IT'S TESTING SEASON!

QUALIFIED PLANS MUST PERFORM ANNUAL TESTING TO BE SURE THAT THE PLAN DOESN'T UNFAIRLY DISCRIMINATE IN FAVOR OF "HIGHLY COMPENSATED EMPLOYEES" (HCEs) OR EXCEED THE CONTRIBUTION LIMITS SET FORTH BY THE IRS. Depending on your plan provisions, it isn't just one calculation, but a series of tests that show that your plan is not discriminatory. If your plan is audited, the auditor is looking for proof of this compliance.

Since most retirement plans operate on a calendar year basis, testing season is now! If a testing failure occurs, correcting the failure by March 15th can save the plan sponsor excise taxes and additional filings. Getting year-end data in early, including complete census information, is paramount. Though McCloud & Associates, Inc. does all the heavy lifting to ensure your plan passes the appropriate testing, all plan sponsors should understand the basics of testing so that they can confirm all tests and any appropriate corrections are completed each year. The following are some helpful definitions to get you through the basics of compliance testing.

IS AN HCE THE SAME AS A KEY EMPLOYEE?

An HCE and a Key employee are two separate definitions used to test different aspects of a retirement plan. Who qualifies as an HCE is determined on an annual basis.

An employee is an HCE if:

- they own more than 5% of the company (including family attribution rules), or
- they received compensation exceeding a threshold set by the IRS in the prior plan year ($120,000 in 2017 for the 2018 plan year HCE determination).

An employee is a "Key" employee if they meet any of the following criteria:

- They own more than 5% of the company (including family attribution rules).
- They own more than 1% of the company (including family attribution rules) and have an annual compensation greater than $150,000.
- They are an officer of the company and have compensation of at least $175,000.

WHAT DO THE DIFFERENT COMPLIANCE TESTS MEAN?

ANNUAL NON-DISCRIMINATION TESTING (ADP/ACP) – If your plan is a 401(k) plan, the ADP and ACP tests are a comparison between the average rates of deferral and matching contributions of HCEs to non-HCEs. Regulations generally allow for a 2% disparity between the two groups. If your plan has opted for a safe harbor election in any given year, it automatically satisfies the ADP and ACP testing.

ANNUAL DEFERRAL LIMIT – Regulations restrict the amount that an individual can defer into a retirement plan in any calendar year. For 2018, an individual could have deferred a maximum of $18,500 and for those who attain or are over age 50 by December 31, 2018, an additional $6,000 can be contributed. Any amounts in excess of the limits must be returned with the appropriate allocation of investment gains by April 15, 2019.

MINIMUM COVERAGE – Minimum coverage testing determines if the plan benefitted the required percentage of non-HCEs. This test is applied, not to the plan as a whole, but to each type of contribution; 401(k) contributions, matching, and employer profit sharing. Generally, each contribution type must meet 70% of the total number of non-HCEs that are not otherwise excludable. Examples of excludable employees are those governed under collective bargaining or non-resident aliens.

TOP-HEAVY TESTING - A plan is considered top-heavy if more than 60% of the benefits belong to "key employees." An annual test must be performed to determine if the key employees have more than 60% of the benefits or assets in the plan after certain allowable adjustments. If it is determined that the plan is top heavy, it must meet the top-heavy minimum contribution and vesting requirements.

ANNUAL ADDITIONS – Like most other aspects of retirement plans, the IRS sets the limit of how much can be contributed to any individual's account for a plan year. Contributions would include amounts from all sources such as 401(k), matching, and employer profit sharing, but also includes any amounts allocated as forfeitures. For 2018, the limit is $55,000 for those under age 50 and $61,000 for those eligible for catch-up contributions.

ALLOWABLE DEDUCTION LIMIT – Regulations restrict an employer's ability to contribute more than 25% of the sum of all participants' compensation to a retirement plan. This restriction only pertains to employer contributions. Employee contributions are disregarded.

GENERAL NON-DISCRIMINATION TESTING – This testing only applies to plans that allocated contributions on a formula which weights contributions in favor of certain employees. These types of plans are commonly referred to as "cross-tested" or "new comparability plans." If a plan uses a "uniform allocation formula," this testing may not apply.

Plan sponsors should be aware that sometimes other companies or plans must be aggregated to satisfy the tests listed above. If you have any questions about the tests, be sure to contact McCloud & Associates, Inc. for further information.

Upcoming Compliance Deadlines for Calendar-Year Plans (12 / 31)

28th February 2019

Form 1099-R – The Form 1099-R is due for any distributions that that occurred during the 2018 calendar year. Note: Participant Loans that are in default may be considered "deemed" distributions and are reportable on Form 1099-R.

15th March 2019

ADP / ACP Corrective Testing – This is the deadline for distributing contributions and earnings to participants as corrective measures to ADP and ACP testing for calendar year plans.

Employer Contributions – Profit Sharing and matching contributions must be deposited for 2018 amounts that will be deducted on the employer's tax return (unless employer returns are on extension).

1st April 2019

Required Minimum Distributions - Regulations require that a participant must receive a required minimum distribution (RMD) by April 1st of the year following the year in which the participant attains age 70 ½. Distributions may be delayed until actual retirement unless the participant is a 5% or more owner.

15th

Excess Deferral Amounts - If a participant makes salary deferral contributions in excess of the IRS-issued limits in any calendar year, the plan must return the excess amount plus earnings to the participant by April 15th of the year following the year in which the excess occurred. The limits for 2018 were $18,500, or $24,500 for those age 50 and over if the plan allowed for catch-up contributions.

KNOW YOUR OPTIONS

IF YOUR PLAN OFFERS A ROTH 401(K) PROVISION, YOUR PARTICIPANTS MIGHT ASK, "WHICH ONE IS BETTER FOR ME?" As the availability of Roth options in 401(k) plans and Roth contribution percentages continue to rise, it's important to be able to guide participants in making the right choice.

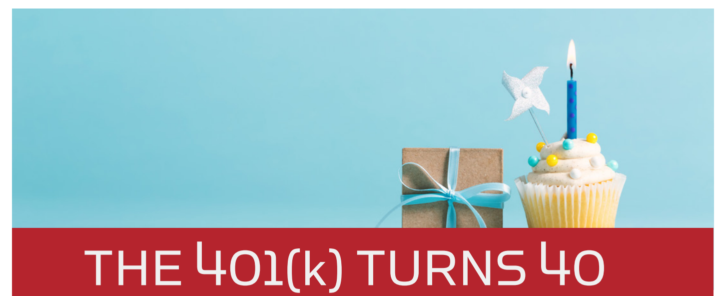
401(k) plans offer many advantages to participants; the ability for accounts to grow on a tax-deferred basis, the chance of receiving employer contributions in the form of a match or non-elective contribution, the ability to contribute even after attaining age 70 ½, and protections from bankruptcy. These benefits are consistent whether a participant chooses traditional or Roth contributions, or even both! So, what makes Roth and traditional routes different and what are the advantages and disadvantages of each?

Traditional 401(k) contributions, or those contributed on a pre-tax basis, have been the mainstay of the 401(k) plan since its inception in 1978. Today, more than 50 million workers are active participants in their employer's 401(k) plan and, until 2001, all contributed on a pre-tax basis. Pre-tax contributions are deducted from an employee's paycheck before the application of federal and state income taxes. (Pennsylvania is the only state that does not exempt 401(k) contributions from personal income tax.) These contributions, along with any employer contributions and investment gains, remain tax-deferred until withdrawal. At the time of withdrawal, the participant will pay all appropriate income taxes due. If withdrawals occur before age 59 ½, disability, or death, an additional early withdrawal penalty of 10% will apply.

On the contrary, Roth deferrals are contributed on an after-tax basis with the employee paying all current federal and state taxes. Once contributed to, these accounts accumulate in the same fashion as traditional 401(k) accounts until withdrawal. With a Roth account, your contributions and their investment earnings can be withdrawn tax-free, provided the withdrawal does not occur before age 59 ½, disability, or death. Even with an early withdrawal, only the investment gains and employer contributions will be taxed as income and subject to the 10% penalty.

What is the attraction of utilizing Roth 401(k)? It's down to the individual participant's tax situation. For young employees, whose income and tax rates are low, paying the tax now makes sense. Chances are, their tax rates will be higher in the future. For those with many years to retirement, the compounding of their investment gains will make up a far greater percentage of their account than their contributions. Being able to withdraw those funds tax-free can be very attractive. For participants who are paying a high tax rate currently and might be closer to retirement, Roth may not be so attractive. One exception might be if the participant plans to leave the Roth as a legacy to their heirs, who can then stretch out the tax-free growth over their lifetime.

Participants don't have to choose one option over the other. Many participants choose to split their deferrals by contributing some on a pre-tax basis and some on a Roth basis, thereby hedging their bets on what future tax rates might bring.



THE 401(k) TURNS 40

IN 2018, THE 401(k) PLAN CELEBRATED ITS 40TH BIRTHDAY! Though extremely popular today, 401(k) plans came about almost by accident. IRC Section 401(k) was passed into law as part of the Revenue Act of 1978 and was included to limit executive compensation. However, in 1980, Ted Benna of the

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Johnson Companies used the provision to create and get IRS approval of the first 401(k) plan for his company. For this he is often referred to as the father of the 401(k).

At its inception, employees could contribute up to 25% of their salary with a maximum of $45,475 per year. Through the mid-80's, the limits were consistently reduced to a low of $7,000. Since that time, they have been increased through cost of living adjustment to the current 2019 limit of $19,000. In 2001, the ability to contribute catch-up and after-tax Roth contributions was passed into law with the Economic Growth and Tax Relief Reconciliation Act.

A lot has changed with 401(k) plans in the last 40 years. In September of 2018, 401(k) plans held an estimated $5.6 trillion in assets! This represents nearly 20% of the $29 trillion in US retirement assets (total of both public and private sector plans). In 2018, the Plan Sponsor Council of America (PSCA) released their 61st Annual Survey. The survey includes the data of over 600 defined contribution plan sponsors with over 40% of responders sponsoring plans with 200 participants or less. While packed with great statistics regarding its findings, the survey highlights some interesting trends in the retirement plan industry.

The good news for 401(k) plan participants: contributions to retirement plans are on the rise. The survey showed that participants saved an average of 7.1% of pay in 2017, up from 6.8% in 2016. This, combined with an increased employer contribution percentage of 5.1%, gives a total savings rate of more than 12%! Roth contributions keep rising with 70% of companies offering this option, especially among plans with fewer than 50 employees. Additionally, the survey showed a trend toward more generous matching formulas with the use of dollar-per-dollar matching contributions above 3% of pay, increasing from 24.1% to 35.8%.

Other plan provision trends show that companies continue to adopt automatic enrollment with 61.2% of plans now using it to boost enrollment. However, automatic enrollment is mostly applied to new hires only. Sixty percent of the plans that elect to use automatic enrollment have default contribution rates above 3%. Nearly 85% of plans allowed for participant loans, with 55% allowing for only one loan at a time, 35% allowing for 2 loans, and 10% allowing for 3 or more.

You can learn more about the PSCA or obtain a copy of the full survey on their website at www.PSCA.org.

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