

**SECTION 401(k) COMPLIANCE CHECK  
QUESTIONNAIRE**

**INTERIM REPORT**  
February 2012

**Internal Revenue Service  
TE/GE Employee Plans  
Employee Plans Compliance Unit (EPCU)**

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## EXECUTIVE SUMMARY

This Interim Report was prepared and published by the Tax Exempt and Government Entities Division (TE/GE) of the Internal Revenue Service (IRS) to share relevant information from the Section 401(k) Compliance Check Questionnaire (401(k) Questionnaire) with the retirement plan community and other interested parties. Section 401(k) plans<sup>1</sup> have become the most prevalent form of retirement plans in the United States. There are currently more than 500,000 section 401(k) plans covering approximately 60 million Americans<sup>2</sup>. The 401(k) Questionnaire is a pivotal part of the Employee Plans (EP) 401(k) [Operating Priority](#) to:

- measure the health of section 401(k) plans;
- better understand compliance issues impacting section 401(k) plans;
- evaluate the effectiveness of voluntary compliance programs and tools; and
- determine how the IRS can best foster compliance.

This Interim Report summarizes the results from the 401(k) Questionnaire responses, generalizing the findings to the section 401(k) plan sponsor population that files Form 5500. The 401(k) Questionnaire was administered by the Employee Plans Compliance Unit (EPCU) and analyzed by TE/GE Research.

The 401(k) Questionnaire requested information in the following areas: demographics, plan participation, employer and employee contributions, top-heavy and nondiscrimination rules, distributions and plan loans, other plan operations, designated Roth features, IRS voluntary compliance and correction programs, and plan administration.

Twelve hundred section 401(k) plan sponsors were randomly selected to complete the 401(k) Questionnaire via a secure website. This was the first online compliance check questionnaire used by TE/GE. Ninety-eight percent of plans receiving the questionnaire responded. Follow-up actions were taken in the case of all non-responders.

A representative sample of the section 401(k) universe was selected and stratified based on plan size, as defined by number of participants. The four strata of plans were as follows: 0-5 participants; 6-100 participants; 101-2,500 participants; and more than 2,500 participants. Responses to the 401(k) Questionnaire are self-reported and have not been verified by the IRS. The results presented in this report are generalized to the section 401(k) plan population that files the Form 5500, through the use of strata weights. Responses based on plan size will be broken out in the final report.

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<sup>1</sup>A section 401(k) plan is a defined contribution plan that includes a cash or deferred arrangement as described in section 401(k) of the Internal Revenue Code.

<sup>2</sup> *Private Pension Plan Bulletin, Abstract of 2008 Form 5500 Annual Reports*, US Department of Labor, Employee Benefits Security Administration, December 2010.

Open-ended responses to narrative questions are also summarized in this report. Most questions asked about the 2008 plan year. This Interim Report includes information on the responses to many, but not all questions included in the questionnaire. Information on questions not discussed in this Interim Report will be included in a final report.

A 95% confidence level was used. Unless otherwise noted, the margin of error for all analyses is less than or equal to 7%. A more detailed discussion of margin of error is presented in the report.

## **Key Findings**

### **Elective Deferral and Other Employee Contributions**

- Fifty-four percent of section 401(k) plans provide a one-year-of-service requirement before allowing participation in the plan.
- Sixty-four percent of section 401(k) plans contain an age-21 eligibility requirement before allowing participation in the plan.
- Forty-one percent of section 401(k) plans allow participants to change elective deferrals at any time.
- Ninety-six percent of section 401(k) plans have provisions that allow catch-up contributions (statutorily allowed additional contributions) for participants age 50 and older.
- Twenty-two percent of section 401(k) plans permit participants to make designated Roth contributions.

### **Employer Contributions**

- Sixty-eight percent of plan sponsors provide matching contributions.
- Sixty-five percent of plans provide some form of employer nonelective contribution such as a profit-sharing contribution.
- Fifty-eight percent of section 401(k) plans contain a one-year-of-service requirement in order for participants to be eligible for matching contributions.
- Twenty percent of section 401(k) plan sponsors identified their plans as being top-heavy in 2008.

### **Changes in Elective Deferrals and Employee After-Tax Contributions**

- From 2006 to 2008, 58 percent of section 401(k) plans experienced a per-participant increase in the dollar amount of elective deferrals.
- From 2006 to 2008, 52 percent of plans experienced a per participant decrease in the percentage of compensation deferred.
- From 2006 to 2008, 67 percent of section 401(k) plans that permit employees to make after-tax contributions experienced a per-participant increase in the amount of such after-tax contributions.

### **Changes in Employer Contributions**

- The percentage of section 401(k) plan sponsors that suspended or discontinued matching contributions in their plans increased from 1 percent in 2006 to 4 percent in 2008.
- The percentage of section 401(k) plan sponsors that suspended or discontinued the nonelective contribution in their plans increased from 2 percent in 2006 to 5 percent in 2008.
- The percentage of section 401(k) plan sponsors that reduced nonelective contributions in their plans increased from 1 percent in 2006 to 5 percent in 2008.

### **Nondiscrimination Testing of Elective Deferrals**

- The majority of 401(k) plan sponsors correct excess contributions within 2 ½ months following the end of the year of the excess.

### **Nondiscrimination Testing of Matching Contributions**

- More than three-quarters of section 401(k) plan sponsors correct nondiscrimination testing failures by distributing excess aggregate contributions.

### **Safe Harbor Section 401(k) Plans**

- Forty-three percent of section 401(k) plans are safe harbor plans.

### **SIMPLE 401(k) plans**

- Five percent of section 401(k) plans are SIMPLE plans.

### **Distributions From Section 401(k) Plans**

- The most common form of benefit in section 401(k) plans is a lump sum.
- Sixty-two percent of section 401(k) plans allow in-service withdrawals.
- Seventy-six percent of section 401(k) plans permit hardship distributions.
- Seventy-nine percent of section 401(k) plans permit direct rollover distributions.

### **Hardship Withdrawals and Participant Loans**

- Seventy-six percent of section 401(k) plans permit hardship distributions.
- Sixty-five percent of section 401(k) plans allow participant loans.

### **Trust Assets**

- One percent of section 401(k) plans allow investment in employer securities.
- One percent of section 401(k) plans have investments in assets held overseas.

### **Employee Plans Compliance Resolution System**

- Sixty-five percent of section 401(k) plan sponsors are aware of the Employee Plans Compliance Resolution System (EPCRS).
- Of those plan sponsors that used EPCRS, the majority found it helpful.

### **The Determination Letter Program**

- Eighty-six percent of section 401(k) plans are some form of pre-approved plan.
- Twenty-three percent of plan sponsors have requested a determination letter from the IRS.

### **Customer Education and Outreach**

- Fifty-seven percent of section 401(k) plan sponsors use the IRS website to obtain information from the IRS.

### **Plan Administration**

- Fifty-three percent of section 401(k) plan sponsors use a third-party administrator for plan administration.
- Third-party administrators are responsible for timely plan amendments in 73 percent of section 401(k) plans.
- Third-party administrators are responsible for the annual preparation of the Form 5500 in 83 percent of section 401(k) plans.

### **Next Steps**

The IRS will use information gathered from the 401(k) Questionnaire, in conjunction with other data, to

- enhance our external section 401(k) plan administration compliance tools,
- produce more useful outreach materials;
- improve voluntary compliance programs;
- assess the need for further formal guidance; and
- define some upcoming projects and enforcement activities.

We encourage section 401(k) plan sponsors to use the 401(k) Questionnaire, in conjunction with the report findings, to strengthen their internal controls over plan operation and to find, fix and avoid errors in their section 401(k) plans.

A final report will include comparisons by the plan size stratifications. These breakdowns will identify differences between small and large plans. The report will also include information on items from the 401(k) Questionnaire not analyzed in this report. It is targeted for release in 2012.

## OVERVIEW

This Interim Report summarizes the results obtained from the Internal Revenue Service's (IRS) Section 401(k) Compliance Check Questionnaire Project. A key focus for IRS Employee Plans (EP) is looking at compliance issues in section 401(k) plans<sup>3</sup> as these plans represent the fastest growing type of employer sponsored retirement plan. The electronic online questionnaire project provides vital information that will help the IRS gain a better understanding of the health and compliance behaviors of section 401(k) plans. It will also assist the IRS in determining how to best allocate its resources to foster voluntary compliance in section 401(k) plans to keep these plans as qualified retirement vehicles for approximately 60 million Americans. Looking at section 401(k) plan compliance is an EP Operating Priority that will continue in FY 2012 and into the future.

### **Background Information About Section 401(k) Plans**

A section 401(k) plan is a type of tax-qualified deferred compensation plan that permits employees to save for retirement on a tax-favored basis. If an employer sponsors a section 401(k) plan, a covered employee can elect to have the employer contribute a portion of his or her cash wages to the plan on a pretax basis. Generally, these deferred wages (commonly referred to as elective contributions, salary deferrals or elective deferrals) are not included as taxable wages for income tax purposes on an employee's Form W-2 when made to the plan and are not included in an employee's income until distributed from the plan. However, these deferred wages made to the plan are subject to Social Security, Medicare, and federal unemployment taxes.

The dollar amount that an employee may elect to defer to a section 401(k) plan is limited by the Internal Revenue Code (Code). An employee's elective deferrals also may be limited based on the terms of the section 401(k) plan. A section 401(k) plan is generally subject to certain nondiscrimination requirements to ensure that higher-paid employees do not defer amounts to the plan that are significantly more than amounts deferred by lower-paid employees; however, an employer may adopt a more simplified plan, known as a safe harbor plan, which automatically meets the nondiscrimination requirements and does not require the employer to conduct nondiscrimination testing.

Employers may offer employees an opportunity to make after-tax salary deferral contributions (known as designated Roth contributions) to a separate designated Roth account in an employer's section 401(k) plan. Unlike other elective deferrals, the amount employees contribute to a designated Roth account is includible in their gross income. Qualified distributions from the Roth account, including previously untaxed earnings, are tax-free.

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<sup>3</sup> A section 401(k) plan is a defined contribution plan that includes a cash or deferred arrangement as described in section 401(k) of the Internal Revenue Code.

Distributions from a section 401(k) plan must be limited to stated events provided under the Code, but may qualify for rollover treatment as long as they meet certain Code requirements. In addition, a section 401(k) plan may permit hardship withdrawals, as long as certain conditions under the Code are met.

For more information on section 401(k) plans, go to our website at [www.irs.gov/ep](http://www.irs.gov/ep).

### **The Focus on Section 401(k) Plans**

Until the mid 1980's, defined benefit pension plans were the predominant type of pension arrangement in the United States. A defined benefit plan provides for a specified benefit upon the employee's retirement. Although many Americans continue to be covered under defined benefit pension plans, the use of defined contribution plans, particularly section 401(k) plans, has become more common. Beginning in 1989, participation in defined contribution plans has exceeded that in defined benefit plans.<sup>4</sup> Many Americans rely on section 401(k) plans as the sole private pension vehicle to fund their retirement. Most private retirement programs in the United States now include a section 401(k) arrangement. There are currently more than 500,000 section 401(k) plans covering approximately 60 million Americans.<sup>5</sup>

### **About the Section 401(k) Compliance Check Questionnaire**

The Section 401(k) Compliance Check Questionnaire ([401\(k\) Questionnaire](#)) is the result of a collaborative project of representatives within the Tax Exempt and Government Entities (TE/GE) Division, including TE/GE Research and Analysis, EP Examinations, EP Rulings and Agreements, EP Customer Education and Outreach, and the Employee Plans Compliance Unit (EPCU). The 401(k) Questionnaire was designed to gather information regarding the form, features, and operation of existing section 401(k) plans. The EPCU sent the 401(k) Questionnaire to 1,200 plan sponsors in May 2010. As explained below, the 1,200 plan sponsors were selected from those plan sponsors who indicated on their 2007 Form 5500 filing that they had a section 401(k) feature in their plans. The 401(k) Questionnaire requested information pertaining to multiple plan years 2006 through 2008. Plan sponsors were able to complete the 401(k) Questionnaire either by accessing a website or by submitting the 401(k) Questionnaire in paper form. More than 99% of respondents submitted the 401(k) Questionnaire via the website.

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<sup>4</sup> Based on U.S. Department of Labor Form 5500 Summaries for 1979-1998.  
<http://www.ebri.org/publications/benfaq/index.cfm?fa=retfaqt14fig2>

<sup>5</sup> *Private Pension Plan Bulletin, Abstract of 2008 Form 5500 Annual Reports*, US Department of Labor, Employee Benefits Security Administration, December 2010.



The information requested in the 401(k) Questionnaire is divided into major subject areas, including:

- Demographics: The types of plans sponsored by the employer, and whether the employer's section 401(k) plan is ongoing, frozen or terminated.
- Plan Participation: The number and categories of employees eligible to participate in the plan, the number of employees excluded, the number of employees making elective deferral contributions, and the bases upon which employer contributions are allocated to participant accounts.
- Employer and Employee Contributions: The nature, amount and frequency of employer and employee contributions to the section 401(k) plan.
- Top-Heavy and Nondiscrimination Rules: The degree to which the plan sponsor is able to demonstrate that the section 401(k) plan benefits rank-and-file employees as compared to highly compensated employees and owners, and whether appropriate corrective actions are taken to the extent required under the nondiscrimination rules of the Code.
- Distributions and Plan Loans: The circumstances under which funds are distributed or withdrawn from the plan, the forms of benefit made available under the plan, and the amounts of such distributions or withdrawals.
- Other Plan Operations: The effect of recent financial conditions on the contribution levels and investment behavior of employers and participants.
- Designated Roth Features: Whether the plan offers participants the opportunity to elect designated Roth contributions and, if so, the amounts contributed.
- IRS Voluntary Compliance Programs: The extent to which plan sponsors are aware of, and utilize, the IRS's voluntary compliance programs and tools, such as the Employee Plans Compliance Resolution System and the 401(k) Fix-It Guide. The 401(k) Questionnaire also asks how these programs and tools can be improved.
- Plan Administration: The plan sponsor's administrative policies and procedures, and the persons responsible for different aspects of the day-to-day operations of the section 401(k) plan.

## **Structure of This Interim Report and Presentation of Data**

Analyses are based on 2008 plan year data unless otherwise noted. All of the data is self-reported by respondents and has not been independently verified by the IRS. In multiple instances analyses are based on responses to more than one question.

In this report, the findings are generalized to the section 401(k) plan population that files the Form 5500. Therefore, references to section 401(k) plans throughout this report refer to the population of section 401(k) plan sponsors that regularly file an annual Form 5500. Plans that are not subject to the Form 5500 series filing requirements or which are subject to the filing requirements but for which a Form 5500 series was not filed are not represented in this report. All findings are calculated using strata weights, which are presented in Figure 1. The strata weights are calculated by dividing the total number of plans in each stratum by the number of plans randomly sampled for that stratum. The only exception to this is the open-ended questions. Not all respondents chose to answer these optional questions and as a result these responses cannot be generalized to the population. Any reference to the responses obtained from an open-ended question reflects only the opinions of the respondents who answered that particular question.

A 95% confidence level was used. Unless otherwise noted, the margin of error for all analyses is less than or equal to 7%. The margin of error is the error caused by observing a sample instead of the entire population when calculating estimates. For example, if 60% of the sample responds that they have a plan feature and there is a 7% margin of error, then there is a 95% chance (i.e., 95% confidence) that the actual number of plans in the population that have that feature is somewhere between 53% and 67%. In some cases, the number of respondents to a particular question is relatively small making the margin or error considerably higher than 7%. Caution should be exercised in relying on findings where the margin of error is exceptionally high.

The sample selection and analysis method are described in the following section. The remaining sections of the report correspond to the 401(k) Questionnaire. Note that responses to all questions are not included in this Interim Report. Information on questions not included in this report will be included in a final report.

A final report will include comparisons by the four plan size stratifications detailed in the *Sample Method* section of this report. These breakdowns will identify differences between small and large plans. It is targeted for release in 2012.

## **SAMPLE SELECTION AND ANALYSIS METHODS**

In preparing the 401(k) Questionnaire, the IRS was sensitive to resource and privacy concerns of the plan sponsors that would be completing the 401(k) Questionnaire. With these concerns in mind, the IRS selected a representative sample of plan sponsors that was not unreasonably large, and yet sufficient to provide a valid analysis of the section 401(k) plan population. The process used to select plan sponsors to participate in the 401(k) Questionnaire is described below.

### **Identifying Section 401(k) Plan Sponsors**

Since most section 401(k) plan sponsors are required to file a Form 5500-series annual return, Form 5500 filings were used to identify section 401(k) plan sponsors. The presence of a section 401(k) feature is identified on the Form 5500 by a “2J” Pension Feature Code in response to Question 8a of Part II of the form. Subject to the exceptions described immediately below, all Form 5500 filers that indicated they had a section 401(k) feature in their filing for their 2007 plan year were included in the initial sample frame.<sup>6</sup> The 2007 plan year was selected for analysis because at the time of selecting the sample, it included the most complete and current data. In total, 455,880 section 401(k) plans were included in the sampling frame.

### **Certain Section 401(k) Plans Excluded**

Plans under IRS examination after December 2008 were excluded from the sampling frame. Additionally, final- and short-plan year Form 5500 returns were excluded from the sampling frame. Section 401(k) plan sponsors that file a Form 5500-EZ (Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan) were also not included in the sampling frame. Unlike the Form 5500, the Form 5500-EZ does not require the identification of a section 401(k) feature.

### **Sample Method**

The IRS contacted 1,200 section 401(k) plan sponsors and requested they complete the 401(k) Questionnaire. The sample population was stratified into four strata based on plan size, as defined by the number of participants. The largest plans (as defined by number of participants) were sampled at a higher rate. While the number of plans with more than 2,500 participants in the section 401(k) population is small compared with the number of plans in the other strata, the total number of individuals covered by these plans is considerably larger. Plans from this stratum represent 17% of the sample plans (200 plans out of 1,200), and the remaining strata were sampled in numbers proportionate to the total number of plans in the section 401(k) plan population.

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<sup>6</sup> The sampling frame is a list of units from which a sample is drawn. All members of the sampling frame have a chance of being selected for the sample.

Figure 1 describes each stratum, the number of plans in each stratum, the proportion of the section 401(k) plan population represented by that stratum, the number of plans randomly sampled for each stratum, and the strata weights used to generalize the findings to the population.

**Figure 1. The Four Strata of Plans Based on Number of Participants**

	Reported Number of Plans	Proportion in the Section 401(k) Segment	Number of Plans Selected	Stratum Weight
Stratum 1 (0-5 participants)	77,154	17%	170	453.85
Stratum 2 (6-100 participants)	319,026	70%	700	455.75
Stratum 3 (101-2,500 participants)	56,465	12%	130	434.35
Stratum 4 (2,501+ participants)	3,235	1%	200	16.18
Total	455,880	100%	1,200	

### **Responses to the 401(k) Questionnaire**

After contact, 116 of the 1,200 randomly selected plans were removed from the sample because they were not section 401(k) plans or were no longer in existence. Of the 116 plans, 27 indicated they were not defined contribution plans and 49 indicated they did not permit elective deferrals. Additionally, 34 plan sponsors could not be located and 6 indicated they were either in bankruptcy, out of business, or had merged into or with another entity.

Therefore, the total sample size for the 401(k) Questionnaire was 1,084. Of these 1,084 plans, 1,060 plans returned the 401(k) Questionnaire while 24 plans did not. This resulted in an overall response rate of 98%.<sup>7</sup>

A preliminary review of available data on the 24 non-responders reveals no obvious anomalies. Specifically, the non-responders are:

- spread across the strata (meaning, there were non-responders in each of the four strata),
- geographically diverse, and
- not different from responders in terms of their past audit history.<sup>8</sup>

Based on the foregoing, population projections contained within this report assume any non-response error to be random.<sup>9</sup>

<sup>7</sup> Of the 1,060 responses, 38 respondents provided partial data.

<sup>8</sup> Analysis was performed on examinations conducted on or after the 2006 plan year. We were able to compare these two groups in terms of geographic location and previous examination history.

The IRS has initiated follow-up action on all non-responders. EP agents nationwide are conducting full-scope examinations of section 401(k) plans of sponsors who did not complete the 401(k) Questionnaire in order to gather the information that the IRS requested.

Not every question was applicable to every section 401(k) plan. Plan sponsors that indicated their plans were safe harbor plans, for example, were not required to answer questions regarding highly and nonhighly compensated employees. Additionally, some respondents did not respond to all questions in the 401(k) Questionnaire. Thus, the sample size for responses to particular questions may vary. Throughout this report, the sample sizes for results are noted.

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<sup>9</sup> According to Guideline 1.3.4 and 1.3.5, Office of Management and Budget (OMB), Standards and Guidelines for Statistical Surveys, September 2006, non-response bias analysis is not needed when the unit response rate is above 80%.

## ELECTIVE DEFERRAL AND OTHER EMPLOYEE CONTRIBUTIONS

Under the Code, alternatives are available to plan sponsors regarding the design of their section 401(k) plans. These include options concerning the eligibility to make elective deferral and other employee contributions, and limitations on the amount of any such contributions.<sup>10</sup> A plan sponsor also must determine how the plan will be structured so that it does not inappropriately discriminate in favor of highly compensated employees.

We asked plan sponsors to provide information related to elective deferrals and other employee contributions. Specifically, plan sponsors were asked questions related to:

- age and service eligibility requirements for elective deferral contributions;
- timing of elective deferral elections;
- catch-up contributions;
- designated Roth contributions;
- employee after-tax contributions; and
- limitations on elective deferral contributions.

### **Age and Service Eligibility Requirements to Make Elective Deferral Contributions**

A section 401(k) plan may require that an employee meet specified age and/or service requirements to be eligible to participate in the cash or deferred arrangement. Code section 401(k)(2)(D) provides that such requirements may not exceed age 21 and one year of service.

Figure 2 shows the percentage of section 401(k) plans that utilize various age requirements for eligibility to make elective deferral and other employee contributions.

**Figure 2. Age Requirements for Participation**

<b>Age Requirement</b>	<b>Plans<sup>11</sup></b>
None	20%
18 years	13%
19-20 years	4%
21 years	64%

<sup>10</sup> For example, IRC § 402(g) limits the dollar amount of elective deferrals an employee may make to the plan each year; however, a plan may restrict an employee to a lesser amount.

<sup>11</sup> Sample size = 1,040. The total percentage is more than 100% due to rounding.

Figure 3 shows the percentage of section 401(k) plans that contain service requirements for eligibility to make elective deferral and other employee contributions.

**Figure 3. Service Requirements for Participation**

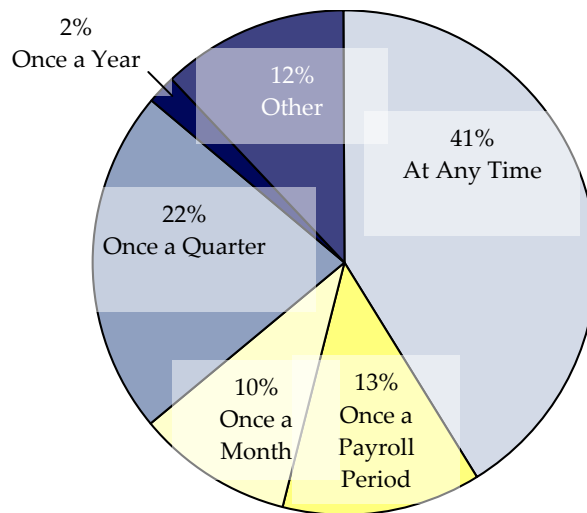
Service Requirement	Plans <sup>12</sup>
None	13%
One month	4%
Six months	14%
One year	54%
Other	14%

**Timing of Elective Deferral Elections**

An employee’s decision to defer income under a section 401(k) plan is elective. An employee’s ability to voluntarily save for retirement under a section 401(k) plan is subject to many variables, and may change from time to time. The law allows plan sponsors flexibility in determining when elections may be modified.

Figure 4 shows the percentage of section 401(k) plans that permit participants to change their elective deferrals at different frequencies (i.e., at any time, once a payroll period, once a month, once a quarter, once a year, or at other intervals).<sup>13</sup>

**Figure 4. Frequency With Which Participants Can Change Their Elective Deferrals.**



<sup>12</sup> Sample size = 1,040. The total percentage is less than 100% due to rounding.

<sup>13</sup> Sample size = 1,034.

## **Catch-Up Contributions**

Section 402(g) of the Code generally limits the total annual amount an employee may defer under a section 401(k) plan to an applicable dollar amount that is indexed for inflation. For 2012, the applicable dollar amount is \$17,000.<sup>14</sup> However, an individual age 50 or over is permitted to make additional elective deferrals, called catch-up contributions, up to a specified dollar limit, which is also subject to a cost-of-living adjustment. For 2012, the maximum catch-up contribution for a year is \$5,500.<sup>15</sup>

A section 401(k) plan is not required to permit employees to make catch-up contributions. However, almost all section 401(k) plans (96%) have provisions that allow participants age 50 and over to make catch-up contributions.<sup>16</sup>

## **Roth Contributions**

Employers may offer employees an opportunity to make after-tax salary deferral contributions (known as designated Roth contributions) to a separate designated Roth account in an employer's section 401(k) plan. Unlike pre-tax elective deferrals, the amount employees contribute to a designated Roth account is includible in their gross income. Qualified distributions from the designated Roth account, including previously untaxed earnings, are tax-free.

Qualified distributions from a Roth account may be rolled over to another designated Roth account (but only in a direct rollover) or to a Roth IRA. Section 401(k) plans are not required to provide for receipt of such direct rollovers.

### **Section 401(k) Plans That Permit Designated Roth Contributions**

Twenty-two percent of section 401(k) plans permit employees to make designated Roth contributions.<sup>17</sup> Of the plans that permit designated Roth contributions, 14% have initiated an eligible rollover distribution.<sup>18</sup>

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<sup>14</sup> 2006 = \$15,000; 2007 = \$15,500; 2008 = \$15,500.

<sup>15</sup> For 2006, 2007, and 2008 the maximum for a year was \$5,000.

<sup>16</sup> Sample size = 1,034.

<sup>17</sup> Sample size = 1,026.

<sup>18</sup> Sample size = 228.



## **Reasons for Not Offering Designated Roth Contributions**

Figure 5 provides the reasons section 401(k) plans do not offer designated Roth contributions.

**Figure 5. Reasons Given for Not Offering Designated Roth Contributions**

<b>Reason for Not Offering Roth Contributions</b>	<b>Plans<sup>19</sup></b>
Employees would not be interested	65%
Administratively burdensome	44%
Rules are too complicated	26%
Too expensive	12%
Service provider does not offer the option	8%
Other	7%

## **Employee After-Tax Contributions**

In addition to providing for a qualified cash or deferred arrangement under Code section 401(k), four-percent of section 401(k) plans permit employees to make employee after-tax contributions.<sup>20</sup>

## **Limitations on Elective Deferral Contributions**

Elective deferral contributions that exceed the applicable dollar amount under Code section 402(g) for a year are referred to as excess deferrals. Excess deferrals (and any associated earnings) must be distributed from the section 401(k) plan by April 15 of the year following the year of deferral. Excess deferrals are taxable to the individual for the year in which the deferrals were made; the earnings on excess deferrals are taxable in the year distributed. If excess deferrals are distributed by the section 401(k) plan sponsor after April 15 of the year following the year in which the deferrals were made, they are still taxable for the year in which the deferrals were made, but are also taxed for the year in which the distribution is made.

Most section 401(k) plan sponsors (96%)<sup>21</sup> have procedures in place to ensure that elective deferrals are limited to the Code section 402(g) amount. Each year from 2006 through 2008, 94% of section 401(k) plan sponsors did not require corrective distributions of excess deferrals. Between 2006 and 2008, 2% of section

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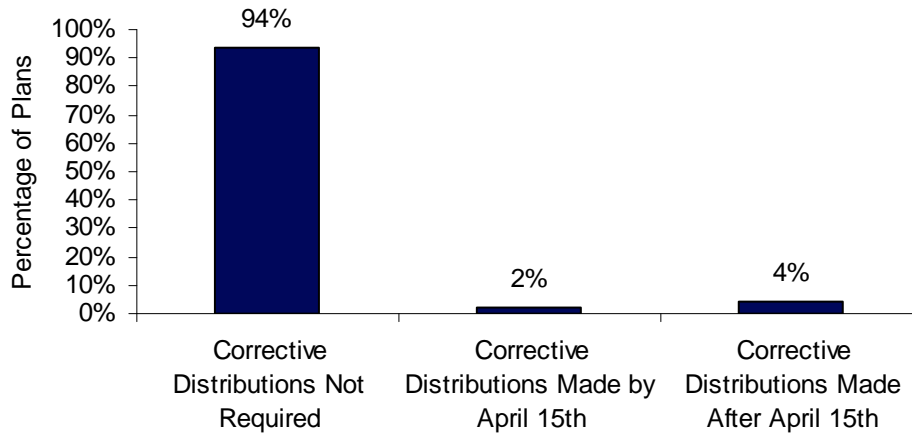
<sup>19</sup> Sample size = 798. Respondents to the 401(k) Questionnaire were provided 6 response options and instructed to select all that apply.

<sup>20</sup> Sample size = 1,034.

<sup>21</sup> Sample size = 1,026.

401(k) plan sponsors made corrective distributions by April 15 of the year following the year in which the excess deferrals occurred. During that same period, 4% of section 401(k) plan sponsors made corrective distributions of excess deferrals after April 15 of the year following the year in which the deferrals were made (see Figure 6).<sup>22</sup>

**Figure 6. Corrective Distributions of Excess Deferrals**



<sup>22</sup> Sample size (2006) = 1,025; Sample size (2007) = 1,024; Sample size (2008) = 1,025.

## EMPLOYER CONTRIBUTIONS

Employer contributions under a section 401(k) plan may be either matching contributions or nonelective contributions. Matching contributions generally match a percentage of an employee's elective deferral contributions. Nonelective contributions are contributions to the plan that the employee may not elect to receive in the form of cash or other benefits.

The 401(k) Questionnaire included questions related to employer contributions. Specifically, plan sponsors were asked questions related to:

- the offering of and eligibility requirements for matching contributions;
- the offering of and eligibility requirements for nonelective contributions; and
- employer contributions under top-heavy plans.

### **Matching Contributions**

Many section 401(k) plans (68%) provide for matching contributions on elective deferrals.<sup>23</sup> Of those plans providing matching contributions, 88% match on the basis of the percentage of deferred compensation. The remaining 12% match on the basis of dollar amount deferred.<sup>24</sup> The majority of section 401(k) plans that provide for matching contributions (64%) match elective deferral contributions without requiring employees to complete any separate or additional service requirements.<sup>25</sup>

### **Age and Service Eligibility Requirements for Matching Contributions**

A section 401(k) plan may require that an employee complete a specified age and/or service requirement before becoming eligible for an allocation of matching contributions under the plan. Code section 410(a)(1) provides that a qualified plan may not require as a condition of participation in the plan a period of service extending beyond the later of the date on which the employee attains the age of 21, or the date on which he or she completes one year of service (two years in certain plans).

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<sup>23</sup> Sample size = 1,034.

<sup>24</sup> Sample size = 736.

<sup>25</sup> Sample size = 736.

Of the plans that offer matching contributions, Figure 7 shows the percentage of plans that have age requirements for eligibility to receive matching contributions.

**Figure 7. Age Requirements for Matching Contributions**

<b>Age Requirement</b>	<b>Plans<sup>26</sup></b>
None	23%
18 years	13%
19-20 years	3%
21 years	61%

Figure 8 shows the percentage of section 401(k) plans that have service requirements for eligibility to receive matching contributions.

**Figure 8. Service Requirements for Matching Contributions**

<b>Service Requirement</b>	<b>Plans<sup>27</sup></b>
None	13%
One month	2%
Six months	14%
One year	58%
Other	14%

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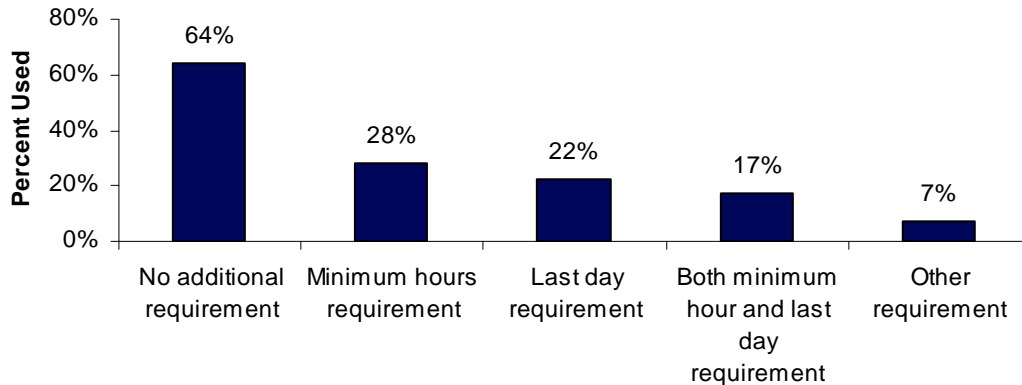
<sup>26</sup> Sample size = 1,040.

<sup>27</sup> Sample size = 827. The total percentage is more than 100% due to rounding.

## **Requirements Applicable to Allocations of Matching Contributions**

As stated earlier, in addition to the eligibility requirements described above, some section 401(k) plans have separate requirements applicable to whether a participant is entitled to an allocation of matching contributions to his or her account. Twenty-two percent of section 401(k) plans that provide for matching contributions require participants to be employed on the last day of the plan year in order to be entitled to an allocation of matching contributions.<sup>28</sup> Seventeen percent of section 401(k) plans that provide for matching contributions require employees to be employed on the last day of the plan year and to complete a minimum number of hours of service in order to receive an allocation of matching contributions (see Figure 9).<sup>29</sup>

**Figure 9. Additional Eligibility Requirements Among Plans Offering Matching Contributions**



## **Nonelective Contributions**

Sixty-five percent of section 401(k) plans provide for some form of employer nonelective contribution, such as a profit-sharing contribution.<sup>30</sup>

From 2006 to 2008, participants receiving employer nonelective contributions decreased by 13%.<sup>31</sup>

<sup>28</sup> Sample size = 736.

<sup>29</sup> Sample size = 736. Instructions for this question permitted respondents to select more than one answer.

<sup>30</sup> Sample size = 1,027.

<sup>31</sup> Sample size = 307.

### **Age and Service Eligibility Requirements for Nonelective Contributions**

As with matching contributions, a section 401(k) plan may require that an employee complete a specified age and/or service requirement before becoming eligible for an allocation of employer nonelective contributions under the plan.

Figure 10 shows, out of the 65% of all section 401(k) plans that provide for employer nonelective contributions, the percentage of such plans that impose age requirements for eligibility to receive allocations of employer nonelective contributions.

**Figure 10. Age Requirements for Nonelective Contributions**

<b>Age Requirement</b>	<b>Plans<sup>32</sup></b>
None	22%
18 years	11%
19-20 years	3%
21 years	63%

Figure 11 shows, out of the 65% of all section 401(k) plans that provide for employer nonelective contributions, the percentage of such plans that impose service requirements for eligibility to receive allocations of employer nonelective contributions.

**Figure 11. Service Requirements for Nonelective Contributions**

<b>Service Requirement</b>	<b>Plans<sup>33</sup></b>
None	11%
One month	2%
Six months	13%
One year	62%
Other	12%

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<sup>32</sup> Sample size = 1,039. The total percentage is less than 100% due to rounding.

<sup>33</sup> Sample size = 756.

## **Top-Heavy Plan Requirements**

Under section 416 of the Code, a section 401(k) plan is top-heavy if the aggregate amount held in the accounts of key employees under the plan exceeds 60% of the aggregate amount held in the accounts of all employees.<sup>34</sup> The term key employee generally refers to an employee who, at any time during the plan year, is:

- an officer of the employer with annual compensation greater than \$165,000 (as adjusted for increases in the cost-of-living);
- a 5% owner of the employer; or
- a 1% owner of the employer having annual compensation of more than \$150,000.<sup>35</sup>

If a plan is top-heavy, it must meet special minimum contribution requirements. Specifically, contributions made on behalf of non-key employees under a top-heavy plan must be at least equal to the lesser of:

- 3% of compensation; or
- the highest percentage contribution made for a key employee.<sup>36</sup>

If an employer maintains more than one qualified plan, the plans may be aggregated for purposes of satisfying the top-heavy contribution requirements.<sup>37</sup> If an employer sponsors more than one qualified plan, the plan documents must specify how the minimum top-heavy contribution requirement will be coordinated between or among those plans.<sup>38</sup> If an employer sponsors a qualified defined contribution plan and a qualified defined benefit plan, the top-heavy contribution requirement can be satisfied by providing a 5% contribution in the defined contribution plan to employees who are participants in both plans.<sup>39</sup>

Some types of qualified plans are not subject to the top-heavy minimum contribution requirements. For example, the top-heavy-minimum contribution rules do not apply to collectively bargained plans.<sup>40</sup> Furthermore, Code section 401(k)(12) safe harbor plans are not subject to the top-heavy minimum contribution requirements.<sup>41</sup>

## **Top-Heavy Requirements and Employer Contributions**

Twenty percent of section 401(k) plan sponsors identify their plans as top-heavy while 55% do not. The remaining 25% of section 401(k) plan sponsors state that the top-heavy

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<sup>34</sup> IRC § 416(g)(1)(A)(ii).

<sup>35</sup> IRC § 416(i)(1)(A).

<sup>36</sup> IRC § 416(c)(2).

<sup>37</sup> IRC § 416(g).

<sup>38</sup> Treas. Reg. § 1.416-1.

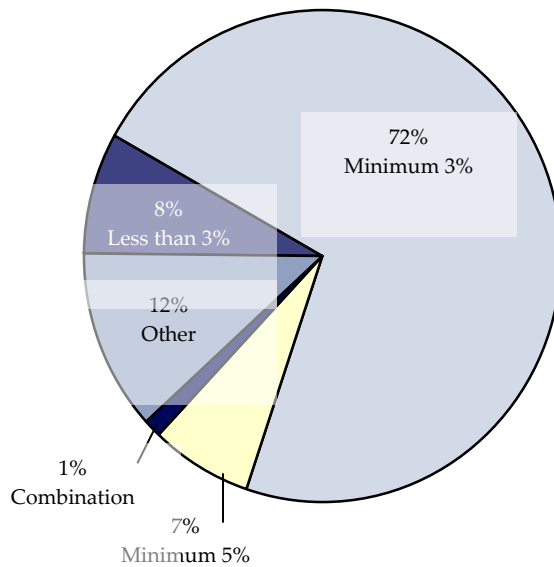
<sup>39</sup> Treas. Reg. § 1.416-1, M-12.

<sup>40</sup> IRC § 416(i)(4).

<sup>41</sup> IRC § 416(g)(4)(H).

rules are not applicable to them.<sup>42</sup> Of the 20% of section 401(k) plans that are top-heavy, 79% provide non-key employees with minimum contributions.<sup>43</sup> Of those plan sponsors that made top-heavy minimum contributions on behalf of non-key employees, the contribution levels varied. Figure 12 shows the percentage of top-heavy section 401(k) plans that provided specified amounts of top-heavy minimum contributions (expressed as a percentage of compensation).<sup>44</sup>

**Figure 12. Contributions Provided by Top-Heavy Plans**



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<sup>42</sup> Sample size = 1,027.

<sup>43</sup> Sample size = 170.

<sup>44</sup> Sample size = 136.



## CHANGES IN ELECTIVE DEFERRALS AND EMPLOYEE AFTER-TAX CONTRIBUTIONS

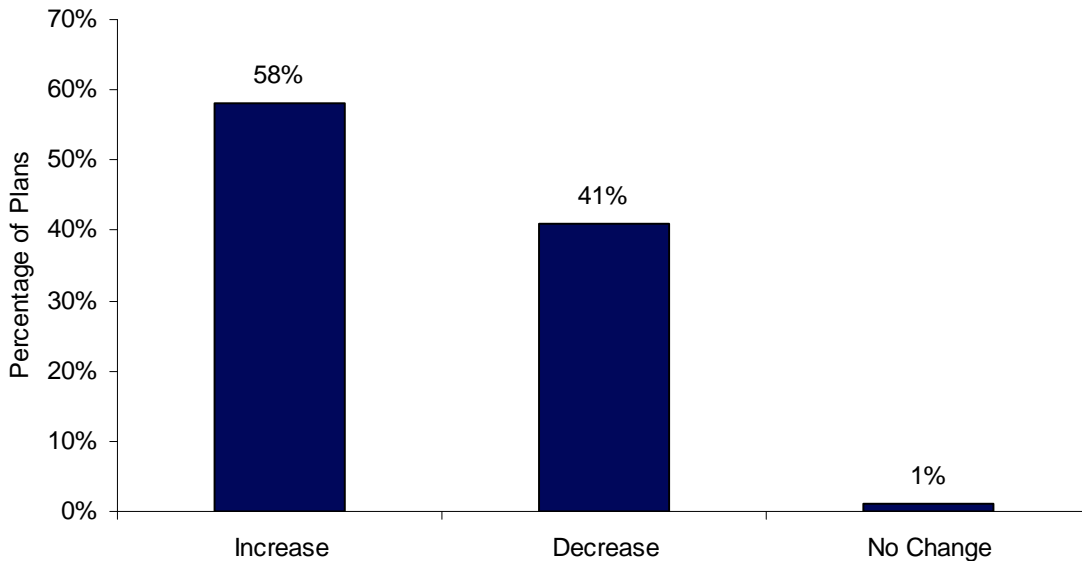
We asked respondents whether employee elective deferrals increased or decreased from 2006 to 2008. Respondents were asked about changes in the following categories:

- the amount of participant elective deferrals;
- elective deferrals as a percentage of compensation;
- catch-up contributions; and
- changes in employee after-tax contributions.

### Amount of Elective Deferral Contributions

From 2006 to 2008, 58% of section 401(k) plans experienced a per-participant increase in the dollar amount of elective deferrals while 41% experienced a per-participant decrease (see Figure 13).<sup>45</sup>

**Figure 13. Change in the Dollar Amount of Elective Deferrals Per Participant From 2006 - 2008**

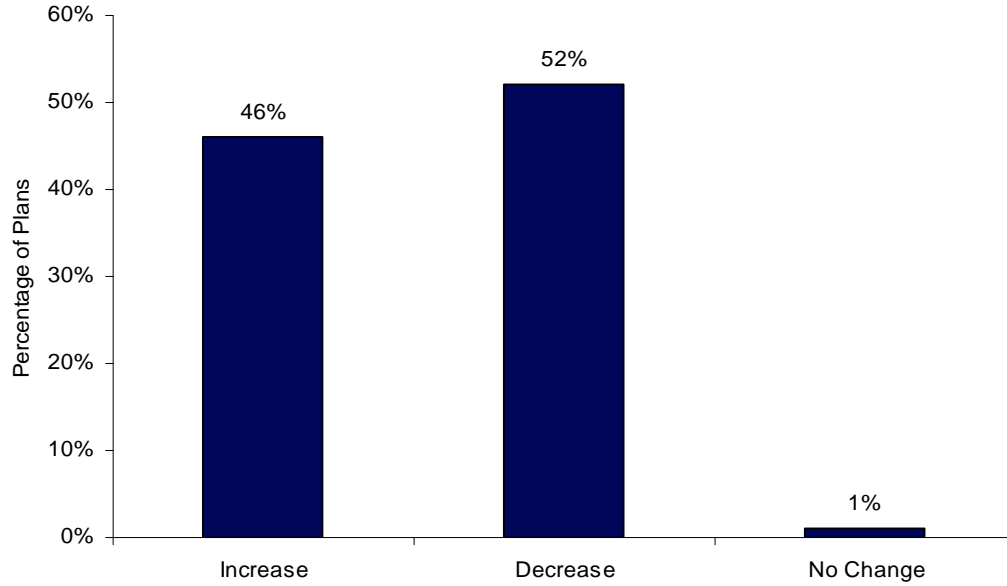


<sup>45</sup> Sample size = 870.

## **Elective Deferrals as a Percentage of Compensation**

During the same 2006 to 2008 period, 46% of section 401(k) plans experienced an increase in the percent of employee compensation deferred under the plan while 52% experienced a decrease (see Figure 14).<sup>46</sup>

**Figure 14. Change in Percent of Employee Compensation Deferred Under the Plan From 2006 - 2008**

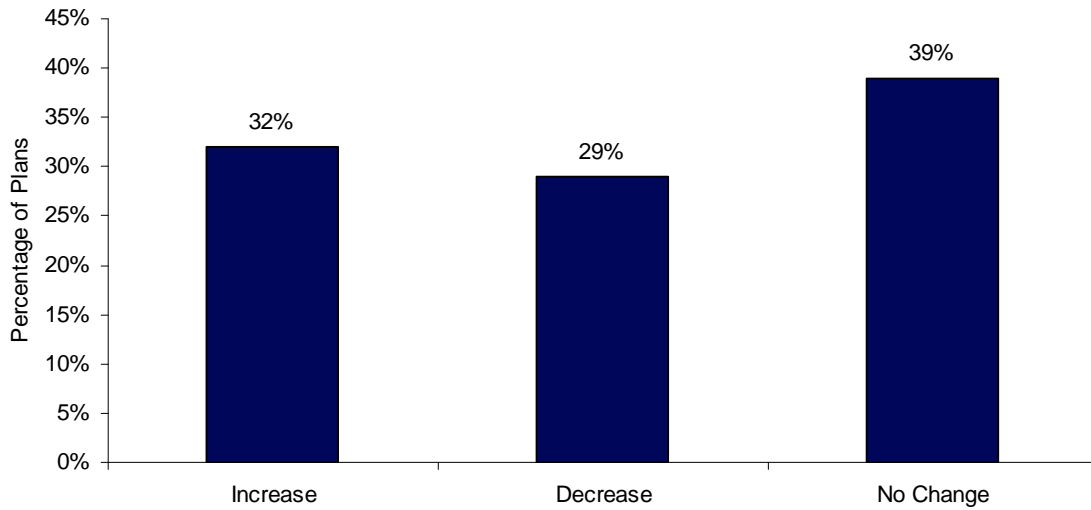


<sup>46</sup> Sample size = 882. The total percentage is less than 100% due to rounding.

## **Catch-Up Contributions**

As noted earlier, almost all section 401(k) plans (96%) have provisions that allow participants age 50 and over to make catch-up contributions. Figure 15 depicts the percentage of section 401(k) plans that experienced a change in catch-up contributions from 2006 to 2008.

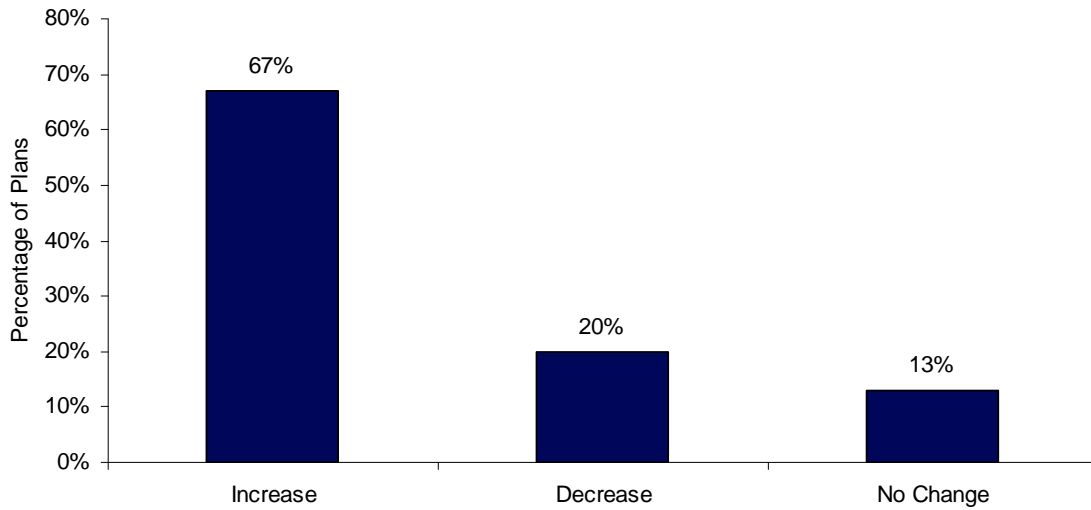
**Figure 15. Change in Dollar Amount of Catch-Up Contributions Per Participant From 2006 - 2008**



## **Changes in Employee After-Tax Contributions**

As noted previously, only 4% of section 401(k) plans permit employees to make employee after-tax contributions. Figure 16 illustrates the percentages of section 401(k) plans permitting employee after-tax contributions from 2006 to 2008 that experienced a change in the amount of such after-tax contributions per participant.<sup>47</sup>

**Figure 16. Change in Dollar Amount of Employee After-Tax Contributions Per Participant From 2006 - 2008**



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<sup>47</sup> Sample size = 59.

## CHANGES IN EMPLOYER CONTRIBUTIONS

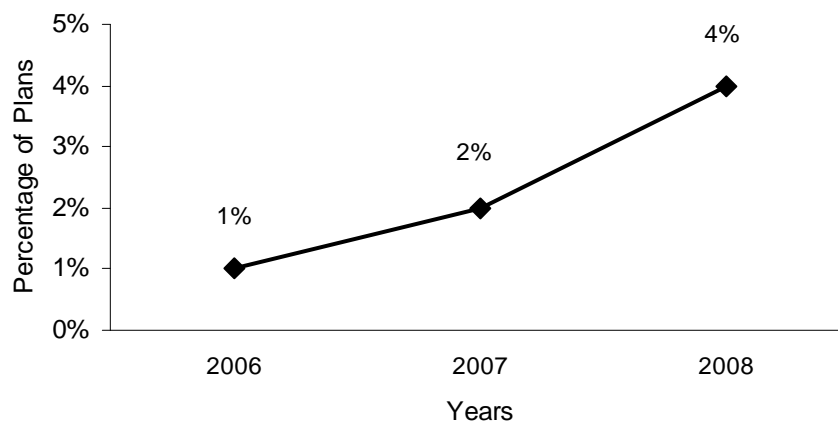
Fifteen percent of section 401(k) plans have experienced a suspension, reduction or discontinuation of matching or nonelective contributions in the last 4 years prior to completing the questionnaire.<sup>48</sup> Similar to questions relating to elective deferral and other employee contributions, plan sponsors were asked whether there was:

- a suspension or discontinuance of matching contributions;
- a reduction of matching contributions;
- a suspension or discontinuance of nonelective contributions; and
- a reduction of nonelective contributions.

### Suspension or Discontinuance of Matching Contributions

Figure 17 shows the increase in the percentage of all section 401(k) plans in which employer matching contributions were suspended or discontinued each year from 2006 through 2008.<sup>49</sup>

**Figure 17. Percentage of Plans That Suspended or Discontinued Matching Contributions**



<sup>48</sup> Sample size = 1,027.

<sup>49</sup> Sample size (2006) = 948; sample size (2007) = 1,015; sample size (2008) = 1,016. A discussion specific to the suspension or discontinuance of matching contributions under safe harbor plans during the period 2006 through 2008 is provided in a later section of this Interim Report.

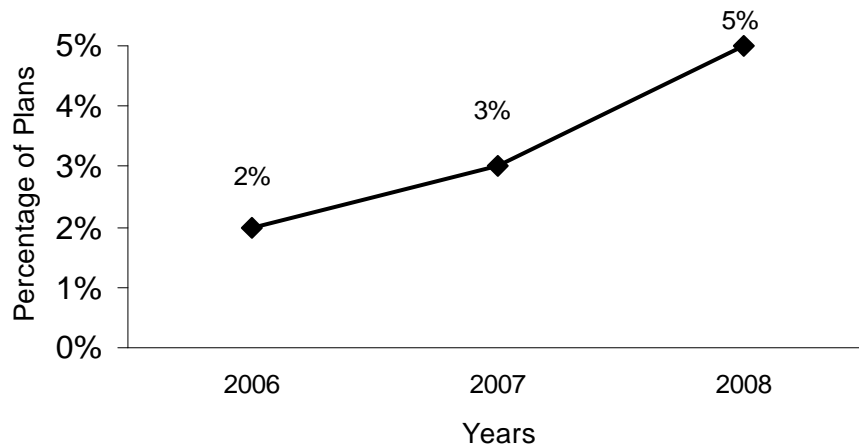
### **Reduction of Matching Contributions**

One percent of all section 401(k) plans reduced employer matching contributions each year from 2006 to 2008.<sup>50</sup>

### **Suspension or Discontinuance of Nonelective Contributions**

Figure 18 depicts the increase in the percentage of all section 401(k) plans in which nonelective contributions were suspended or discontinued from 2006 to 2008.<sup>51</sup>

**Figure 18. Percentage of Plans That Suspended or Discontinued Nonelective Contributions**



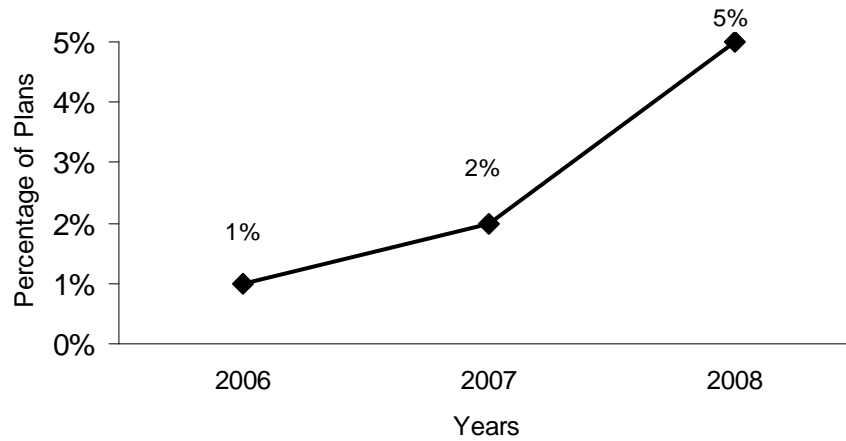
<sup>50</sup> Sample size (2006) = 948; sample size (2007) = 1,015; sample size (2008) = 1,016.

<sup>51</sup> Sample size (2006) = 949; sample size (2007) = 1,016; sample size (2008) = 1,017.

## Reduction of Nonelective Contributions

Figure 19 depicts the increase in the percentage of all section 401(k) plans in which nonelective contributions were reduced from 2006 through 2008.<sup>52</sup>

**Figure 19. Percentage of Plans That Reduced Nonelective Contributions**



<sup>52</sup> Sample size (2006) = 949; sample size (2007) = 1,016; sample size (2008) = 1,017.

## **NONDISCRIMINATION TESTING OF ELECTIVE DEFERRALS**

In general, employers that sponsor qualified cash or deferred arrangements under Code section 401(k) are required to demonstrate that their plans do not discriminate in favor of highly compensated employees (within the meaning of Code section 414(q)) by running the actual deferral percentage (ADP) test.<sup>53</sup> The ADP test is an objective test that provides a limit on the amount of elective deferrals that may be made to the plan on behalf of highly compensated employees (HCEs) as compared to the amount of elective deferrals made to the plan on behalf of nonhighly compensated employees (NHCEs). ADP testing is not required for SIMPLE section 401(k) plans described in section 401(k)(11) or for safe harbor section 401(k) plans described in Code section 401(k)(12) or 401(k)(13).

Plan sponsors were asked on the 401(k) Questionnaire to respond to questions related to:

- applying the ADP test;
- correcting ADP test failures; and
- the timing of ADP test corrective distributions.

### **Applying the ADP Test**

Under the ADP test, the average of the actual deferral percentages of HCEs is compared to the average of the actual deferral percentages of NHCEs. Effective for plan years beginning after December 31, 1996, plan administrators are permitted to apply the ADP test using prior year data in determining the actual deferral percentages of NHCEs.

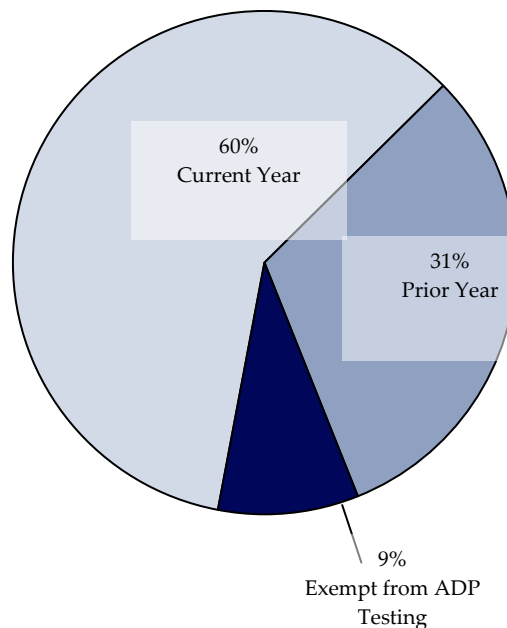
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<sup>53</sup> IRC § 401(k)(3).



Figure 20 depicts the testing method used by section 401(k) plan sponsors subject to the ADP test.<sup>54</sup>

**Figure 20. Testing Method Used for ADP Testing**



### **Correcting ADP Test Failures**

If a section 401(k) plan fails the ADP test, corrective action must be taken to protect the qualified status of the plan. An amount of elective deferral contributions allocated to the plan account of an HCE that is greater than that permitted under the ADP test is referred to as an excess contribution. A plan sponsor may correct excess contributions in one of the following ways:

- the employer may make additional contributions to the NHCEs in the plan in the form of qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs) that are treated as elective deferrals for purposes of the ADP test;
- the excess contributions may be recharacterized as employee after-tax contributions;
- excess contributions, together with any corresponding earnings, may be distributed to HCEs; or
- a plan sponsor may use a combination of the foregoing correction methods.<sup>55</sup>

<sup>54</sup> Sample size = 454. Nine percent of the population identifies as exempt from ADP testing despite reporting that they made a correction in 2008.

<sup>55</sup> Treas. Reg. § 1.401(k)-2(b)(1).

Figure 21 shows the method of correction used by those plan sponsors subject to the ADP test that had a result that required a correction of excess contributions.

**Figure 21. Usage of Correction Methods by Plan Year**

<b>Method of Correction</b>	<b>2006<sup>56</sup></b>	<b>2007<sup>57</sup></b>	<b>2008<sup>58</sup></b>
Distribution of excess contributions and related earnings	61% <sup>59</sup>	58% <sup>60</sup>	67% <sup>61</sup>
Additional contributions of QNECs	4%	3%	4%
Additional contributions of QMACs	0%	0%	0%
Recharacterizing elective deferrals as employee after-tax contributions	23% <sup>62</sup>	26% <sup>63</sup>	17%
More than one correction method	5%	7%	7%
Other method	7%	6%	4%

### **The Timing of ADP Test Corrective Distributions**

In order to preserve the qualified status of a section 401(k) plan, distributions of excess contributions must be completed by the end of the 12-month period following the close of the plan year in which the excess contributions occurred.<sup>64</sup> If corrective distributions are made after the first 2½ months following the end of the year of the excess, the employer is liable for an excise tax.<sup>65</sup>

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<sup>56</sup> Sample size = 163.

<sup>57</sup> Sample size = 181.

<sup>58</sup> Sample size = 177. The total percentage is less than 100% due to rounding.

<sup>59</sup> Margin of error = 9%.

<sup>60</sup> Margin of error = 8%.

<sup>61</sup> Margin of error = 8%.

<sup>62</sup> Margin of Error = 8%.

<sup>63</sup> Margin of error = 8%.

<sup>64</sup> IRC § 401(k)(8); Treas. Reg. § 1.401(k)-2(b)(2)(v).

<sup>65</sup> IRC § 4979(f).

Figure 22 shows the percentage of plan sponsors subject to the ADP test that corrected excess contributions broken down by the time it took them to make the correction and the plan year.<sup>66</sup>

**Figure 22. Percentage of Plan Sponsors Correcting Excess Contributions by Time of Correction and Plan Year**

<b>Time of Correction</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Within 2½ months	63% <sup>67</sup>	67% <sup>68</sup>	68% <sup>69</sup>
Later than 2½ months	9%	11%	13%
No correction was required to be made	28%	22%	18%

Figure 23 provides the percentage of plan sponsors subject to the ADP test that from 2006 to 2008 made corrective distributions of excess contributions and when.<sup>70</sup>

**Figure 23. Correction Time for Years 2006-2008**

<b>Time of Correction</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Within 12 months	60% <sup>71</sup>	65% <sup>72</sup>	69% <sup>73</sup>
Later than 12 months	1%	2%	3%
No correction was required to be made	39% <sup>74</sup>	32% <sup>75</sup>	28% <sup>76</sup>

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<sup>66</sup> Sample size = 163.

<sup>67</sup> Margin of error = 9%.

<sup>68</sup> Margin of error = 8%.

<sup>69</sup> Margin of error = 8%. The total percentage is less than 100% due to rounding.

<sup>70</sup> Sample size = 163.

<sup>71</sup> Margin of error = 9%.

<sup>72</sup> Margin of error = 8%.

<sup>73</sup> Margin of error = 8%.

<sup>74</sup> Margin of error = 9%.

<sup>75</sup> Margin of error = 8%.

<sup>76</sup> Margin of error = 8%.

## **NONDISCRIMINATION TESTING OF MATCHING CONTRIBUTIONS**

The actual contribution percentage (ACP) test is an objective test under the Code that provides a limit on the amount of matching contributions and employee after-tax contributions that may be provided under a section 401(k) plan on behalf of HCEs. As with ADP testing, the ACP test is not required for safe harbor section 401(k) plans described in Code section 401(m)(11) or 401(m)(12).<sup>77</sup>

Plan sponsors were asked to respond to questions related to:

- applying the ACP test;
- correcting ACP testing failures; and
- the timing of ACP test corrective distributions.

### **Applying the ACP Test**

Under the ACP test, each participant's contribution percentage is determined by dividing the applicable contributions by the compensation defined in the plan document. The average of the contribution percentages of HCEs is compared to the average of the contribution percentages of NHCEs. Effective for plan years beginning after December 31, 1996, plan administrators are permitted to apply the ACP test using prior year data in determining the contribution percentages of NHCEs. Alternatively, a plan administrator may perform the ACP test using current year data for both HCEs and NHCEs. Sixty-nine percent of plan sponsors that perform the ACP test use current year data, while 31% use prior year data.<sup>78</sup>

### **Correcting ACP Test Failures**

If a section 401(k) plan fails the ACP test, corrective action must be taken to protect the qualified status of the plan. An amount of matching contributions or employee after-tax contributions allocated to the plan account of an HCE that is greater than that permitted under the ACP test is referred to as an excess aggregate contribution. A plan sponsor may correct excess aggregate contributions in one of the following ways:

- the employer may make additional contributions to the NHCEs in the plan in the form of matching contributions or qualified nonelective contributions (QNECs);
- excess aggregate contributions may be distributed to HCEs or forfeited in accordance with applicable regulations; or
- a plan sponsor may use a combination of the foregoing correction methods.<sup>79</sup>

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<sup>77</sup> IRC § 401(m)(1).

<sup>78</sup> Sample size = 454. Margin of error = 15%.

<sup>79</sup> Treas. Reg. § 1.401(m)-2(b)(1).

Figure 24 shows the percentages of section 401(k) plan sponsors subject to the ACP test that corrected excess aggregate contributions from 2006 to 2008 using various methods.

**Figure 24. Percentages of Plan Sponsors Correcting Excess Aggregate Contributions by Method of Correction and Plan Year**

<b>Method of Correction</b>	<b>2006<sup>80</sup></b>	<b>2007<sup>81</sup></b>	<b>2008<sup>82</sup></b>
Distribution of excess aggregate contributions	83% <sup>83</sup>	88% <sup>84</sup>	90% <sup>85</sup>
Additional contributions of QNECs	0%	0%	0%
Additional contributions of QMACs	0%	0%	0%
More than one correction method	4% <sup>86</sup>	0%	0%
Other method	12% <sup>87</sup>	12% <sup>88</sup>	10% <sup>89</sup>

### **The Timing of ACP Test Corrective Distributions**

In order to preserve the qualified status of a section 401(k) plan, distributions of excess aggregate contributions must be completed by the end of the 12-month period following the close of the plan year in which the excess aggregate contributions occurred.<sup>90</sup> If corrective distributions are made after the first 2½ months following the end of the year of the excess, the employer is liable for an excise tax.<sup>91</sup> Figure 25 depicts the percentage of section 401(k) plan sponsors subject to the ACP test that corrected excess aggregate contributions broken down by the time it took them to make the correction and the plan year.

**Figure 25. Percentage of Plan Sponsors Correcting Excess Aggregate Contributions by Time of Distribution and Plan Year**

<b>Time of Distribution</b>	<b>2006<sup>92</sup></b>	<b>2007<sup>93</sup></b>	<b>2008<sup>94</sup></b>
Within 2½ months	79% <sup>95</sup>	78% <sup>96</sup>	76% <sup>97</sup>

<sup>80</sup> Sample size = 40. The total percentage is less than 100% due to rounding.

<sup>81</sup> Sample size = 46.

<sup>82</sup> Sample size = 47.

<sup>83</sup> Margin of error = 15%.

<sup>84</sup> Margin of error = 11%.

<sup>85</sup> Margin of error = 11%.

<sup>86</sup> Margin of error = 8%.

<sup>87</sup> Margin of error = 13%.

<sup>88</sup> Margin of error = 11%.

<sup>89</sup> Margin of error = 11%.

<sup>90</sup> IRC § 401(m)(6); Treas. Reg. § 1.401(m)-2(b)(2)(v).

<sup>91</sup> IRC § 4979(f).

<sup>92</sup> Sample size = 40. The total percentage is less than 100% due to rounding.

<sup>93</sup> Sample size = 46.

<sup>94</sup> Sample size = 47.

<sup>95</sup> Margin of error = 16%.

<sup>96</sup> Margin of error = 16%.

Later than 2½ months	12% <sup>98</sup>	19% <sup>99</sup>	17% <sup>100</sup>
No distribution was required to be made	8% <sup>101</sup>	3%	7% <sup>102</sup>

Figure 26 depicts the percentage of section 401(k) plan sponsors subject to the ACP test that corrected excess aggregate contributions broken down by the time it took them to make the correction and the plan year.

**Figure 26. Correction Time for Excess Aggregate Contributions for 2006-2008 Years**

<b>Time of Distribution</b>	<b>2006<sup>103</sup></b>	<b>2007<sup>104</sup></b>	<b>2008<sup>105</sup></b>
Within 12 months	72% <sup>106</sup>	91% <sup>107</sup>	83% <sup>108</sup>
Later than 12 months	4% <sup>109</sup>	0%	3%
No distribution was required to be made	25% <sup>110</sup>	9% <sup>111</sup>	14% <sup>112</sup>

## SAFE HARBOR SECTION 401(k) PLANS

Section 401(k) plans that satisfy the safe harbor requirements described in Code sections 401(k)(12) or 401(k)(13) and 401(m)(11) or 401(m)(12) are deemed to provide nondiscriminatory elective deferral and matching contributions. Accordingly, safe harbor plans are not required to demonstrate that elective deferral contributions are nondiscriminatory under the ADP test of Code section 401(k)(3), or that matching contributions are nondiscriminatory under the ACP test of Code section 401(m)(2).

Forty-three percent of section 401(k) plans are safe harbor plans.<sup>113</sup> Some of these safe harbor plans satisfy the requirements of Code section 401(k)(12) and 401(m)(11). However, effective for plan years beginning on or after January 1, 2008, plan sponsors could establish or adopt a safe harbor plan that meets the requirements described in Code

<sup>97</sup> Margin of error = 16%.

<sup>98</sup> Margin of error = 13%.

<sup>99</sup> Margin of error = 13%.

<sup>100</sup> Margin of error = 14%.

<sup>101</sup> Margin of error = 11%.

<sup>102</sup> Margin of error = 9%.

<sup>103</sup> Sample size = 40. The total percentage is more than 100% due to rounding.

<sup>104</sup> Sample size = 46.

<sup>105</sup> Sample size = 47.

<sup>106</sup> Margin of error = 18%.

<sup>107</sup> Margin of error = 10%.

<sup>108</sup> Margin of error = 14%.

<sup>109</sup> Margin of error = 8%.

<sup>110</sup> Margin of error = 18%.

<sup>111</sup> Margin of error = 10%.

<sup>112</sup> Margin of error = 13%.

<sup>113</sup> Sample size = 1,026.

section 401(k)(13) and 401(m)(12) (a “qualified automatic contribution arrangement,” or “QACA”).

The 401(k) Questionnaire asked safe harbor section 401(k) plan sponsors to provide information about:

- employer contributions;
- notice requirements; and
- suspension, discontinuance, or reduction of matching contributions.

### **Employer Contributions Under Safe Harbor Plans**

In order to constitute a safe harbor plan, a section 401(k) plan must provide for certain minimum matching or nonelective employer contributions. A safe harbor plan may satisfy the minimum matching contribution requirement by providing either a basic or an enhanced matching contribution. The basic matching contribution for a section 401(k)(12) safe harbor plan is a contribution equal to 100 percent of the employee’s elective deferrals up to 3 percent of compensation and 50 percent of the employee’s elective deferrals to the extent that such elective deferrals exceed 3 percent but do not exceed 5 percent of the employee’s compensation. An enhanced matching contribution meets the safe harbor requirements if:

- the rate of the employer’s matching contribution does not increase as an employee’s rate of elective deferrals increases; and
- the aggregate amount of matching contributions at any rate of elective deferrals is at least equal to the aggregate amount of matching contributions that would be made under the basic matching formula for the type of safe harbor plan involved.<sup>114</sup>

As an alternative, a safe harbor plan may provide for a nonelective contribution of 3 percent to each employee.

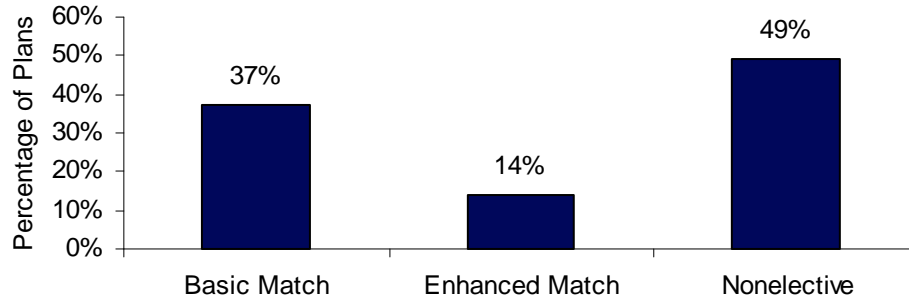
Figure 27 shows the percentage of safe harbor section 401(k) plans that satisfy the safe harbor requirements by providing basic matching contributions, enhanced matching contributions, and nonelective contributions.<sup>115</sup>

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<sup>114</sup> IRC §§ 401(k)(12)(B)(iii) and 401(k)(13)(D)(ii).

<sup>115</sup> Sample size = 400.

**Figure 27. Types of Contributions Provided by Section 401(k) Safe Harbor Plans**

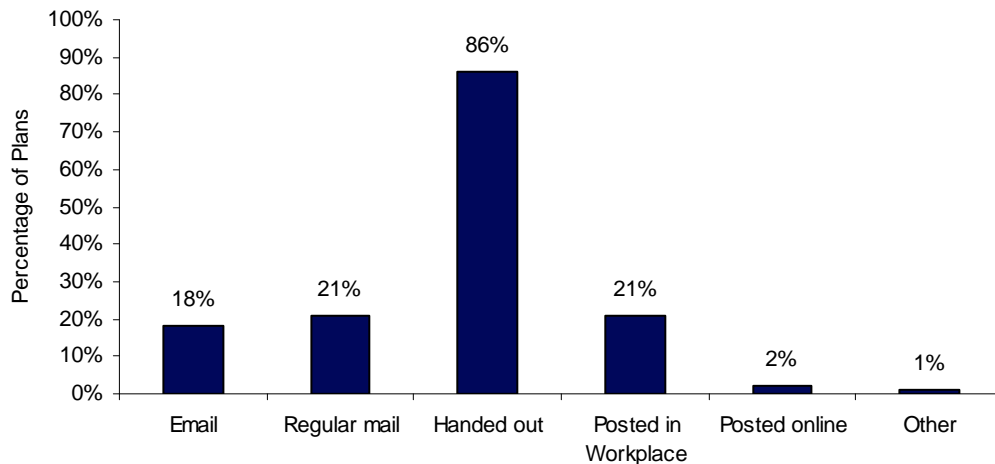




## **Notice Requirements Under Safe Harbor Plans**

In order to satisfy the section 401(k) safe harbor requirements, each employee eligible to participate must, within a reasonable period before any plan year, be given notice of the employee's rights and obligations under the arrangement.<sup>116</sup> The Code does not specify exactly how the notice must be delivered to eligible employees. Figure 28 provides the breakdown of the methods safe harbor section 401(k) plan sponsors use to provide the safe harbor notice to eligible employees.<sup>117</sup>

**Figure 28. Methods Used for Providing Safe Harbor Notices**



## **Suspension, Discontinuance or Reduction of Matching Contributions Under Safe Harbor Plans**

Safe harbor plans are generally required to be adopted before the first day of the plan year and remain in effect for an entire 12-month period.<sup>118</sup> Notwithstanding the general rule that a safe harbor plan must remain in effect for an entire 12-month period, a plan sponsor may reduce or suspend safe harbor matching contributions mid-year, but only if:

- eligible employees are provided at least 30 days advance notice before the reduction or suspension is effective;
- eligible employees are given a reasonable opportunity after receiving such notice, and prior to the reduction or suspension of basic or enhanced matching contributions, to change their cash or deferred elections and, if applicable, employee after-tax contribution elections; and
- the plan is amended to provide that the ADP and ACP tests will be satisfied for the entire plan year in which the reduction or suspension occurs.<sup>119</sup>

<sup>116</sup> IRC §§ 401(k)(12)(D) and 401(k)(13)(E); Treas. Reg. § 1.401(k)-3(d).

<sup>117</sup> Sample size = 400. Instructions for this question permitted respondents to select more than one answer.

<sup>118</sup> See Treas. Reg. § 1.401(k)-3(e).

<sup>119</sup> See Treas. Reg. § 1.401(k)-3(g)(1). See also Reg. § 1.401(m)-3(h)(1).

Due to overlapping margins of error, there is not a statistically significant difference in the percent of plans that reduced basic or enhanced matching contributions between 2006 (3%) and 2008 (11%). Likewise, there is not a statistically significant difference in the percent of plans that suspended or discontinued basic or enhanced matching contributions between 2006 (3%) and 2008 (11%).<sup>120</sup>

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<sup>120</sup> Sample size (2006) = 44; Sample size (2007) = 48; Sample size (2008)= 51.

## SIMPLE 401(k) PLANS

Under Code sections 401(k)(11) and 401(m)(10), an employer can establish a SIMPLE 401(k) plan and avoid ADP and ACP nondiscrimination testing. A SIMPLE 401(k) plan may only be established by an employer that has no more than 100 employees who received at least \$5,000 in compensation from the employer during the preceding year. Five percent of all section 401(k) plans are SIMPLE plans.<sup>121</sup>

We asked plan sponsors for information regarding SIMPLE 401(k) plans and the limitations on elective deferral contributions and employer contributions.

### **Limitations on Elective Deferral Contributions Under SIMPLE 401(k) Plans**

For 2012, elective deferrals to a SIMPLE 401(k) plan cannot exceed \$11,500.<sup>122</sup> The dollar amount is adjusted by the Secretary of the Treasury for cost-of-living increases, in multiples of \$500. Four percent of SIMPLE 401(k) plans exceeded the limit each year from 2006 to 2008.<sup>123</sup>

### **Limitations on Employer Contributions Under SIMPLE 401(k) Plans**

Under a SIMPLE 401(k) plan, an employer must make a contribution each year of either:

- a matching contribution equal to the employee's elective deferrals (including any catch-up contributions) for the calendar year; but not to exceed 3 percent of the employee's compensation (as limited by Code section 401(a)(17)); or
- a nonelective contribution equal to 2 percent of the employee's compensation (as limited by section 401(a)(17)) for the entire calendar year for each eligible employee who had compensation of at least \$5,000 for the year.

Sixty-seven percent of SIMPLE 401(k) plan sponsors make the 3% matching contribution, while 33% percent make the 2% nonelective contribution.<sup>124</sup>

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<sup>121</sup> Sample size = 1,026.

<sup>122</sup> 2006 and 2007 limit = \$10,500; 2008 limit = \$11,500.

<sup>123</sup> Sample size = 49.

<sup>124</sup> Sample size = 49. Margin of error = 14%.

## DISTRIBUTIONS FROM SECTION 401(k) PLANS

A section 401(k) plan sponsor is permitted some plan-design discretion regarding the form in which benefits are paid and when distributions are permitted. This section of the report explores the form and timing of distributions from section 401(k) plans. The 401(k) Questionnaire asked plan sponsors to provide information regarding distributions, specifically as they relate to:

- the various forms of benefits under the plan;
- involuntary cash-outs;
- in-kind distributions;
- in-service withdrawals;
- direct rollover distributions; and
- reporting of distributions.

### **Forms of Benefit**

Figure 29 shows the forms of benefit provided by section 401(k) plans.<sup>125</sup>

**Figure 29. Forms of Benefit Under Section 401(k) Plans**

<b>Form of Benefit</b>	<b>Plans</b>
Lump sum	99%
Installment payments	38%
Qualified joint and survivor annuity	19%
Life annuity	11%
Other	6%

### **Involuntary Cash-Outs**

Upon termination of employment, if a participant's account balance exceeds \$5,000 (not including rollovers), a section 401(k) plan generally may not require a participant to take a distribution without his or her consent.<sup>126</sup> However, if the value of the participant's account balance is \$5,000 or less, a section 401(k) plan may provide that the account balance will be distributed to the participant without his or her consent. This is known as an involuntary cash-out.<sup>127</sup>

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<sup>125</sup> Sample size = 1,026. Instructions for this question permitted respondents to select more than one answer.

<sup>126</sup> IRC § 411(a)(11)

<sup>127</sup> IRC § 411(a)(11)

Seventy-two percent of section 401(k) plans provide for involuntary cash-outs.<sup>128</sup> These plans permit cash-outs based on different account balance thresholds.

Figure 30 provides the percentage of plans that permit cash-outs based on specified account balance thresholds.<sup>129</sup>

**Figure 30. Account Balance Thresholds for Cash-Outs**

<b>Account Balance Threshold</b>	<b>Plans</b>
\$1,000	58%
\$3,500	1%
\$5,000	38%
Other Amount	3%

### **In-Kind Distributions**

A plan asset that is held in a form other than cash may be distributed to a section 401(k) plan participant in-kind. Two percent of section 401(k) plans made in-kind distributions from 2006 to 2008..<sup>130</sup>

### **In-Service Withdrawals**

A section 401(k) plan may permit a distribution to a participant while he or she is still employed under certain circumstances. Sixty-two percent of section 401(k) plans permit in-service withdrawals.<sup>131</sup>

### **Direct Rollover Distributions**

A direct rollover from a section 401(k) plan is a direct trustee-to-trustee transfer from a section 401(k) plan to another eligible retirement plan.<sup>132</sup> A qualified plan must allow a participant to elect a direct rollover with respect to certain eligible rollover distributions.<sup>133</sup> Seventy-nine percent of section 401(k) plans permit a direct rollover.<sup>134</sup>

### **Reporting of Distributions**

Distributions from a section 401(k) plan must generally be reported using IRS Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. An employer, or its withholding agent, must provide a Form 1099-R to any section 401(k) plan participant that receives a distribution of \$10 or

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<sup>128</sup> Sample size = 1,026.

<sup>129</sup> Sample size = 768.

<sup>130</sup> Sample size = 1,026.

<sup>131</sup> Sample size = 1,026.

<sup>132</sup> IRC § 401(a)(31)

<sup>133</sup> IRC § 401(a)(31)

<sup>134</sup> Sample size = 1,026.

more. Ninety-nine percent of section 401(k) plans comply with the requirement to provide participants with a Form 1099-R for any year in which they receive a distribution.<sup>135</sup>

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<sup>135</sup> Sample size = 1,026.

## HARDSHIP WITHDRAWALS AND PARTICIPANT LOANS

Qualified retirement plan rules generally restrict participants' access to their account balances before they cease employment. In the case of section 401(k) plans, two exceptions to this general principle are hardship withdrawals and participant loans. The 401(k) Questionnaire asked plan sponsors to provide information regarding:

- hardship withdrawals;
- participant loans and coverage;
- whether plan loans are made on a reasonably equivalent basis;
- plan loan interest rates, repayment periods, and repayment methods.

### Hardship Withdrawals

A hardship withdrawal is a distribution to a participant from his or her vested account balance in the event of an immediate and heavy financial need. A section 401(k) plan is not required to allow hardship distributions.<sup>136</sup> Seventy-six percent of section 401(k) plans permit hardship distributions.<sup>137</sup> Of the plans that provide for hardship distributions, 99%<sup>138</sup> allow all participants to receive one. Figure 31 lists, for specific types of hardship events, the percentage of section 401(k) plans that allow a hardship distribution.<sup>139</sup>

**Figure 31. Percentage of Plans That Allow Hardship Distributions by Event**

Type of Event	Plans
Payment of Medical Expenses	98%
Purchase of Primary Residence	93%
Payment of Education Expenses	92%
Prevention of Foreclosure	94%
Payment of Funeral Expenses	86%
Making Repairs to Residence	73%
Other	4%

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<sup>136</sup> IRC § 401(k)-1(d)(3) provides that the determination of the existence of an immediate and heavy financial need must be made in accordance with nondiscriminatory and objective standards set forth in the plan.

<sup>137</sup> Sample size = 1,026.

<sup>138</sup> Sample size = 820.

<sup>139</sup> Sample size = 820. Instructions for this question permitted respondents to select more than one answer.

## **Participant Loans and Coverage**

Section 401(k) plans generally may, but are not required to, allow participants to borrow from their vested account balances. However, such loans are subject to a number of rules and restrictions. Sixty-five percent of section 401(k) plans permit participant loans.<sup>140</sup>

Code section 4975(d)(1)(A) provides that a participant loan will constitute a prohibited transaction unless such loans are made available to all participants or beneficiaries on a reasonably equivalent basis. Most section 401(k) plans that permit participant loans (96%) provide them to all classes of participants.<sup>141</sup>

### **Interest Rates Charged for Participant Loans**

Code section 4975(d)(1)(D) states that participant loans that do not bear a reasonable rate of interest are prohibited transactions. The Code does not mandate the use of any specific, stated interest rate. Figure 32 shows the rates of interest charged by section 401(k) plans that permit participant loans.

**Figure 32. Interest Rate Charged by Plans**

<b>Interest Rate</b>	<b>Plans<sup>142</sup></b>
Prime Rate	16%
Prime Rate Plus One Percent	46%
Prime Rate Plus Two Percent	19%
Prime Rate Plus Three Percent	1%
Local Bank Rate	11%
Other Rate	8%

### **Repayment Periods for Participant Loans**

Code section 72(p)(2)(B) provides that a participant loan will be deemed to be a taxable distribution unless the loan is required to be repaid within 5 years. A longer repayment period is permitted under the Code if the loan is used by the participant to acquire a principal residence. Under Code section 72(p)(2)(C), such loan repayments must be made at least quarterly under a level amortization schedule.

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<sup>140</sup> Sample size = 1,026.

<sup>141</sup> Sample size = 713.

<sup>142</sup> Sample size = 713. The total percentage is more than 100% due to rounding.



Ninety-four percent of section 401(k) plans that permit loans conform to the requirement that participant loans that are not used to acquire a principal residence must be repaid within 5 years.<sup>143</sup> For those section 401(k) plans that permit participant loans for the purchase of the participant’s principal residence, Figure 33 shows the repayment period applicable to such loans.

**Figure 33. Repayment Period for Principal Residence Loans**

<b>Repayment Period</b>	<b>Plans<sup>144</sup></b>
Five Years	23%
Fifteen Years	22%
Thirty Years	24%
Other Period	24%
No Limit	7%

For those section 401(k) plans that permit loans, Figure 34 shows the intervals at which repayment is required.

**Figure 34. Loan Repayment Interval**

<b>Frequency</b>	<b>Plans<sup>145</sup></b>
Every Payroll Period	81%
Quarterly	11%
Monthly	5%
Other Interval	2%

### **Repayment Methods for Participant Loans**

Of section 401(k) plans that permit loans, 93% require repayment through payroll deduction.<sup>146</sup> The operative plan documents generally specify the treatment of an outstanding loan when a participant ceases employment. Eighty-seven percent of section 401(k) plans that permit loans treat unpaid loans as a cash distribution or require immediate repayment upon termination of employment.<sup>147</sup> Thirteen percent allow the participant to continue to make loan repayments even after a termination of employment.<sup>148</sup>

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<sup>143</sup> Sample size = 713.

<sup>144</sup> Sample size = 713.

<sup>145</sup> Sample size = 713. The total percentage is less than 100% due to rounding.

<sup>146</sup> Sample size = 713.

<sup>147</sup> Sample size = 713.

<sup>148</sup> Sample size = 713.

## TRUST ASSETS

Section 401(k) assets may include a variety of holdings, including employer securities, assets that give rise to unrelated business taxable income (UBTI) under Code section 511, and investments held overseas.

Plan sponsors were asked to respond to items on the 401(k) Questionnaire about:

- investments in non-traditional assets; and
- offering diversification rights when investing in employer securities.

### **Percentage of Section 401(k) Plans That Invest in Non-traditional Assets**

Figure 35 depicts the percentages of section 401(k) plans that invest in non-traditional assets.

**Figure 35. Percentages of Plans That Have Assets Invested in Non-Traditional Investments**

Nature of Asset	Plans <sup>149</sup>
Securities of the employer maintaining the plan	1%
Assets giving rise to UBTI	0%
Assets held in foreign investments	1%

### **Diversification Rights**

Code section 401(a)(35), which was added by the Pension Protection Act of 2006, mandates diversification requirements applicable to certain defined contribution plans holding publicly traded employer securities.

Ninety-eight percent of section 401(k) plans that invested in employer stock in 2006, 2007 or 2008 offered diversification rights to participants.<sup>150</sup> The frequency with which participants are able to diversify the investment of their plan accounts varies among section 401(k) plans. The most common interval at which section 401(k) plans permit participants to sell employer securities is daily.

Code section 401(a)(35)(C) mandates that a participant who has completed at least three years of service, and the beneficiary of any such deceased participant, must be allowed to diversify the publicly traded employer securities allocated to his or her employer contribution account. Of those plans that invested in employer stock in 2006, 2007 or

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<sup>149</sup> Sample size = 1,026.

<sup>150</sup> Sample size = 79.

2008, most section 401(k) plans permit participants who have completed at least 3 years of service to sell employer securities immediately from nonelective employer contribution accounts or from matching contribution accounts.

# EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM

EP seeks to assist plan sponsors in maintaining the qualified status of their retirement programs. The Employee Plans Compliance Resolution System (EPCRS) is an extremely important part of EP's operations. EPCRS is designed to promote the correction of qualification failures in a manner that is in the best interests of all affected parties.

## **About EPCRS**

EPCRS is a system of correction programs that may be used by plan sponsors to correct qualification failures with respect to a qualified plan. EPCRS permits plan sponsors to correct these failures and thereby continue to provide employees with retirement benefits on a tax-favored basis. The IRS issues a revenue procedure periodically that comprehensively sets forth the procedures applicable to the most recent iteration of EPCRS. EPCRS consists of three basic programs -

- **Self Correction Program (SCP)**: SCP allows plan sponsors to correct insignificant operational failures at any time without IRS approval and without the payment of any fees or sanctions. Plan sponsors may also correct significant operational failures through the SCP, also without IRS approval or the payment of any fees or sanctions, provided the compliance failure is corrected within a specified period of time.<sup>151</sup>
- **Voluntary Correction Program (VCP)**: VCP permits a plan sponsor to correct most compliance failures, even if significant, at any time, provided the plan is not under examination by the IRS. In order to take advantage of the VCP, a plan sponsor must submit an application to the IRS seeking approval of the correction method, and pay a fee based on the size of the plan.
- **Audit Closing Agreement Program (Audit CAP)**: Audit CAP is utilized only when a plan is under examination. Under this EPCRS program, the plan sponsor corrects plan qualification failures and pays a sanction that reflects the nature, extent, and severity of the plan's qualification failures. In return, the IRS enters into a closing agreement with the plan sponsor that permits the plan to retain its tax-qualified status.

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<sup>151</sup> The correction of a significant operational failure under SCP generally must be completed by the last day of the second plan year following the plan year for which the failure occurred. However, there are some exceptions to this rule.

We asked plan sponsors to answer questions regarding their experiences with EPCRS. Specifically they were asked about:

- awareness of EPCRS programs;
- usage of EPCRS programs;
- usage of standard correction procedures found in the EPCRS revenue procedure;
- helpfulness of EPCRS; and
- ways to improve EPCRS.

### **Awareness of EPCRS**

EPCRS is intended to be readily available to all qualified plan sponsors as an effective tool for maintaining compliance with applicable law. A majority of section 401(k) plan sponsors (65%) are aware of EPCRS.<sup>152</sup>

### **Use of EPCRS Programs**

One of the cornerstone EPCRS principles is that plan sponsors must maintain administrative systems and procedures designed to facilitate overall compliance with the Code. However, mistakes occur, even with the best systems and procedures. It is not expected that all plans will find it necessary to use an EPCRS program. Six percent of section 401(k) plan sponsors have used one or more EPCRS programs.<sup>153</sup>

Of plan sponsors that have used EPCRS, the SCP and VCP programs were utilized about equally.<sup>154</sup> Audit CAP usage could not be determined accurately because plans that were under examination immediately before, or at the time of, the selection of the 401(k) Questionnaire sample were excluded from the sampling frame. Some plan sponsors have used multiple EPCRS programs. Of the 6% of plan sponsors that have used EPCRS, 6% have used two or more EPCRS programs.<sup>155</sup>

### **Use of Standard Correction Methods**

A general principle under EPCRS is that a proposed correction method must be reasonable. The revenue procedure describing EPCRS provides a number of standard correction methods for the most common compliance failures.<sup>156</sup> A standard correction method is deemed to be reasonable. Most plan sponsors that have used EPCRS (75%)

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<sup>152</sup> Sample size = 1,025.

<sup>153</sup> Respondents who indicated they were not aware of the EPCRS were not subsequently asked if they had used EPCRS. For this analysis, it was inferred that a respondent that was not aware of EPCRS had also not used it. Sample size = 1,025.

<sup>154</sup> Sample size = 162. Margin of error for SCP = 12%. Margin of error for VCP = 13%.

<sup>155</sup> Sample size = 162.

<sup>156</sup> See Rev. Proc. 2008-50 (current).

were able to use one of the standard correction methods set forth in the revenue procedure.<sup>157</sup>

### **Helpfulness of EPCRS**

As stated earlier, EPCRS is intended to constitute a useful tool for maintaining plan compliance. Of those that have used EPCRS, 75% found it helpful.<sup>158</sup>

### **Improving EPCRS**

Respondents to the 401(k) Questionnaire were given the opportunity to provide comments regarding how EPCRS could be made easier to use. Because these questions were optional, not all plan sponsors responded. Therefore the summaries of general comments and recommendations to improve SCP below cannot be generalized to the entire section 401(k) population. The summary of comments in the following sections reflects only the opinions of those plan sponsors that answered the questions. In general, respondents reported that EPCRS was fairly easy to use.

#### **Create SCP Compliance Forms and Checklists**

Some respondents stated that SCP would be easier to use if the EPCRS revenue procedure included forms and checklists similar to those provided for VCP. The respondents indicated that such forms and checklists would make it easier to document a plan sponsor's use of SCP and the correction method used.

#### **Allow More SCP Corrections by Plan Amendment**

Under SCP, a plan sponsor generally corrects an operational failure, that is, a failure to operate the plan in accordance with plan terms, by conforming plan operation to the provisions in the plan document. However, in limited circumstances, a plan sponsor may amend its plan to conform to the way the plan was operated. Under SCP, a plan amendment that conforms the terms of the plan to the plan's operations may be adopted in the following circumstances:

- failure to apply the appropriate limitations of Code section 401(a)(17) to the amount of compensation that may be taken into account under the plan;<sup>159</sup>
- hardship distribution and plan loan failures; and
- early inclusion in the plan of otherwise eligible employees.

Respondents asked that corrections by retroactive plan amendment under SCP be permitted under more circumstances.

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<sup>157</sup> Sample Size= 162. Margin of Error = 12%.

<sup>158</sup> Sample Size= 162. Margin of Error = 11%.

<sup>159</sup> IRC § 401(a)(17) provides that a trust shall not constitute a qualified trust unless under the plan of which such trust is a part the annual compensation of each employee taken into account under the plan for any year does not exceed \$200,000 (as indexed for inflation).

## **Expand Use of SCP for Correcting Significant Failures**

The correction of a significant operational failure under SCP generally must be completed by the last day of the second plan year following the plan year for which the failure occurred.<sup>160</sup> Some respondents believed the two-year limit on the correction of significant operational failures under SCP should be removed, provided the correction is made in the best interests of all plan participants.

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<sup>160</sup> See Rev. Proc. 2008-50, Part IV, Section 9.02.

## THE DETERMINATION LETTER PROGRAM

One of the requirements of a qualified plan is that the written terms of the plan satisfy certain Code provisions. EP's determination letter program permits plan sponsors to submit their plan document to the IRS for a determination that the plan language meets applicable statutory requirements.

The 401(k) Questionnaire asked plan sponsors to indicate whether their section 401(k) plan:

- is part of a profit-sharing or other type of plan;
- is a pre-approved or individually designed plan;
- has been submitted under the determination letter program.

### **Section 401(k) Arrangements That Are Part of a Profit-Sharing or Other Plan**

A qualified cash or deferred arrangement (CODA) under section 401(k) of the Code may be added as a feature to certain types of plans. In the majority of cases (78%), a CODA is part of a profit-sharing plan.<sup>161</sup> A profit-sharing plan may provide for an employer contribution in addition to the employees' elective deferrals. These employer contributions may be either discretionary or fixed. Generally under a profit-sharing plan with a discretionary contribution formula, the employer may elect each year whether to make an employer contribution, separate from the employees' elective deferrals, and the amount of any such employer contribution.

Approximately 2% of all CODAs are a feature of a money purchase pension plan (1.6%),<sup>162</sup> target benefit plan (0.56%), or a stock bonus or employee stock ownership plan (0.37%). About 20% of section 401(k) plan sponsors do not identify their plans as a profit-sharing, money purchase pension, target benefit, stock bonus or employee stock ownership plan.<sup>163</sup>

### **Pre-Approved or Individually Designed Section 401(k) Plans**

Pre-approved plan documents are drafted by service providers, such as financial institutions or consulting firms, to be made available to their customers. The form of the plan is pre-approved by the IRS. Employers adopt such a plan document after it has been approved by the IRS. Unlike a pre-approved plan, an individually designed plan is one

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<sup>161</sup> Sample size = 1,059.

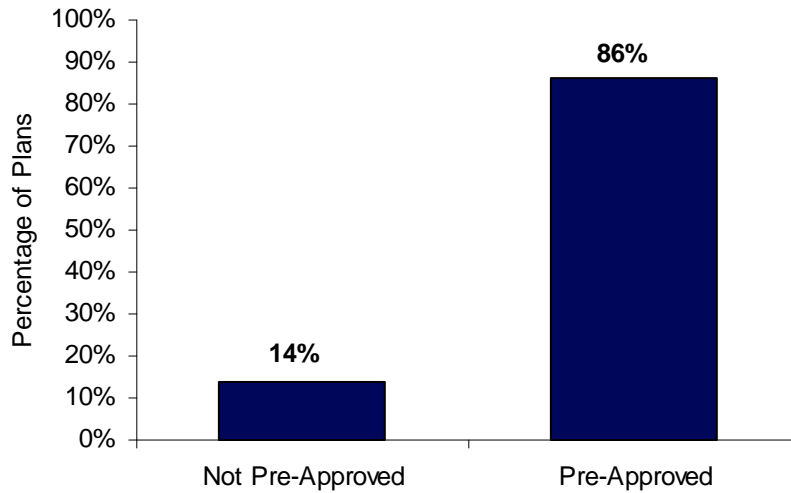
<sup>162</sup> Code section 401(k)(1) provides that a pre-ERISA money purchase pension plan may have a cash or deferred arrangement. Code section 401(k)(6) defines such a plan as one that is a defined contribution plan which was in existence on June 27, 1974 and which included a salary reduction arrangement on that date. Neither the employee contributions nor the employer contributions may exceed the levels provided for by the contribution formula in effect under the plan on such date.

<sup>163</sup> Sample size = 1,059.



that is prepared specifically for a particular employer. A large majority of section 401(k) plans (86%) are some form of pre-approved plan, such as a master or prototype plan (standardized or nonstandardized) or a volume submitter plan (see Figure 36).<sup>164</sup>

**Figure 36. Pre-Approved Plans**



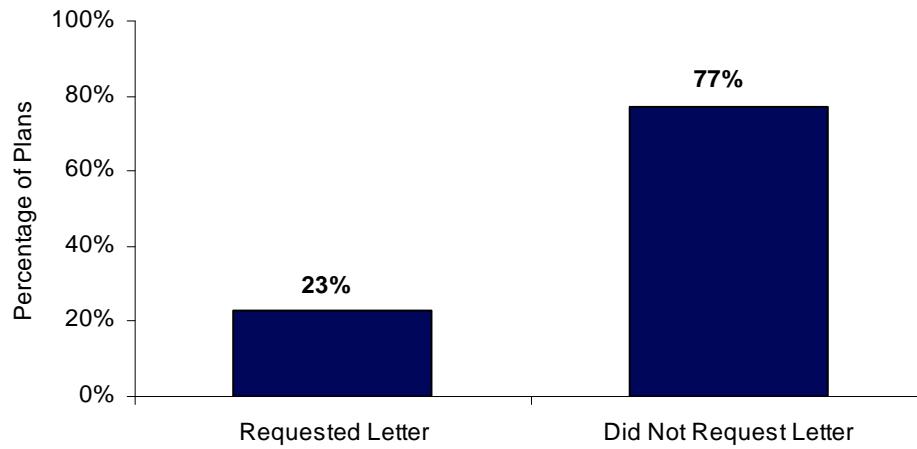
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<sup>164</sup> Sample size = 1,054.

## **Utilization of the Determination Letter Program**

Seventy-seven percent of employers sponsoring section 401(k) plans have never participated in the determination letter program (see Figure 37).<sup>165</sup>

**Figure 37. Participation in the Determination Letter Program**



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<sup>165</sup> Sample size = 1,053.

## CUSTOMER EDUCATION AND OUTREACH

EP's Customer Education and Outreach (CE&O) provides employers and employees with important information and educational programs regarding employee plans. Examples of CE&O's activities include participation in conferences, seminars and workshops, and publishing information through the IRS website.

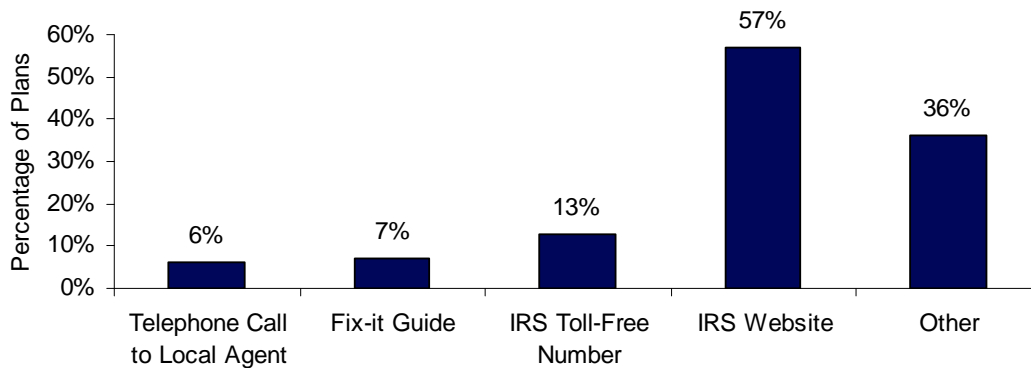
The 401(k) Questionnaire asked plan sponsors to provide information on:

- methods of getting information from the IRS; and
- awareness and usage of the 401(k) Fix-It Guide.

### **Methods of Getting Information From the IRS About Retirement Plans**

Figure 38 depicts the percentage of plan sponsors that called a local agent, used the Fix-It Guides, called the IRS toll free number, used the IRS website or used another, unspecified resource to learn more about section 401(k) plans.<sup>166</sup>

**Figure 38. Methods Used to Obtain Information From the IRS**



<sup>166</sup> Sample size = 1,024. Instructions for this question permitted respondents to select more than one answer.

## **Awareness and Use of the 401(k) Fix-It Guide**

One of the most visited EP publications for section 401(k) plan sponsors on the IRS website is the 401(k) Fix-It Guide. The purpose of the 401(k) Fix-It Guide is to provide:

- a general understanding of section 401(k) plans;
- an explanation of EPCRS;
- a description of the compliance mistakes that most frequently occur with respect to section 401(k) plans; and
- tips on how to find, fix and avoid common compliance mistakes.

The 401(k) Fix-It Guide includes:

- a 401(k) Checklist, which contains review questions plan sponsors may use to identify areas of noncompliance;
- a table listing potential mistakes by category;
- an explanation of applicable laws;
- definitions of key terms; and
- instructions on how to correct, and the appropriate EPCRS correction program for each type of common mistake.

Forty-one percent of section 401(k) plan sponsors are aware of the 401(k) Fix-It Guide.<sup>167</sup> Seven percent of section 401(k) plan sponsors have used it.<sup>168</sup> Of the section 401(k) plan sponsors that used the 401(k) Fix-It Guide, the majority (82%) found it useful.<sup>169</sup>

## **EP Customer Education and Outreach Efforts to Help Small Businesses**

Section 401(k) plan sponsors were able to make comments regarding potential difficulties of complying with the requirements of sections 401(k) and 401(m) of the Code. Some of the comments from the small plan community indicated that people felt overwhelmed and needed help understanding the basic rules applicable to plan administration. They asked for online instruction and, in particular, video presentations of core subjects relating to section 401(k) plan administration.

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<sup>167</sup> Sample size = 1,026.

<sup>168</sup> To calculate this we had to infer that respondents that were not aware of the 401(k) Fix-It Guide had also not used it.

<sup>169</sup> Sample size = 51. Margin of Error = 19%.

EP has undertaken a major initiative to specifically address the needs of small business owners on the IRS website. New materials on the website include video instruction and other educational presentations for small section 401(k) plan sponsors. In 2011, CE&O activities aimed at helping small employers included:

- collaborating with the Advisory Committee on Tax Exempt and Governmental Entities (ACT), an independent advisory committee of professionals, to augment EP's small business outreach efforts and learn more about the specialized needs of small business plan sponsors;
- creating innovative electronic tools to help small businesses improve their internal controls, perform self audits and avail themselves of EPCRS programs;
- initiating focus groups to develop better ways to communicate with small business owners and understand their specialized needs;
- designing a new format for the EP newsletter that makes it easier to navigate and update;
- developing webinars to share current topics with plan sponsors;
- continuing to work on enhancing the IRS Fix-It Guides by adding a series of video presentations; and
- finalizing six videos for YouTube that encourage small business owners to use IRS educational materials.

## PLAN ADMINISTRATION

The 401(k) Questionnaire included questions regarding:

- policies and procedures in place to self-audit plan administration;
- the persons responsible for plan administration;
- the persons responsible for plan amendments;
- preparing the Form 5500 annual report; and
- recent changes in administration.

### **Policies and Procedures**

Ninety-three percent of section 401(k) plan sponsors have policies and procedures in place to self-audit plan administration.<sup>170</sup> Of these, 92% review their policies and procedures every year while 3% review their policies and procedures every two years. Four percent of plans review their policies and procedures at some other interval.<sup>171</sup>

### **Responsibility for Administration**

Section 401(k) plan sponsors rely on a variety of persons for the primary administration of their plan. Figure 39 indicates who is primarily responsible for plan administration.

**Figure 39. Person(s) With Primary Responsibility for Plan Administration<sup>172</sup>**

<b>Person(s) Responsible</b>	<b>Plans</b>
Company Financial Staff	20%
Company Human Resources Staff	15%
Company Legal Staff	0%
External Accountant	2%
External Legal	1%
Insurance Company	1%
Third-party Administrator	53%
Actuary	0%
Other External Provider	2%
Other Internal Staff	5%

<sup>170</sup> Sample size = 1,025.

<sup>171</sup> Sample size = 965.

<sup>172</sup> Sample size = 1,025. The total percentage is less than 100% due to rounding.

## **Responsibility for Plan Amendments**

Figure 40 shows the person(s) with the authority to amend a section 401(k) plan.

**Figure 40. Person(s) With Authority to Amend the Plan<sup>173</sup>**

<b>Person(s)</b>	<b>Plans</b>
Board of Directors	26%
Plan Trustees	44%
Company Officer	24%
Other	6%

Figure 41 shows who ensures that the plan is amended within the appropriate time frames mandated by statute

**Figure 41. Who Ensures That the Plan is Timely Amended<sup>174</sup>**

<b>Responsibility for Timely Amendments</b>	<b>Plans</b>
Internal Legal	1%
Internal Administrator	13%
Third-party Administrator	73%
Insurance Company	2%
External Legal	6%
Other	5%

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<sup>173</sup> Sample size = 1,025.

<sup>174</sup> Sample size = 1,025.

## **Responsibility for Form 5500 Annual Reports**

Form 5500, Annual Return/Report of Employee Benefit Plan, is used to report information concerning employee benefit plans, including section 401(k) plans. Each Form 5500 must accurately reflect the characteristics and operations of the plan being reported. Figure 42 shows who prepares Form 5500.

**Figure 42. Who Prepares Form 5500 for the Plan<sup>175</sup>**

<b>Form 5500 Preparer</b>	<b>Plans</b>
Company Financial Staff	3%
Company Human Resources Staff	1%
External Accountant	6%
Third-Party Administrator	83%
Other	7%

## **Changes in Administration**

Figure 43 shows the frequency with which sponsors of section 401(k) plans have changed the administrator of the plan in the last three years.

**Figure 43. Number of Administrator Changes in Last Three Years<sup>176</sup>**

<b>Number of Changes</b>	<b>Plans</b>
None	82%
One	16%
Two	2%
Three or More	1%

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<sup>175</sup> Sample size = 1,025.

<sup>176</sup> Sample size = 1,025. The total percentage is more than 100% due to rounding.



## NEXT STEPS

The information from the 401(k) Questionnaires will allow the IRS to gain a better understanding of section 401(k) plan compliance. The narrative responses will assist us in identifying outreach needs (both in terms of targeting population segments and in improving outreach materials) and compliance issues relating to both participant education and awareness and plan sponsor compliance. For example, we learned that approximately 65% of respondents knew about our EPCRS voluntary compliance programs and approximately 35% did not. By analyzing which portion of this market segment is unfamiliar with our correction programs, we can better target our education and outreach.

The IRS will use the information learned from the 401(k) Questionnaires in improving products available. For example, a key focus of the 401(k) Questionnaire was whether the most common mistakes highlighted in the IRS 401(k) Fix-It Guides are being addressed through self-correction or voluntary compliance. The 401(k) Questionnaire results are being used to identify areas where we need additional guidance and/or changes to the EPCRS revenue procedure. This may include addressing any new issues that surface as a result of recent law changes that affect section 401(k) plans.

The information from the analysis of the 401(k) Questionnaire responses may be used to improve our EP Determination Letter program. For example, we learned that a large portion of section 401(k) plans are pre-approved plans. The results of the 401(k) Questionnaires will also be an important component for improving EP Examination's enforcement program.

A final report will include comparisons by the four plan size stratifications detailed in the *Sample Method* section of this report. These breakdowns will identify differences between small and large plans. The final report will also include information on questions not analyzed in this report. It is targeted for release in 2012.