating that the plan document contains all of the necessary limits and language, and in form, at the time the letter is issued, constitutes a qualified plan. The Favorable Determination Letter does not guarantee that the operation of the plan is approved, just the language of the plan.

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If a plan sponsor wishes to change the terms of the plan, these changes must be adopted in writing as an amendment to the plan. You must also notify participants of any material changes to the plan. Like the plan document, an amendment is also a legal, binding document and you should get assistance from a professional. Certain rules apply to the timing and types of amendments that are permitted to be made to a qualified plan, and the desired amendment may also be restricted depending on the type of document originally selected. For example, an amendment which does not conform to one of the preapproved language options of the original volume submitter document may cause the plan to lose reliance on the Advisory Letter.

All qualified plan documents must be kept up to date – that is, amended for changes in the law or regulations. Whenever a law or regulation is enacted that affects qualified plans, the plan document may need to be amended to change or add new language. Periodically, the entire plan document must be restated. Currently the IRS requires restatements every 6 years for volume submitters and prototypes. Individually designed plans no longer have a set schedule for restatements.

What is a Catch-up Contribution?

For a 401(k) plan, a catch-up contribution is a salary deferral that exceeds either a plan or statutory limit, or would otherwise be returned to the participant due to failure of the Average Deferral Percentage (ADP) test. Catch-up contributions are available only to those participants who will be at least age 50 by the end of the year, and are limited by IRC §414(v). For 2017, this limit is $6,000.

There are several reasons for a salary deferral to be reclassified as a catch-up contribution.

One statutory limit is the IRC §402(g) limit, which applies to the participant's maximum permitted salary deferral. For 2017, this limit is the lesser of $18,000 or 100% of compensation.

The second statutory limit is the IRC §415 annual additions limit. If the total of all employer contributions, forfeitures, and salary deferrals allocated to a participant's account for a year exceeds the lesser of $54,000 (for 2017) or 100% of compensation, up to $6,000 of salary deferrals which cause the total to be in excess of $54,000 can be reclassified as a catch-up contribution.

If a participant must have a portion of their salary deferral returned as a correction due to the failure of the ADP test, then up to $6,000 of the salary deferral that would otherwise be returned can be reclassified as catch-up contributions, provided the participant has not already reached the catch-up limit of $6,000.

In addition to the limits described above, a plan may have a lower deferral limit for all participants, or for a group of participants such as HCEs (Highly Compensated Employees) or owners/shareholders. For example, a plan may place a limit of $5,000 on deferrals for HCEs. Salary deferrals of up to $6,000 in excess of this limit may be reclassified as catch-up contributions for those participants who will be at least age 50 by the end of the calendar year. Special care should be taken when the plan year does not coincide with the calendar year.

Catch-up contributions from all sources are limited to $6,000 for 2017. Amounts in excess of this limit are excess deferrals, and must be returned to the participant. Catch-up contributions are not included in nondiscrimination testing, such as the ADP test, rate group testing, and the average benefits percentage test.

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What is a "Required Minimum Distribution (RMD)" and When Does Someone Have to Take One?

Generally, a "Required Minimum Distribution" is a taxable distribution from a qualified retirement plan upon attainment of age 70½. This is similar to the requirement that an IRA holder begin taking distributions from the IRA at attainment of age 70½.

If the participant is eligible to commence his or her monthly retirement benefits from a defined benefit plan, commencing such benefits will generally satisfy the RMD rules, as long as the payment period does not extend beyond the expected lifetime of the participant (or joint lifetimes of the participant and spouse).

If the participant is a "more than 5% owner", he is required to begin taking distributions each year from the plan, beginning with the calendar year in which he reaches age 70½ and has accrued a non-forfeitable benefit or account balance. If the participant is <u>not</u> a "more than 5% owner" AND if the plan document allows, he may defer taking his distribution until he actually terminates employment. For this purpose, the definition of "more than 5% owner" is provided in IRC §416, and includes constructive ownership.

If the participant's birthday is in the first half of the calendar year, the first distribution must be taken for the year which contains the participant's 70th birthday. If the participant's birthday is in the second half of the year, the first distribution must be taken for the year which contains the participant's 71st birthday. This year for which the first distribution is made is called the "first distribution year".

The timing, amount, and form of payment of the RMD will depend on the type of plan (defined contribution or defined benefit).

<u>RMD from Defined Contribution Plans</u>

The RMD from a profit sharing, 401(k), money purchase, or target benefit plan are all calculated in the same manner: the "account balance" method. First, the vested account balance as of the end of the prior plan year is calculated. (If the plan year is not a calendar year, additional contributions deposited between the end of the plan year and the end of the calendar year must be added to the account balance.) Using the age on the birthday in the calendar distribution year, the appropriate factor is determined, using the IRS's Uniform Life Table. (If the participant's sole beneficiary is a spouse more than 10 years younger than the participant, the IRS's RMD Joint and Last Survivor Table must be used to determine the factor instead.)

The RMD is the vested account balance as of the end of the prior year (as adjusted) divided by the appropriate factor.

For the first distribution year only, the participant can delay receiving the distribution until April 1 of the following year. For every year thereafter, the participant must take the annual distribution by the end of each calendar year.

<u>RMD from Defined Benefit Plans</u>

The RMD from defined benefit plans (including cash balance plans) is calculated using the accrued benefit method. If the participant has not commenced taking his or her benefit by the required beginning date, then the participant must commence taking a minimum portion of the benefit. The participant may have three options:

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- The first option is to commence the entire vested benefit, as accrued through the end of the first distribution year, in an annuity form as if the participant has retired. Note: the plan document must allow in-service distributions.

- The second option is to take a lump sum payment of the entire vested benefit, use the account balance method to calculate the RMD and take this into income, and roll over the remainder into another plan or an IRA. Note: the plan document must allow in-service distributions after attainment of normal retirement age, AND the plan must be sufficiently funded to allow the distribution.

- The final option is to convert the benefit to a "certain-period only" payment stream over the expected lifetime (using the same IRS tables as for an RMD from a Defined Contribution plan). This option generally allows the smallest annual amount to be taken as an RMD, and also allows the remaining payments to be converted to a lump sum at a later date.

Participants who are still working may earn additional vested benefits which must be taken as an additional RMD after the benefits are accrued. A new RMD election is required for each year's additional accrual.

How Does a Pension Deduction Work for a Sole Proprietor?

Over the years, Congress has made changes to pension provisions in the Internal Revenue Code to provide fairly equal treatment to corporations and to unincorporated entities. One discrepancy that remains is the inability for sole proprietors to carry over a net loss created because a contribution to a qualified plan exceeds the sole proprietor's earned income[1].

Earned income is generally the sole proprietor's net Schedule C income minus ½ of the self-employment tax. Section 404(a)(8)(C) of the Code provides that contributions to a qualified plan meet the conditions of Code Section 162, and are therefore deductible, "to the extent that such contributions do not exceed the earned income of the individual".

If the minimum funding requirement for a sole proprietor's defined benefit exceeds his earned income for that year, he is in the unfortunate position of either making a non-deductible contribution to the plan, or not making the full contribution and incurring an excise tax on the funding shortfall. The IRS, in informal guidance, has indicated that "the statute does not appear to accommodate a carryover" to future tax years to alleviate the dilemma. Indeed, Code Section 4972(c)(4) includes a special rule for sole proprietors in just this situation to relieve them from the excise tax on non-deductible contributions. Alas, the non-deductible contribution does not create a basis for the proprietor, so ultimately that money will be taxed twice.

The proprietor can avoid double taxation with careful planning, if the tax return is filed <u>without extension</u> for the year in question. Let's look at an example where the proprietor has earned income[2] of $100,000 for 2016, and the minimum required contribution to his defined benefit plan is $150,000, plus an interest adjustment, depending on the deposit dates of the contribution.

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Step one: By April 15, 2017, deposit no more than $100,000, claim that contribution on the 2016 tax return, and file without extension by April 15, 2017.

Step two: Between April 16 and September 15, 2017, deposit the remaining required contribution, plus any interest adjustments. This will meet the 2016 minimum funding requirement by the required due date of September 15, 2017. Because the remaining contribution is deposited after "the time prescribed by law for filing the return" (i.e. April 15, 2017), it is deductible in the 2017 tax year rather than the 2016 tax year, even though it is applied to the 2016 plan year.

Note that just applying for an extension to file the tax return will prevent the proprietor from employing this technique, even if the filing is actually submitted by April 15. The extension changes "the time prescribed by law for filing the return" to October 15, and any contribution for the 2016 plan year made by that date is automatically deemed to have been made on December 31, 2016[3].

What is a Highly Compensated Employee (HCE)?

Qualified plans must not discriminate in favor of Highly Compensation Employees (HCEs).

Nondiscrimination testing is done using HCE and non-HCE classifications. This includes testing for minimum coverage and participation, benefit and salary deferral levels, and a collection of plan provisions known as "benefits, rights, and features". So, who is an HCE?

An employee is an HCE for a plan year if the employee meets at least one of two tests: 1) the 5% owner test; and 2) the compensation test. [IRC §414(q)(1)]

An employee is an HCE under the 5% owner test if the employee owns more than 5% of the employer (or a related employer) at any time during the current year (the "determination" year) or the prior year (the "lookback" year). Ownership may be attributed to family members in certain circumstances. [IRC §414(q)(1)(A)]

An employee is an HCE under the compensation test if the employee's gross compensation (IRC §415 compensation, including elective deferrals) for the lookback year is more than the HCE compensation level for that year. The HCE compensation level is adjusted periodically. For 2015 to 2017, the level is $120,000. [IRC §414(q)(1)(B]

What is a Top-Paid Group Election?

In determining who is a Highly Compensated Employee (HCE), the employer may choose to apply the "Top-Paid Group election". This election limits the number of employees who are treated as satisfying the compensation test to the top-paid 20% of nonexcludable employees. Note that this limitation applies ONLY to the compensation test, and not to the ownership test.

Under this election, an employee would be considered a Highly Compensated Employee **only** if 1) the employee is in the top 20% of the nonexcludable employees in the lookback year when ranked by compensation, **and** 2) the employee's compensation in the lookback year was in excess of the HCE compensation level for that year.

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The Top-Paid Group election must be stated in the plan document. If amending the plan, the election must be made (or eliminated) prior to the end of the year in which the change is effective. Note: there could be anti-cutback issues if a defined contribution plan does not have a last day provision, and the change results in a lower allocation to a participant than would have been provided under the previous definition.

The Top-Paid Group election applies for all testing purposes, across all plans of an employer, for each year in which it is effective. If the employer maintains two or more plans with different plan years, the Top-Paid Group election applies to all plan years that begin in the same calendar year. All of an employer's plan documents must contain the same election.

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[1] This situation can arise for any entity that is taxed as a sole proprietor, such as a single-member LLC.
[2] Earned income as used here is net Schedule C income minus ½ Self-employment tax.
[3] Internal Revenue Code Section 404(a)(6).

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