

Retirement News for Employers

Tax Information for Sponsors of Retirement Plans
Internal Revenue Service Tax Exempt and Government Entities

Summer 2011

Compensation Errors in Retirement Plans

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Avoiding Compensation Errors in Retirement Plans

Using an incorrect definition of compensation in your retirement plan can lead to costly operational failures that can affect your plan's qualified status. Impacted areas may include:

- **Contributions and benefits**
For example, a plan operational failure will occur when an employer makes profit-sharing contributions using base compensation instead of base compensation plus commissions as required by the plan document.
- **Nondiscrimination requirements**
A qualification failure may occur if the plan excludes overtime (or other) pay from its definition of compensation resulting in nonhighly compensated employees receiving a lower contribution rate than highly compensated employees.
- **Employer's deduction for plan contributions**
A nondeductible contribution may result if the employer uses a higher amount of compensation than that allowed under the Internal Revenue Code (see Code [§404](#).) The employer may owe additional tax including excise taxes on the excess (see Code [§4972](#) and [Pub. 560](#) - Excise taxes.)
- **Highly compensated or key employees, plan limits and top-heavy minimum benefits**
The plan will have a qualification failure unless it uses the statutory definition of compensation for these [limits and minimums](#) (see Code §§ [415](#) and [416](#).)

Tips to avoid compensation-related failures

1. Review your plan document's definitions of compensation for each plan purpose.
2. Use the statutory definition of compensation when required.
3. Transmit accurate compensation data for each employee to your payroll processor and plan administrator.
4. Consider amending your plan to use one definition of compensation for all plan purposes.
5. Periodically review your plan for errors and fix them as quickly as possible using IRS [correction programs](#)

Correcting Common Plan Errors - Compensation Errors in Defined Contribution Plans

The Issue

The amount an employer contributes to a 401(k) or other type of defined contribution plan is based on the compensation paid to employees. Compensation is defined in the plan. If an incorrect amount of compensation is used to determine contributions, the contributions will be incorrect. This will cause an operational failure (failing to follow the terms of the plan in its operation).

Your plan document (or adoption agreement if you use a pre-approved plan) may have multiple definitions of compensation, including definitions for purposes of calculating:

- salary deferrals,
- matching contributions, and
- discretionary contributions.

The plan is not required to use the same definition of compensation for all contribution types. For example, a plan may allocate discretionary contributions based on an employee's base salary only, while salary deferral contributions may be based on all forms of compensation including bonuses, commissions and other pay.

The Problem

Errors related to compensation can occur when:

- the third party administrator or payroll processor does not know the plan's definition of compensation;
- the plan's definition of compensation is amended, but the third party administrator or payroll processor is not notified;
- payroll systems are not updated to reflect the revised definition; or
- payroll systems are not updated when the types of compensation paid change.

Fixing the Problem

Contribution errors caused by incorrect compensation figures can be corrected using IRS retirement plan correction programs -- known as the Employee Plans Compliance Resolution System (EPCRS) and outlined in [Revenue Procedure 2008-50](#).

Self-Correction

The error can be self-corrected, without IRS approval, if the mistake is insignificant or, if significant, if the plan sponsor corrects the mistake within two years. A plan sponsor can use self-correction only if the plan has practices and procedures in place designed to promote overall tax law compliance.

Voluntary Correction Program

Plan sponsors can correct errors with IRS approval by using the [Voluntary Correction Program](#).

Your submission to the VCP should:

- describe the plan failure and proposed correction method,

- show calculations for your proposed corrective contributions, and
- state your proposal for fixing the administrative practices that allowed the failure to happen.

[Appendix D](#) of Rev. Proc. 2008-50 may be used for your VCP submission.

Your correction method should put the participants in the position they would have been had the failure not occurred. You may need to make corrective contributions for participants or you may need to distribute excess amounts from the plan.

Compensation that should have been excluded

Including too much compensation to determine plan contributions will result in excess employer contributions. To correct the excess, the plan sponsor should:

- distribute excess elective deferrals, plus earnings, to each affected participant, and
- forfeit excess discretionary contributions according to the method required by the plan document. The plan terms will require the sponsor to either:
 - reallocate the forfeitures to plan participants based on the correct compensation, if appropriate, or
 - hold the forfeitures in an unallocated account to reduce future plan contributions.

Example:

Employer Z sponsors a 401(k) plan for its employees. The plan amended its definition of compensation to exclude bonuses for making deferrals and allocating other contributions, effective in 2009. For the 2010 plan year, Employer Z did not exclude bonuses from compensation in determining deferrals and allocations. Three of Z's employees had base compensation of \$120,000 and a \$30,000 bonus. Each of these employees had deferral percentages of 6% of compensation and Z made a discretionary profit-sharing contribution of 5% of compensation to each participant's account. The plan document provides that forfeitures will be used to offset future employer contributions.

- Each of the three employees properly deferred 6% of their \$120,000 base compensation (\$7,200), but improperly deferred 6% of the \$30,000 bonus (\$1,800).
- Each of the three employees properly received a profit-sharing allocation equal to 5% of their \$120,000 compensation (\$6,000) but improperly received an allocation equal to 5% of the \$30,000 bonus (\$1,500).

Correction:

1. Excess salary deferrals - The plan should distribute the improper salary deferrals of \$1,800, plus earnings, to each of the three employees.
2. Excess discretionary contributions - Each of the three employees should forfeit the excess discretionary contributions of \$1,500, plus earnings. These forfeitures can be placed in an unallocated account to use for nonelective contributions in future plan years, according to the terms of the plan.

Compensation that should have been included

If you erroneously omitted some forms of compensation from elective deferrals, matching or discretionary contributions, you should make corrective contributions for the affected participants.

1. **Missed salary deferrals**

Multiply the amount of the omitted compensation by the deferral percentage that the employee specified in his salary reduction agreement. This is the employee's "missed deferral."

50% of the missed deferral is the employee's "missed deferral opportunity."

Contribute this amount to the employee's account, plus earnings through the date you make your corrective contribution.

2. **Missed matching contributions**

If you agreed to match all or part of the employees' elective deferrals, make a matching contribution based on the missed deferral, plus earnings through the date of correction.

Do not base matching contributions on 50% of the missed deferral (the "missed deferral opportunity"). Matching contributions must be based on the full missed deferral.

3. **Missed discretionary contributions**

If you made discretionary contributions to participants for the plan year, contribute the same percentage of the omitted compensation as was contributed with respect to the compensation that was properly included, plus earnings through the date of correction.

You do not have to reduce the account balances of employees who may have received greater allocations of employer contributions than they would have received had the compensation error not occurred.

You may choose to reallocate contributions to reflect the allocations that would have been made had the error not occurred.

Example:

Employer Z sponsors a 401(k) plan for its employees. The plan includes bonuses and commissions in its definition of compensation for deferrals and allocations. Three of Z's employees received bonuses of \$30,000 in 2010. Each of these employees had deferral percentages of 6% of compensation. The plan provides for a 100% matching contribution on the first 4% of deferrals, and Z decided to make a discretionary contribution of 5% of compensation for each participant. Z did not withhold deferrals from the bonus checks or include the bonuses in its matching or discretionary contribution allocations.

1. Each of the three employees had a missed deferral of 6% of their \$30,000 bonus (\$1,800).
2. The missed deferral opportunity for each employee was 50% of their missed deferral (\$900). Z should contribute this amount to each employee's account.
3. Each employee should have received an additional matching contribution of 4% of the \$30,000 omitted compensation (\$1,200). The matching contribution is based on the full missed deferral, and not on the lower missed deferral opportunity (\$900).
4. Each employee should receive a 5% discretionary contribution for the \$30,000 omitted compensation (\$1,500).

Corrective contributions should reflect earnings

Corrective contributions should be increased to reflect earnings through the correction date based on the participant's own investment results.

Making Sure it Doesn't Happen Again

- Perform an annual review of your plan's operations to ensure that contributions are made based on the correct definition of compensation.
- When you amend or restate your plan, check its compensation definitions against the old plan document, noting any differences.
- If you start to pay a new type of compensation, such as bonuses or overtime, check your plan language to confirm its proper treatment, and then tell your payroll processor or third party administrator about it.
- If possible, simplify your plan's definition of compensation and use the same definition for multiple purposes.

Visit the [Correcting Plan Errors](#) page for more information on this and other plan errors, including our [Fix-It Guides](#).

We're Glad You Asked! - How do you define a partner's "compensation" for retirement plan purposes?

A partnership makes annual contributions to a partner's retirement plan account based on her net earned income.

Net earned income

For a partner, this is calculated in the same way as for most other [self-employed plan participants](#) by starting with the partner's earned income and then subtracting:

- plan contributions for the partner, and
- half of her self-employment tax.

Pub. 560 has [tables and worksheets](#) to calculate the deduction for contributions to a qualified plan for a partner.

Partner's earned income

A partner's earned income is the income she receives for her services to materially help produce that income (see Code §§ [1402](#) and [401\(c\)\(2\)](#).) A partner must separately calculate her earned income for each trade or business.

Not every partner may have earned income (for example, a limited partner who does not provide services to the partnership and is merely an investor). Also, all of a partner's income from the partnership may not be earned income (for example, investment income that is passed through the partnership to the partners).

Reporting a partner's earned income

Each partner's earned income or loss is listed on [Schedule K-1](#) (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.* The partnership must give a Schedule K-1 to each partner by the filing due date (including extensions) of the partnership's [Form 1065](#), *U.S. Return of Partnership Income* ([instructions](#)).

Additional Resources:

- [Publication 541](#), *Partnerships*
- [Publication 560](#), *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*

We're Glad You Asked! - Should our plan administrator withhold 20% for federal income tax from all retirement plan distributions?

No. The plan administrator should only withhold 20% for federal income tax from [eligible rollover distributions](#). A plan administrator doesn't have to apply withholding if expected distributions to an individual are less than \$200 for the year. The 20% withholding generally only applies to any previously untaxed amount of the eligible rollover distribution (not to any already taxed amount - [cost](#)). However, no withholding is required if the plan directly rolls over (in a trustee-to-trustee transfer) the amount to another qualified retirement plan or IRA.

Distributions that are [not eligible rollover distributions](#) are subject to different withholding rates depending on whether they are **periodic** or **nonperiodic** payments.

- **Periodic payments** are made at regular intervals for more than 1 year (for example, an annuity).
 - Generally, the plan administrator must withhold at the rate for a married individual with 3 withholding exemptions. However, the plan administrator must notify the recipient of his or her right to:
 - elect no withholding or elect to have a different amount withheld, by filing [Form W-4P, Withholding Certificate for Pension or Annuity Payments](#), with the plan administrator; and
 - revoke the election at any time.
 - The plan administrator must withhold 10% from any required minimum distributions and 20% from any excess amount distributed that is an eligible rollover distribution.
- **Nonperiodic payments** are distributions that usually aren't made at regular intervals and are not eligible rollover distributions, for example:
 - distributions of excess annual additions;
 - distributions of excess contributions and excess aggregate contributions from most plans if made within 2 ½ months after the end of the plan year;
 - hardship distributions; and
 - loans treated as distributions.

The plan administrator must withhold 10% from these payments. However, the recipient may elect no withholding or have a different amount withheld by filing a Form W-4P with the plan administrator.

Special Situations

- Distributions made because of recognized [disasters](#).
- Special withholding rules apply to certain noncash distributions, including:
 - employer securities; and
 - a participant's accrued benefit offset because of a defaulted loan. (see Treas. Reg. [§31-3405\(c\)-1](#)).

- Distributions delivered outside the U.S. or U.S. possessions.
- Distributions from [designated Roth accounts](#) in 401(k), 403(b) or 457(b) plans:
 - [Qualified distribution](#) - no withholding because the distribution is not taxable.
 - [Nonqualified distribution](#) - withholding required only from any distributed earnings that the recipient must include in gross income.

Penalties

A plan administrator may be subject to penalties for failing to:

- properly withhold, deposit or report taxes; and
- electronically deposit withheld taxes. (see for example, Code §§ [6656](#) and [6672](#), [6721](#), [6722](#) and Treas. Reg. §[31.6302-1\(h\)](#))

Additional Resources

- [Publication 15-A](#), *Employer's Supplemental Tax Guide*
- [Publication 505](#), *Tax Withholding and Estimated Tax*
- [Publication 575](#), *Pension and Annuity Income*

Desk Side Chat...With Monika Templeman

Why Plan Sponsors Should Read Our Examination Projects Results

In each issue, Monika Templeman, Director of EP Examinations, responds to questions and offers insights on retirement plan topics uncovered during audits. You may provide feedback or suggest future topics for discussion by emailing her at: RetirementPlanComments@irs.gov.

Monika, your office oversees and posts the results of LESE Projects for plan sponsors' review. Can you explain this acronym?

LESE stands for Learn, Educate, Self-Correct, Enforce - the steps in the project process.

Learn:

We sample a small population of Form 5500 returns to learn about a specific problem plan sponsors may be having with compliance.

Educate:

We publish what we learn on the Web and create outreach materials to educate plan sponsors about a specific compliance problem.

Self-Correct:

Plan sponsors can use our published information about a specific compliance problem to perform a self-audit, and, if necessary, self-correct using one of our [correction programs](#).

Enforce.

We take a firm position with those plan sponsors who choose not to correct their errors.

What type of information will plan sponsors find in these reports?

They will find detailed explanations about the most frequent plan errors and tips on how to avoid these errors. I'll use the [401\(k\) Top-Heavy Project Report](#) as an example.

- First, we list the specific test group, which were 401(k) plans covering three to eight participants with the potential to be top-heavy.
- Second, we present a brief overview of the requirements of the Code and regulations.
- Third, we state the project results, a list of the top six errors we found, and provide detailed information on the top two errors. For example, this project's report shows that the second most frequent error was that plans were in violation of the top-heavy contribution requirements. The report then describes the top four reasons for that error. In this instance, the main reason was that plan sponsors weren't testing for top-heaviness.

Should plan sponsors use this project's findings to make certain their plans comply with the top-heavy rules?

Yes, I highly recommend this approach; it is our key reason for publishing these reports. Plan sponsors who use the reports to perform an internal check on their plan can determine if their plan is in compliance and if not, use either the [Self-Correction Program](#) or [Voluntary Correction Program](#).

What are some of the other projects that plan sponsors can learn about?

We are preparing 10 new reports that we'll post to our [LESE](#) Project page. Some of the upcoming project reports include:

1. 401(k) plan Form 5500 returns that disclosed corrective distributions **that did not properly correct excess contributions** (for example, incomplete [ADP/ACP corrective distributions](#)). The primary issue we found was plans only partially corrected ADP test failures.
2. We obtained a snapshot view of **small qualified plans with investments in real estate** that also had either additional investments in participant loans or filed a Schedule D (DFE/Participating Plan Information). We wanted to get a better understanding of problems associated with plans with these types of investments. We found that the two main issues were prohibited transactions involving participant loans and failing to use fair market value for real estate and other investments.
3. Another project focused on defined contribution plans reporting an average employer contribution per participant that **appeared to exceed the Code §415(c) dollar limit**.
4. We audited Forms 5500 for 401(k) plans that showed **participant contributions may have exceeded the Code §402(g) elective deferral limits**.

Visit IRS.gov/retirement for information on upcoming projects and reports.

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DOL News

The Department of Labor’s Employee Benefits Security Administration announced new guidance as featured below. You can subscribe to [DOL/EBSA’s](#) website for updates.

Extension and Alignment of Applicability Dates for Fee Disclosure Rules

On July 19, DOL/EBSA published a [final rule](#) to extend and align the applicability dates for its retirement plan fee disclosure rules.

DOL/EBSA published an [interim final regulation](#) under ERISA §408(b)(2) on July 16, 2010 requiring retirement plan service providers to disclose comprehensive information about their fees and about potential conflicts of interest to plan fiduciaries. This regulation was to become effective for plan contracts or arrangements for services in existence on or after July 16, 2011. This final rule moves the effective date to April 1, 2012.

DOL/EBSA also published a [final participant-level regulation](#) on October 20, 2010, requiring that employers disclose information about plan and investment costs to workers who direct their own investments in ERISA-covered 401(k) and other individual account plans. The regulation, which applies for plan years beginning on or after November 1, 2011, contained a 60-day transition rule permitting initial compliance no later than 60 days after the beginning of the first plan year on or after November 1. This final rule retains a modified version of the 60-day transition rule that works with the new effective date of the 408(b)(2) regulation to ensure that it becomes effective first and that all plans will be able to take advantage of the transition period following the effective date of the 408(b)(2) regulation.

Proposed Definition of “Fiduciary” of Employee Benefit Plans

On October 22, DOL/EBSA published a [proposed rule](#) to update the definition of “fiduciary” to more broadly define the term as a person who provides investment advice to plans for a fee or other compensation.

The proposed amendment would update the definition to take into account changes in the marketplace and in the practices of investment advice providers.

As the proposal notes, the 1975 rule’s approach to fiduciary status may inappropriately limit DOL/EBSA’s ability to protect plan sponsors, plans, participants and beneficiaries from conflicts of interest that may arise from diverse, complex fee practices in retirement plan services. The 1975 regulation may leave many employers, participants and beneficiaries, expecting to receive unbiased advice, unaware of the potential conflicts of interest of the investment advice providers.

The proposed rule, which more closely reflects the statutory definition, is designed to remedy this problem and to protect plan officials and participants who expect unbiased advice, by giving a more clear understanding of when individuals providing such advice are subject to ERISA's fiduciary standards.

DOL/EBSA held a public hearing on March 1 and 2 on the proposed regulation. The public hearing record was extended for 15 days after the transcript was posted on DOL/EBSA's website to give the public opportunity to comment on issues raised at the hearing. The [dedicated Web page](#) for this includes public comments (pre- and post hearing), the transcript of the hearing, and statements and interviews by Assistant Secretary Phyllis C. Borzi regarding the regulation. This includes Assistant Secretary Borzi's recent [testimony](#) before the House Committee on Education and the Workforce, Subcommittee on Health, Employment, Labor and Pensions.

Electronic Disclosure by Employee Benefit Plans

On April 7, DOL/EBSA published a [Request for Information \(RFI\)](#) to solicit public comments to assist in determining whether to modify current rules regarding the electronic distribution of employee benefit plan information. Plan information, such as quarterly account statements, is required to be disclosed under ERISA.

The RFI lists 30 specific questions on a broad range of topics related to electronic distribution of benefit plan information. The comment period has closed. [Comments](#) received are available

Mark Your Calendar

Operating a retirement plan can be a time-consuming job. To help you, we have listed some important dates in the upcoming months. Please note that the filing dates are for calendar-year plans. Noncalendar-year plans must adjust their dates.

August 30 - September 1: [IRS Nationwide Tax Forum](#) – Washington, D.C. (National Harbor).

September 15: Deadline for making final required minimum contributions for 2010 for money purchase and defined benefit plans.

September 15: Last day to set up a SEP plan for 2010 if you file a Form 1120 business tax return and have an extension of your March 15, 2011, due date.

September 15: Last day to elect (or change a standing election) for single-employer defined benefit plans to:

- use funding balances to offset the minimum required contribution for the 2010 plan year,
- credit excess contributions for the 2010 plan year to the plan's prefunding balance, and
- revoke a previous election to use a funding balance to offset the minimum required contribution for the 2010 plan year, to the extent the election exceeded the full minimum required contribution for the year (only for plans with valuation dates that are not the first day of the plan year).

September 30: Last day for sponsors of single-employer defined benefit plans to obtain AFTAP certification from the plan's enrolled actuary to avoid triggering benefit restrictions under Code §436 through (at least) the end of 2011.

October 1: Sponsors of single-employer defined benefit plans that have not received a certified AFTAP from the plan's enrolled actuary should review benefit restrictions under Code §436 to determine whether additional restrictions apply or if other action is required.

October 15: Last day for sponsors of single-employer defined benefit plans to reinstate a standing election made earlier to use funding balances to offset minimum required contributions and/or to add excess contributions to the prefunding balance if the enrolled actuary signing the 2010 Schedule SB is not the same as the actuary named in the earlier election.

October 15: Deadline for making third quarter contributions for 2011 to defined benefit plans.

October 17: File 2010 (if you filed for a 2-1/2 month extension prior to August 1):

- [Form 5500](#), *Annual Return/Report of Employee Benefit Plan*,
- [Form 5500-SF](#), *Short Form Annual Return/Report of Small Benefit Plan*, or
- [Form 5500-EZ](#), *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan*.

November 2: Last day for employers with SIMPLE IRA or SIMPLE 401(k) plans to notify eligible employees of their 2012 salary deferral rights and whether the employer will make matching or nonelective employer contributions in 2012.

View other [Upcoming EP Educational Events](#).

Retirement Tips for Individuals

Retirement Savings Check-up

Are you saving enough to have the lifestyle you want when you retire? Now is a good time to check whether you're taking full advantage of all your retirement savings opportunities and adjust your contributions.

Do you have a retirement plan at work?

If you haven't already joined your employer's plan, enroll as soon as you can. Many retirement plans have quarterly or semi-annual entry dates. Ask your employer when you can participate and consider joining on the next entry date.

Salary Deferral Contributions - If your employer's plan allows you to contribute part of your pay, you can decrease your taxable income by making pre-tax salary deferral contributions. Many plans allow participants to submit salary deferral elections at any time, so review your contribution rate to ensure you are contributing as much as you can.

The maximum annual salary deferral contributions allowed for 2011 are:

- \$16,500 to 401(k), 403(b) or 457(b) plans
- \$11,500 to SIMPLE plans

If you are age 50 or older by the end of the year, your plan may allow you to make additional catch-up contributions of:

- \$5,500 to 401(k), 403(b) or 457(b) plans
- \$2,500 to SIMPLE plans

Many 401(k) plans also match part of your salary deferral contributions. For example, your plan may contribute a percentage for every dollar you defer to the plan up to a certain amount. Contact your employer for details and adjust your salary deferrals to take full advantage of matching contributions.

Do you have an IRA?

For 2011, you may be able to contribute to a traditional or Roth IRA the smaller of:

- \$5,000 (\$6,000 if you are age 50 or older), or
- your taxable compensation for the year.

This is the most you can contribute, regardless of whether your contributions are to one or more traditional or Roth IRAs or whether all or part of the contributions are nondeductible.

The amount of traditional IRA contributions you can deduct depends on whether either you or your spouse was covered by an employer retirement plan for any part of the year or if your income is above certain amounts.

Maximize your retirement savings by periodically reviewing your retirement goals, savings options and annual contributions!

Additional Resources:

- [Publication 590, Individual Retirement Arrangements \(IRAs\)](#)
- [Plan Participant/Employee Web pages](#)
- [Retirement Plans Frequently Asked Questions](#)