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401(k) and Other Retirement Topics for Beginners and Non-ERISA Attorneys

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401(k) and Other Retirement Topics for Beginners and Non-ERISA Attorneys

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Topics To Be Covered

- Which laws/agencies govern qualified retirement plans?
- Why have a qualified retirement plan?
- Types of defined contribution qualified plans
- Plan formulas
- Calculating service
- Participation and coverage
- Vesting
- Forfeitures
- Plan loans
- Benefit limitations
- Timing of benefit payments
- Forms of benefit payments
- Taxation of benefits
- Fiduciary Duties for ERISA-Covered defined contribution plans
- ERISA's Preemption of State Laws

Background

- Employee Retirement Income Security Act
 - Title I – Department of Labor
 - Title II – Department of Treasury/IRS
 - Title IV – Pension Benefit Guaranty Corporation (for DB Plans)
- Satisfaction of Internal Revenue Code (“IRC”) for tax qualification = “qualified retirement plan”
 - Voluntary
 - Many requirements duplicated in ERISA

Tax Advantages of Qualified Plan

- Significant Financial Benefits
 - Employer
 - Tax Deduction
 - Tax Deferred Build up of Plan Assets
 - Employee
 - Tax Deferral for Contributions
 - Match/Employer Contributions
 - Tax-deferred build-up of plan assets

Consequences of Code Nonqualification

- Plan Disqualification
- Loss of Employer Deduction
- Plan Earnings are Taxed
- Vested Participants Taxed on Contributions and Value of Plan Benefit Before Paid

Variety of Qualified Retirement Plans

- Single Employer Plan vs. Multiple Employer
- Multiemployer Plan
- Some qualification rules vary based on type of plan or type of entity sponsoring plan

Employer/Plan Sponsor

- Purpose of aggregation of related entities
- Controlled groups
- Affiliated service groups
- Plan Sponsor
 - Single employer plan = employer
 - Multiemployer = Board of Trustees
 - Multiple Employer = Board of Trustees
- Named Fiduciary – designated in Plan document

Definition of Employee

- **Common Law Definition-** applies for purposes of the Code qualification requirements.
- **Self-Employed Individuals** - treated as employees for purposes of the qualified plan rules, but not always for ERISA or Taft-Hartley Act
- **Independent Contractors** - To determine whether an individual is an employee or an independent contractor courts generally apply a multifactor test to get to the “economic reality” of the arrangement.
- **Leased Employees** – who provide agreed services for recipient on substantially full-time basis for at least one year and who are under primary direction/control of recipient considered employees of recipient for some qualified-plan rules.

Defined Contribution Plan Structure

- Contributions + investment earnings or losses = participant's accrued benefit
- Plan or CBA specifies when contributions are made
- Benefits often payable before retirement
- Definitely determinable benefits – plan specifies how allocations will be done
- Employer contributions generally percentage of compensation
- Participation can be automatic or elective (as for 401(k) plans)
- Not covered by Title IV of ERISA/No PBGC Insurance protection for participants

Defined Contribution Plan Types

- 401(k) Plan -- technically feature of plan (e.g., part of profit sharing plan)
- Profit Sharing Plan
- Stock Bonus Plans
- Money Purchase Pension Plan
- Employee Stock Ownership Plan
- 403(b) Plan
- DC plan must state whether it is intended to qualify under Code as money purchase pension plan, profit sharing plan or stock bonus plan.

Calculating Service for Participation and Vesting

- Hours of Service
 - Basic Definition
 - Plan Document
 - Equivalencies
- Elapsed Time Alternative Rule
 - Periods of Service
 - Periods of Severance
- Computation Periods
 - For Eligibility and Participation
 - For Vesting

Eligibility To Participate

MAXIMUM AGE AND SERVICE CONDITIONS ON TIME OF PARTICIPATION

- **Minimum Age and Service Basic Rule.**
 - No more than 1 year of service and no age limit above 21; or
 - Up to 2 years of service if 100% vested after 2 years
- **Initial Participation.**
 - Employee who meets eligibility rule must commence participation no later than earlier of:
 - 1st day of 1st plan year after meeting age and service rules; or
 - A date six months after satisfying age and service rules.
- **No Maximum Age Conditions Permitted.**
- **SECURE Act – New Rule for Part-Time Non-Bargained Employees**

Exceptions to Maximum Participation Rules

- **Permissible Business Criteria Exclusions.**
- **Caution** -- IRS Field Directive on part-time employees
- **One-Year Hold Out.**
 - General Rule: All years of service with employer taken into account for eligibility.
 - Reemployed person picks up where she left off on years of service *as of* her reemployment date.
 - Exception: “One year hold out” rule allows plan to disregard (temporarily) service credited *before* one-year break in service until year of service completed *after* return to employment.
 - Once employee completes year of service after reemployment, pre-break in service must be retroactively credited effective as of reemployment date.

General Rules for Automatic Contribution Arrangements

- Upon eligibility to participate in Plan, Participants treated as electing to defer a uniform % of pay until they opt out
- No special limit on % that can be deferred (same annual dollar limits apply)
- Automatic deferrals must be invested under “qualified default investment alternative” rules
- Required notice to participants within a reasonable time before each plan year with right not to make elective deferrals, to change % of elective deferrals, and default investment
- Employee must have a reasonable period of time after receipt of notice and before elective deferrals commence to make elections
- Penalty on plan administrator for notice failure up to \$1,100 per day

Eligible Automatic Contribution Arrangement (EACA)

- Plan may allow participants to withdraw automatic deferrals within 90 days of 1st deferral
- Not subject to 10% excise tax on early withdrawals or other distribution limitations
- May also avoid 10% excise tax if make corrective distributions within 6 months of end of the PY (instead of 2 ½ months that would otherwise apply)

Qualified Automatic Contribution Arrangement (QACA)

- Safe harbor rule - QACA deemed to satisfy ADP and ACP non-discrimination tests and top-heavy rules
- **Basic safe harbor/elective safe harbor:** employer matches 100% of up to 3% of employee's contributions and then 50% of employee's additional contributions, up to 5%.
- **Enhanced safe harbor:** Higher match than basic- for example, match of up to 4% of an employee's contributions.
- **Nonelective safe harbor:** employer makes 3% retirement contribution for all workers, regardless of whether employee chooses to participate in plan.
- Similar notice as automatic contribution arrangement required
- QACA may be applied only to new participants or to both current and new participants

DC Plan Vesting

- Right to keep the benefit/account earned if terminate service
- Employee contributions – always 100% vested
- All employer contributions, including matching contributions, must vest no later than:
 - Three-Year Cliff- no more than 3 years of vesting service to be 100% vested
 - Two-to-Six Year Graded-
 - 2 years-20%
 - 3 years- 40%
 - 4 years-60%
 - 5 years-80%
 - 6 years-100%

Other Vesting Rules

- Vesting Based on Normal Retirement Age (“NRA”) - § 411(a)(8)
 - vested no later than later of age 65 or 5th anniversary
- Can’t amend plan to take away vested right
- Can’t extend vesting schedule for anyone with at least 3 years of service
- Full Vesting of Affected Participants Required
 - Plan termination
 - Complete discontinuance of contributions
 - Partial plan termination
- For DC Plans, uncommon issue

Breaks in Service

- Breaks in Service -Result in Loss of Unvested Benefits
- Rule of Parity
- One-Year Hold Out Rule
- Family Leave
- Military Leave

Forfeitures

- Vested benefits cannot be “forfeited”
- Benefits cancelled but not treated as forfeited if:
 - Death (unless married and spousal benefits required)
 - Reemployment and suspension of benefits while working
 - Retroactive Amendment (if permitted under Code)

Plan Loans – Basics

Loans to participants from DC Plan permissible option if certain conditions met:

- Must not exceed lesser of (a) \$50,000 minus highest outstanding unpaid loan balance in year before new loan, or (b) greater of ½ of vested benefit or \$10,000. **Special Rules During COVID-19.**
- Repay within 5 years unless to buy participant's principal residence.
- Substantially level payments (not less frequently than quarterly) with exceptions.
- May permit cure period for missed payments.
- Legally enforceable written agreement with amount, term and repayment schedule.
- Available to all participants and beneficiaries on reasonably equivalent basis;
- Must bear reasonable rate of interest; and
- Be adequately secured.
- Special rules for participants who enter qualified military service.

Plan Loans – **Special Rules During COVID-19 Under CARES Act**

- **Optional Increase to Plan Loan Maximums to \$100,000 for Qualified Participants.** Plans may increase the limit on total loans from March 27 until September 22, 2020 from \$50,000 or one half of the participant’s vested account balance, whichever is less, to \$100,000 or full amount of the vested account balance, whichever is less.
- **Mandatory Suspension of Plan Loan Repayments in 2020 for Participants Affected by COVID-19 from March 27, 2020 to September 23, 2020:**
 - From March 27 until December 31, 2020, participants with outstanding loans (and new loans taken during this 180-day period) who suffered adverse financial consequences as result of COVID-19 can suspend loan repayments through 2020.
 - Any payments after suspension period will need to be adjusted to reflect delay in repayment and include any interest accruing during delay.
 - Suspension of loan payments appears to be mandatory for qualified participants who certify that they have been affected by COVID-19, using same definition of “qualified” as CRDs.

Good Loans Gone Bad

- If loan fails to meet rules or defaults on payments = deemed distribution
 - Excise taxes if early distributions or to five percent owners.
- Deemed distribution not treated as in-service or rollover distribution.
- Plan loan offset occurs when account offset to repay loan.
- Offset = actual distribution. Can't offset if no in-service distribution.
- If deemed distribution but not repaid, no future loan nontaxable unless repayments by payroll deduction and more security.
- Deemed distribution counts for determining amount of future loans.
- To avoid deemed distribution, prior defaulted loan must be repaid in same substantially level installments.
- No limit on number of loans under final regulations.

CODE LIMITS ON BENEFITS

Minimums For Participation and Coverage

- **OVERVIEW**

- Qualified plan cannot be limited to highly compensated employees
- Plan must cover sufficiently broad group and proportionate number of lower-paid employees.
- Three general groups of rules:
 - Minimum age and service and time of participation rules to prevent unreasonable conditions **before** participation.
 - Minimum coverage rules to ensure sufficient % of lower paid employees **eligible** to participate.
 - Minimum participation rules to ensure employers cover sufficient # of employees.

Limits on DC Plan Contributions

- **Code §415 limits** amounts that may be allocated each year to employee's accounts under all of employer's **DC** plans.
- Maximum annual DC total employer plus employee contributions = LESSER of \$58,000 or 100% of employee's compensation for 2021
- Definition of pay used in plan formula also limited - \$290,000 for 2021 (indexed annually) under plan formula and under maximum contribution limit
- 100% of employee's average pay for highest-paid 3 consecutive years of plan participation.
- **Top-heavy requirements.** Looks at ratio of value of benefits for key employees (5% owners, 1% owners over \$150,000 and 50 highest-paid officers over \$185,000) vs. non-key employees.
- **Other federal laws.** Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA") protects participants during and after military service.

Special Nondiscrimination Rules for 401(k) Plans

- Average deferral percentage (ADP)
- Average contribution percentage (ACP)
- Safe harbor plans do not have to test
- ADP/ACP % for HCEs
 - No more than 125% of prior year NHCE % or
 - No more than 200% of and 2 % points over prior year NHCE%
- Employer may elect to use current year NHCE%
- Safe harbor or general test for profit sharing contributions
- Benefits, rights and features testing for all plans

Safe Harbor Plan Rules

- If 401(k) Plan meets “safe harbor” rules, automatically pass ADP and ACP testing
- Helpful for plans covering more highly compensated employees.
- Three options for employer/plan chooses:
- **Basic safe harbor/elective safe harbor:** employer matches 100% of up to 3% of employee's contributions and then 50% of employee's additional contributions, up to 5%.
- **Enhanced safe harbor:** Higher match than basic- for example, match of up to 4% of an employee's contributions.
- **Nonelective safe harbor:** employer makes 3% retirement contribution for all workers, regardless of whether employee chooses to participate in plan.

TIMING OF DISTRIBUTIONS

Time of Payment From DC Plan

- Typically, termination of employment
- Some plans allow distributions while employed (profit sharing, stock bonus) upon:
 - Occurrence of specified event (e.g., disability, qualified birth or adoption)
 - After fixed number of years
 - Hardship withdrawals
 - After age 59 ½
 - **Special Rules During COVID-19.**
- 401(k) plan – qualified reservist distributions
- Plan termination (401(k) partial termination)

Time of Payment From DC Plan- COVID Rules

- **Optional Coronavirus-related Distributions (CRD) for Qualified Participants.** To offer coronavirus-related distributions to qualified participants as follows:
 - Up to \$100,000 to be taken in 2020.
 - Participants are “qualified” if they, or their spouses or dependents, are diagnosed with COVID or resulting disease, or if they suffer “adverse financial consequences as a result of” COVID.
 - Plan chooses how to determine if qualified. Plan may rely on participant’s self-certification of eligibility and is not required to obtain documentation of diagnosis or financial hardship from participants to making CRD available.
- CRDs not subject to prohibition on in-service distributions or 10% penalty on early distributions before age 59½.
- Income tax on CRD may be spread out over three-year period.
- For plans that choose to permit CRDs, it appears that plan must allow participant to repay CRD to account up to three years after CRD taken.
- CARES Act (March 2020) - CRD only for 401(k) and profit-sharing plans, not money purchase plans.
- SECURE Act (December 2020) – Lowers in-service distribution age from 62 to age 59 ½ for money purchase plans for 2020 forward (alternative to CRD).

Required Minimum Distributions (RMD)

- Distribution must begin by April 1 of calendar year following later of calendar year participant:
 - Reaches age 70 ½
 - Retires
- 50% excise tax on participant if required amount not distributed
 - Waived for reasonable error
- SECURE Act - Effective 12/31/19, required beginning date increased age from age 70½ to age 72 for participants who reach age 70½ after 12/31/19
- **Special Rules During COVID-19 for 2020.**

Required Minimum Distributions Plan- COVID Rules

- **Optional Suspension of 2020 RMD for All Participants.** CARES Act permits DC plans to suspend any RMD for 2020 to any participants (whether affected by COVID or not) until 2021.
- Different options for plans:
 - Offer choice to receive RMD or not
 - Suspend all RMDs for 2020
 - Waive it unless participant affirmatively elected to receive RMD.
 - If plan already paid participant RMD in 2020, including someone who turned 70 ½ during 2019, participant had option to return RMD to their plan account.

General Timing of Distributions After Death

- Distributions after death continue as selected by participant, can't slow payment stream
- If distributions have not begun at death, paid to beneficiary
 - Within 5 years
 - Begin within 1 year and paid over beneficiary's life
- Spouse may defer until participant's RMD

Hardship Withdrawals

- Plan can permit distributions upon “hardship” due to “immediate and heavy financial need”.
- IRS safe harbor (most plans follow) includes following to be immediate and heavy financial needs:
 - costs directly related to purchase (excluding mortgage payments) of principal residence;
 - payment of tuition and related educational fees for next 12 months of post-secondary education for participant, spouse, children or other dependents;
 - payment of expenses to prevent your eviction from principal residence or foreclosure of mortgage secured by your principal residence; and
 - payment of expenses incurred for Code Section 213(d) medical care for you or your spouse or dependents, or necessary to obtain such medical care.
 - funeral or burial expenses for your deceased parent, spouse, child, or dependent; and
 - expenses to repair damage to your principal residence from federally declared natural disaster, (without regard to loss limits).
- In most cases, employee may only receive Hardship Distribution if received all other available distributions and all non-taxable loans under all plans maintained by Employer.
- Further, once have received Hardship Distribution, maybe limits on making employee contributions to Fund for 6 months from date received (plan option) Hardship Distribution (but no longer required by law).
- Hardship Withdrawal not eligible rollover distribution and subject to 10% federal income tax withholding rate unless extension applies.

BENEFIT PAYMENT FORMS

Standard DC Payment Options

- Lump sum
- Installments for 10, 15, or 20 years
- Money purchase pension plans must satisfy QJSA/QPSA/QOSA rules
 - Single life annuity-required “QJSA” for unmarried participants
 - Joint and survivor annuity-qualified and optional
- Other DC plans not affected if –
 - No annuities
 - Surviving spouse is sole beneficiary or consents to another beneficiary

Taxation of Distributions

- Penalties on Early Distributions
- Special Treatment for Lump-Sum Distributions
- Basis Recovery Rules
 - General
 - Defined Contribution Plan
- Net Unrealized Appreciation
- Rollovers

REPORTING AND DISCLOSURE

ERISA's Reporting and Disclosure Framework

- Employee Retirement Income Security Act of 1974 (“ERISA”)
 - Designed to protect rights of participants and beneficiaries in “employee benefit plans”
- For Plans Subject To Reporting And Disclosure Under ERISA
- Form 5500 Annual Reporting
- Disclosures From Plan To Participants And Beneficiaries (“**P & B**”)
- Disclosures From Plan To Others (Employers, Labor Representatives)
- Other Disclosures To Government Agencies Beyond Form 5500
- Disclosures From Others To Plan (Providers, Employers)
- New (2020) Rules on Electronic Disclosure

Reporting and Disclosure Periodic Benefit Statements

- Quarterly for participant directed plans; annually otherwise
- Statements must include:
 - Total benefits accrued/account balance;
 - Amount of nonforfeitable benefits (vesting %);
 - Value of each investment; and
 - For participant directed accounts, explanation of any restrictions on ability to direct investments, the importance of diversification, and DOL website.
- DOL has provided model diversification language for statement
- Penalty of up to \$110 per day per participant for failure to provide notice
- Effective PY beginning after 12/31/06; delayed CBA effective date applies

Determination Letter Procedures

- **NOT REQUIRED** but most plans request IRS “determination letter” or “DL” that plan document meets qualification requirements.
- IRS reviews document for defects and qualification issues.
- If IRS issues favorable DL, plan protected against subsequent IRS challenge as to *form* of plan.
- Not protection against failure to *operate* in compliance with qualification requirements.
- IRS determination letter procedures change frequently.
- Before submitting application to IRS, notice to “interested parties”.
- Special timing rules for notices and model notice.

FIDUCIARY STANDARD FOR ERISA-COVERED RETIREMENT PLANS

Fiduciary Rules

- Under ERISA Section 3(21), “fiduciary” broadly defined to include any person who:
 - Exercises discretionary authority or control over management or disposition of plan assets
 - Has discretionary authority or responsibility for plan administration
 - Renders investment advice for fee
- Includes those named as fiduciaries in governing documents and those responsible for appointing other fiduciaries
 - Function more important than title
- Named Fiduciary – designated in Plan/Trust documents

Fiduciary Rules

- ERISA Section 404: Affirmative fiduciary duties
 - Duty of loyalty (exclusive benefit rule)
 - Duty of prudence (“prudent expert” standard)
 - Duty to diversify investments
- ERISA Section 406: Prohibited transactions
 - Section 406(a)(1) per se prohibited transactions
 - Section 406(b)(1) self dealing transactions
 - Section 406(b)(2) party in interest transactions
 - Section 406(b)(3) “anti-kickback” rules

Special Fiduciary Issues and 401(k) Plan Investments

- Section 404(c)—“self-directed participant investments” - no fiduciary responsibility if participant controls investment of account in individual account plan
- Fiduciaries protected from liability if participant exercised control over investments and ERISA Section 404(c) and regulations are satisfied
- Fiduciaries not protected during black-out periods or when contributions invested in default fund because participant cannot exercise control
- Except Participant is not considered as losing ability to exercise control over account during “qualified change in investment options” if:
 - Notice of change at least 30 and no more than 60 days before change effective, with comparison of current and new options and explanation that participant’s account invested in new option with similar risk and return to prior option (“mapping”);
 - Participant has not provided instructions contrary to proposed change; and
 - Participant has ability to exercise control immediately prior to change.

PREEMPTION

ERISA Preemption

- ERISA § 514 general rule: State Laws that “relate to” ERISA plans are preempted
 - Exceptions (“savings clause”)
 - State laws governing insurance, banking and securities
 - Generally applicable state criminal laws
 - Exception to exceptions (“deemer clause”)
 - States can’t “deem” uninsured ERISA plans to be insurers
- RESULT: States cannot directly regulate any ERISA plan
 - But states may be able to indirectly regulate ERISA plans through regulation (often of health insurance issuers and insurance products) that are sold to ERISA plans
- 2006: Clarified ERISA preempts state laws that might otherwise preclude payroll deductions without written consent of employee, with respect to automatic contribution arrangement.

Questions

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