401(k) Plan Checklist

This Checklist is *not* a complete description of all plan requirements, and should not be used as a substitute for a complete plan review	**For Business Owner's Use** DO NOT SEND THIS CHECKLIST TO THE IRS

Every year it is important that you review the requirements for operating your 401(k) retirement plan. This Checklist is a "quick tool" to help you keep your plan in compliance with many of the important rules. Underlined text below will link to expanded explanations and resources available at www.irs.gov/ep.

1. Has your plan document been updated since 2001? *(From time to time, plans must be amended for various law changes.)* ☐ Yes ☐ No

2. Have you notified the people who service your plan of any plan changes? *(Organize your plan's operation by building a 'Who Does What' listing of everyone servicing your plan.)* ☐ Yes ☐ No

3. Is your plan's operation based on the definitions and requirements found in your plan document? *(Failure to follow the terms of the plan is a common problem encountered on audit.)* ☐ Yes ☐ No

4. Were all eligible employees identified and given the opportunity to make a salary deferral election? *(By supplying your TPA or advisor with information regarding all employees who receive a Form W-2, you may reduce the risk of omitting employees.)* ☐ Yes ☐ No

5. Have you identified for the people who service your plan, all your highly compensated employees, including owners, shareholders, and their family members. *(Proper testing of your plan starts with knowing which employees to include in your nondiscrimination tests.)* ☐ Yes ☐ No

6. Is the plan's definition of compensation used for all deferrals and allocations? *(Your plan uses a specific definition of compensation for benefit calculations, nondiscrimination testing, limitations, etc.)* ☐ Yes ☐ No

7. Have you timely deposited employee deferrals each pay period? *(You are required to deposit deferrals as soon as they can be segregated from the employer's assets. Many employers deposit salary deferrals when making payroll tax deposits.)* ☐ Yes ☐ No

8. Have the 401(k) nondiscrimination tests (ADP and ACP) been performed? *(Find out how a safe harbor 401(k) plan may completely avoid these tests.)* ☐ Yes ☐ No

9. Have you filed a Form 5500 series return and was the Summary Annual Report distributed to all participants this year? *(A Form 5500 series return must generally be filed within 7 months after the plan year end.)* ☐ Yes ☐ No

10. If your plan allows for catch-up contributions, have each of your employees age 50 and over been informed of their right to make catch-up deferrals? *(If offered, this option must be included in your document and must be offered to all employees age 50 and over. If not offered, this question is N/A.)* ☐ Yes ☐ No

If you answered "No" to any of the above questions, you may have made a mistake in the operation of your 401(k) plan. This Checklist is only a guide to a more compliant plan, so answering yes to each question may not mean your plan is 100% compliant. Many mistakes can be corrected easily, without penalty and without notifying the IRS.

- **contact your benefits professional.**
- **visit the IRS at www.irs.gov/ep**
- **call the IRS at (877)829-5500.**

1) Law Changes:

Laws related to retirement plans change frequently. Ten major changes in the past 25 years and numerous smaller changes mean that what worked last year may no longer work now. Or law changes might mean you can simplify some areas of plan administration or improve benefits. Changes to pension law in the future are a good bet. Plan language and operation will need to be changed to keep the plan within the law and to take advantage of increased benefit limits.

Knowing your plan has been properly updated may not be a simple process. Certain plans must be individually amended for each change, while others may have a specimen document that is amended. We recommend you maintain contact, on at least a yearly basis, with the company that sold you the plan. If they send you a set of amendments to formally adopt, make certain you properly execute the documents per their instructions. Keep a copy of all changes made to your document.

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2) Service Your Plan:

The plan sponsor is ultimately responsible for keeping the plan in compliance with applicable tax laws; however, there may be many different employees, vendors, and tax professionals who service your plan. This retirement team may include more than a dozen people in larger plans or as few as one in a small plan. Any changes made to your plan document or to the operation of your plan should be conveyed to everyone providing service to your plan. For example, assume your plan document is amended to change the definition of compensation. That change should then be communicated to all persons involved in determining deferral amounts to be withheld from the participant's pay, performing your plan's ADP and ACP tests, or allocating employer contributions. Communication among the people who service your plan is essential for a compliant plan.

a. If you made any changes to your plan document, all persons who service your plan should be informed of those changes and what they mean to the operation of your plan
b. If you amend your plan document, you should also amend your summary plan description (SPD). If an SPD is materially modified, a summary of the material modifications (SMM) must be given to the plan participants within 210 days after the end of the plan year in which the modification was adopted.
c. If you've changed the way you operate your plan, those changes should also be communicated to the persons providing service to your plan. You may need to reflect these changes in your plan document through a plan amendment.
d. If you've changed the trustees for your plan, those changes also need to be conveyed and your plan document and SPD may need to be updated.

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3) Plan's Operation:

Operation of your plan must conform to the terms of the plan document. The plan document defines what are employees and employers, how to become a participant, and how much and what compensation is used for allocations under the plan, limitations, discrimination tests, etc. Your plan document also describes how contributions are limited, what discrimination tests must be performed, and explains how and when accounts may be distributed. Most everything you need to know to operate your plan should be contained in the plan document.

That being said, it's not unusual for an employer to have difficulty finding an up-to-date copy of their plan document. Many times an employer may have a "cheat sheet" listing some plan requirements, rarely consulting their document. Over time, as changes are made to the plan document, the persons in charge of the plan's day-to-day operation continue to operate the plan as they've done for many years. In this scenario, the plan may not be operating in accordance with the plan document.

Plan sponsors need to review the plan document on a yearly basis to ensure it conforms to the plan's operation and applicable tax rules.

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4) Eligible Employees:

Your plan document contains a specific definition of *employee* and provides requirements for when those employees become plan participants eligible to make salary deferrals into your 401(k) plan. Employers sometimes assume certain employees, such as part-timers, are not covered by the plan. Similarly, employees who elect not to make salary deferrals are often mistakenly treated as ineligible employees. To reduce the risk of omitting eligible employees, the persons servicing your plan should be provided with a list of all employees employed during the year, along with dates of birth, dates of hire, dates of termination, number of hours worked, compensation for the plan year, 401(k) election information, and any other information necessary to properly administer the plan.

Generally, each employee who receives a Form W-2 should be treated as an eligible employee unless they can be properly excluded by the plan's terms. Using the plan's definitions for employer, employee, and the plan's age, service, and entry requirements, a determination of eligibility should be made for each employee receiving a Form W-2. That can be a fairly simple process; however, if the employer uses leased employees, contract labor, or has shared ownership of other enterprises, determining eligible employees can become very complicated. If you find yourself in one of these complex situations, please seek a retirement plan professional to help with the determination of who is eligible for your retirement plan.

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5) Highly Compensated Employees:

An important aspect of performing the ADP and ACP tests is to properly identify the highly compensated employees (HCEs). HCEs are defined under Internal Revenue Code (IRC) section 414(q) and generally include any employee who (A) was a 5% owner at any time during the year or preceding year, or (B) for the preceding year had compensation from the employer in excess of $95,000 (for 2005) and, if the employer elects, was a member of the top-paid group (top 20%) of employees.

Remember when you're determining who is a 5% owner, family aggregation rules apply. These family aggregation rules may affect the treatment of stock owned directly or indirectly by family members. Any individual who is a spouse, child, grandparent, or parent of someone who is a 5% owner, or who together with that individual would own more than 5% of a company's stock, is treated as a 5% owner. As a 5% owner, each of these individuals would be considered HCEs for the plan year. It's important to identify the family ownership interests of all company stock and to forward that information to the TPA, advisor, or persons performing the ADP and ACP tests.

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6) Compensation:

A plan's definition of compensation must satisfy applicable rules for the purpose of determining the amount of contributions. This compensation cannot exceed $210,000 in 2005, and is subject to cost-of-living adjustments for later years. The definition of compensation stated in the plan document must be consistently followed in the operation of the plan. Compensation generally includes the pay a participant received from the employer for personal services for a year including:

1) Wages and salaries.
2) Fees for professional services.
3) Other amounts received (cash or non-cash) for personal services actually rendered by an employee, including, but not limited to, the following items:
    a. Commissions and tips,
    b. Fringe benefits, and
    c. Bonuses.

Plan sponsors may not be aware their plans contain different definitions of compensation for different plan purposes. In some cases, the sponsor or administrator will use the incorrect definition of compensation when calculating the ADP or ACP test or when computing the employer matching contribution. We also see plans where the plan administrator fails to limit the definition of compensation as required under IRC section 401(a)(17).

Plan sponsors and administrators need to be familiar with the terms of the plan document to ensure they use the proper definition of compensation for contributions, limitations, and nondiscrimination testing purposes. It is important to know whether (i) certain types of compensation are excluded, (ii) compensation is limited for certain purposes, and (iii) if compensation is determined using different computation periods (e.g. plan year vs. calendar year).

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7) Timely Deposited:

The employer makes contributions to the trust for the amounts of the salary deferrals made by the plan's participants. Department of Labor requires that contributions be made on the *earliest date that the plan sponsor is able to segregate the amounts from the employer's general assets.* This can usually be done on the date that the employee's paycheck is issued. In no event can the amount be deposited later than the 15th day of the following month. Keep in mind that the rules regarding the 15th day of the following month do not provide a safe harbor for depositing deferrals. Rather, it sets the maximum deadline. A deposit not made timely is treated as a use of trust assets by the employer and constitutes a prohibited transaction. Prohibited transactions are subject to a 15% excise tax payable with the filing of Form 5330.

Even though correction of this prohibited transaction, along with the excise tax for deposits being a few days late may be small, the costs associated with calculating lost earnings and allocating those amounts may be substantial. This Department of Labor rule does not provide for a de minimis exception, so move those salary deferrals into a plan account as soon as possible! Not only will timely deposits keep your plan in compliance, lost earnings for contributions that are just a week late may become substantial over the working lifetime of a participant.

Contributions made by the employer to match part or all of the participant's salary deferral may be made at the time of the salary deferral contribution or later, but in no event later than the due date of the employer's income tax return, including extensions. Contributions made by the employer that are not tied to salary deferral amounts must be made no later than the due date of the employer's income tax return, including extensions.

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8) Nondiscrimination Tests:

There are only a few situations in a 401(k) plan that would permit an employer to avoid performing the 401(k) nondiscrimination tests (ADP and ACP).

- Your plan contains only properly identified highly compensated employees and no non-highly compensated employees, or
- Conversely, your plan contains only properly identified non-highly compensated employees and no highly compensated employees, or
- Your plan is a safe harbor 401(k) plan, or
- Your plan is a SIMPLE 401(k) plan.

All 401(k) plans that do not meet one of the exceptions must perform the proper 401(k) nondiscrimination tests. Plans that fail to perform the required nondiscrimination tests have not met an important responsibility. Many times, this occurs when the employer has no one in the company responsible for conducting the nondiscrimination testing or ensuring the testing is conducted each year by a third-party administrator.

Plan sponsors shoulder ultimate responsibility for ensuring the plan operates in compliance with the rules under IRC sections 401(k) and 401(m). Practices and procedures should be in place to ensure all required nondiscrimination testing is properly completed.

When conducting the ADP and/or ACP tests, certain plan participants are often incorrectly excluded. When identifying eligible employees for the ADP/ACP tests, plan administrators often incorrectly exclude part-time employees, employees who begin or terminate participation during a plan year, employees who are only eligible for a short time during the plan year, or those who simply choose not to defer.

The plan administrator must include all eligible employees for purposes of ADP and/or ACP testing. Eligible employees include all employees who are directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year. This means that an employee who can defer at any time during a plan year must be included in the testing, including part-time employees who satisfy the eligibility requirements.

If you would like to avoid the complexities of the ADP and ACP tests, a safe harbor 401(k) plan may be right for you. A safe harbor plan provides many benefits for the employer:

- No ADP or ACP testing requirement.
- Reduced administrative costs will offset some of the costs associated with the required match or contribution.
- Highly compensated employees may contribute up to the IRC section 402(g) limit ($14,000 for 2005) no matter what amounts were contributed by the rank-and-file employees.

Under a safe harbor plan, two different contribution formulas are available to satisfy the safe harbor.

- Matching Formula – An employer matches 100% of salary deferrals up to 3% of compensation and then 50% of salary deferrals on the next 2% of compensation, or
- Non-elective Formula - Alternatively, an employer may make a non-elective contribution of at least 3% of each eligible employee's compensation.

Remember, under the Matching Formula, the match is made for all eligible employees who choose to make a salary deferral. Under the Non-elective Formula, all eligible employees receive the non-elective contribution, regardless of whether they choose to make a salary deferral.

A safe harbor plan may avoid the ADP and ACP tests, but not without some additional complexities. Here are just a few of the new requirements a safe harbor plan must follow:

- Plan document must include safe harbor plan language.
- Eligible participants must receive written notice 30 days prior to the beginning of the plan year that the plan is intended to be a safe harbor plan for the coming plan year. This notice must be provided for each year the plan will be a safe harbor plan.
- An allocation requirement such as 1,000 hours of service or employment on the last day of the plan year may not be imposed on safe harbor contributions.
- Safe harbor contributions are always 100% vested.
- Safe harbor contributions may not be eligible for in-service withdrawals prior to age 59 ½.
- An ongoing 401(k) plan may only be amended to a safe harbor plan for the beginning of the plan year.

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9) Form 5500:

For further information, see the Form 5500 Corner on our EP Forms & Publications web page (www.irs.gov/ep).

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10) Catch-Up Contributions:

A 401(k) plan may permit participants who are age 50 or over at the end of the calendar year to make additional salary deferral contributions. These additional contributions (commonly referred to as catch-up contributions) are not subject to the general limits that apply to 401(k) plans. An employer is not required to provide for catch-up contributions in any of its plans. However, if a plan allows catch-up contributions, it must allow all participants who are eligible for the catch-up to make the same election with respect to catch-up contributions.

If a plan participant participates in a traditional or safe harbor 401(k) plan:

- The catch-up contribution limit for 2005 is $4,000.
- The limit increases to $5,000 for 2006.
- The limit is subject to cost-of-living increases after 2006.

The catch-up contribution a participant can make for a year cannot exceed the **lesser** of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the salary deferrals that are *not* catch-up contributions.

If an eligible participant participates in plans of different employers, he or she can treat amounts as catch-up contributions regardless of whether the individual plans permit those contributions. In this case, it is up to the participant to monitor his or her deferrals to make sure they do not exceed the applicable limits.

Example: If Joe Saver, who's over 50, has only one employer and participates in that employer's 401(k) plan, the plan would have to permit catch-up contributions before he could defer the maximum of $18,000 for 2005 (the $14,000 limit for 2005 plus the $4,000 catch-up maximum). If the plan didn't permit catch-up contributions, the most he could defer would be $14,000. However, if Joe participates in two 401(k) plans each maintained by unrelated employers, he can defer a total of $18,000 even if neither plan has catch-up provisions. Of course Joe couldn't defer more than $14,000 under either plan and he would be responsible for monitoring his own contributions.

The rules relating to catch-up contributions are complex and a plan participant's limits may differ according to provisions in the specific plan.

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