# 401k Guide for the Plan Sponsor

Welcome to our 401k Guide for the Plan Sponsor!

The information contained on this site was designed and developed by various governmental agencies, and compiled and organized by 401k Network as a general guide to basic information for 401(k) Plan Sponsors.

We hope you find this guide helpful in understanding and complying with the rules that apply to 401(k) plans. We want to hear all of your comments; what you like about this guide and items not contained in this guide you would like to see.

If you have any comments or suggestions, please e-mail us at: info@401k-network.com

In order to best meet your needs, we have developed separate guides for plan sponsors and for plan participants. The table of contents for each is located below.

Plan Sponsors



The information contained in this site:

- Addresses federal 401(k) plans issues rather than issues related to state laws.
- The guide provides general information. It is not intended to be all-inclusive.
- Is not intended to replace the advice of your attorney or other plan professional

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# 401(k) Resource Guide - Plan Sponsors - 401(k) Plan Overview

This 401(k) Guide provides general information. You should contact your plan administrator for information specific to your plan.

A 401(k) plan is a qualified (i.e., meets the standards set forth in the Internal Revenue Code (IRC) for tax-favored status) profit-sharing, stock bonus, pre-ERISA money purchase pension, or a rural cooperative plan under which an employee can elect to have the employer contribute a portion of the employee's cash wages to the plan on a pre-tax basis. These deferred wages (elective deferrals) are not subject to federal income tax withholding at the time of deferral, and they are not reflected as taxable income on the employee's Form 1040, U.S. Individual Income Tax Return.

The employer reports elective deferrals on the participant's Form W-2, Wage and Tax Statement. Although these amounts are not treated as current income for federal income tax purposes, they are included as wages subject to social security (FICA), Medicare, and federal unemployment taxes (FUTA). Refer to Publication 525, Taxable and Nontaxable Income, for more information about elective deferrals. Refer to the Form W-2 Instructions, for more information on how amounts should be reported.

Beginning in 2006, 401(k) plans will be permitted to allow employees to designate some or all of their elective deferrals as "Roth elective deferrals" that will generally be subject to taxation under the rules applicable to Roth IRAs. The information contained in this guide does not pertain to Roth 401(k)s unless specifically stated.

Two of the tax advantages of sponsoring a 401(k) plan are:

Employer contributions are deductible on the employer's federal income tax return to the extent that the contributions do not exceed the limitations described in section 404 of the Internal Revenue Code. Refer to Publication 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans), for more information about deduction limitations.

Elective deferrals and investment gains are not currently taxed and enjoy tax deferral until distribution.

There are several types of 401(k) plans available to employers - traditional 401(k) plans, safe harbor 401(k) plans and SIMPLE 401(k) plans. Different rules apply to each. For tax-favored status, a plan must be operated in accordance with the applicable rules. Therefore, it is important that the employer be familiar with the special rules that apply to its plan so the plan is administered in accordance with those rules. To qualify for the tax benefits available to qualified plans, a plan must both contain language that meets certain requirements (qualification rules) of the tax law and be operated in accordance with the plan's provisions. The following is a brief overview of important qualification rules. It is not intended to be all-inclusive.

Traditional 401(k) plans. A traditional 401(k) plan allows eligible employees (i.e., employees eligible to participate in the plan) to make pre-tax elective deferrals through payroll deductions. In addition, in a traditional 401(k) plan, employers have the option of making contributions on behalf of all participants, making matching contributions based on employees' elective deferrals, or both. These employer contributions can be subject to a vesting schedule which provides that an employee's right to employer contributions becomes non-forfeitable only after a period of time, or be immediately vested. Rules relating to traditional 401(k) plans require that contributions made under the plan meet specific nondiscrimination requirements. In order to ensure that the plan satisfies these requirements, the employer must perform annual tests, known as the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests, to verify that deferred wages and employer matching contributions do not discriminate in favor of highly compensated employees.

Safe harbor 401(k) plans. A safe harbor 401(k) plan is similar to a traditional 401(k) plan, but, among other things, it must provide for employer contributions that are fully vested when made. These contributions may be employer matching contributions, limited to employees who defer, or employer contributions made on behalf of all eligible employees, regardless of whether they make elective deferrals. The safe harbor 401(k) plan is not subject to the complex annual nondiscrimination tests that apply to traditional 401(k) plans.

Safe harbor 401(k) plans that do not provide any additional contributions in a year are exempted from the top-heavy rules of section 416 of the Internal Revenue Code.

Employers sponsoring safe harbor 401(k) plans must satisfy certain notice requirements. The notice requirements are satisfied if each eligible employee for the plan year is given written notice of the employee's rights and obligations under the plan and the notice satisfies the content and timing requirements.

In order to satisfy the content requirement, the notice must describe the safe harbor method in use, how eligible employees make elections, any other plans involved, etc. Income Tax Regulations section 1.401(k)-3(d)(2) contains information on satisfying the content requirement using electronic media and referencing the plan's Summary Plan Description.

The timing requirement requires that the employer must provide notice within a reasonable period before each plan year. This requirement is deemed to be satisfied if the notice is provided to each eligible employee at least 30 days and not more than 90 days before the beginning of each plan year. There are special rules for employees who become eligible after the 90th day. See Income Tax Regulations section 1.401(k)-3(d)(3).

Both the traditional and safe harbor plans are for employers of any size and can be combined with other retirement plans.

SIMPLE 401(k) plans. The SIMPLE 401(k) plan was created so that small businesses could have an effective, cost-efficient way to offer retirement benefits to their employees. A SIMPLE 401(k) plan is not subject to the annual nondiscrimination tests that apply to traditional 401(k) plans. As with a safe harbor 401(k) plan, the employer is required to make employer contributions that are fully vested. This type of 401(k) plan is available to employers with 100 or fewer employees who received at least $5,000 in compensation from the employer for the preceding calendar year. Employees who are eligible to participate in a SIMPLE 401(k) plan may not receive any contributions or benefit accruals under any other plans of the employer.

For more information on traditional, safe harbor and SIMPLE 401(k) plans, see Publication 4222, 401(k) Plans for Small Businesses.

Restriction on conditions of participation. A 401(k) plan cannot require, as a condition of participation, that an employee complete more than 1 year of service.

Automatic enrollment in a 401(k) plan. A 401(k) plan can have an automatic enrollment feature. This feature permits the employer to automatically reduce the employee's wages by a fixed percentage or amount and contribute that amount to the 401(k) plan unless the employee has affirmatively chosen not to have his or her wages reduced or has chosen to have his or her wages reduced by a different percentage. These contributions qualify as elective deferrals. This has been an effective way for many employers to increase participation in their 401(k) plans. These contributions qualify as elective deferrals. For more information about 401(k) plans with an automatic enrollment feature, refer to Income Tax Regulations section 1.401(k)-1(A)(3)(ii).

Elective deferral limits. The law, under IRC section 402(g), limits the amount that a participant can defer on a pre-tax basis each year. A discussion of those limitations is available.

Elective deferrals that exceed the section 402(g) dollar limit for a year or are recharacterized as after-tax contributions as part of a correction of the Actual Deferral Percentage (nondiscrimination) test are included in the employee's gross income.

Matching contributions. If the plan document permits, the employer can make matching contributions for an employee who contributes elective deferrals to the 401(k) plan. For example, a 401(k) plan might provide that the employer will contribute 50 cents for each dollar that participating employees choose to defer under the plan. As mentioned earlier, employer matching contributions may be subject to annual tests to determine if nondiscrimination requirements are met.

Other employer contributions. If the plan document permits, the employer can make additional contributions (other than matching contributions) for participants, including participants who choose not to contribute elective deferrals to the 401(k) plan. If the 401(k) plan is top-heavy, the employer may be required to make minimum contributions on behalf of certain employees. In general, a plan is top-heavy if the account balances of key employees exceed 60% of the account balances of all employees.

The rules relating to the determination of whether a plan is top-heavy are complex. Please refer to section 1.416-1 of the Income Tax Regulations for the rules describing how to determine whether a plan is top-heavy.

Employee compensation limit. In 2005, no more than $210,000 of an employee's compensation can be taken into account when figuring contributions. This limit is $220,000 for 2006 and is indexed for inflation.

Vesting requirements. All employees must be fully (100%) vested in their elective deferrals. A plan may require completion of a specific number of years of service for vesting in other employer or matching contributions. For example, a plan may require that the employee complete 2 years of service for a 20% vested interest in employer contributions and additional years of service for increases in the vested percentage.

Distributions. General rules relating to distributions are available. For more information about the treatment of retirement plan distributions, refer to Publication 575, Pension and Annuity Income.

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## 401(k) Guide - Plan Sponsors - Starting Your Plan

Once an employer has decided on the type of plan that is best suited for its purposes, it must adopt a plan document. An employer may choose from the following plan document options:

An individually designed plan

A Master or Prototype plan (M&P plan)

A Volume Submitter plan

More information on these options is included here.

Income Tax Regulation section 1.401-1(a)(2) requires that a plan must be a definite written program that is communicated to employees.

Effective date of plan. The plan may not be made effective earlier than the first day of the employer's tax year in which the plan was adopted. In other words, an employer may adopt the plan document on the last day of its tax year, with an effective date retroactive to the first day of that tax year, but not any earlier.

The 401(k) feature of the plan, however, may not be made effective earlier than the adoption date. In other words, employees may not make elective deferrals nor make deferrals from previously earned compensation any earlier than the date the 401(k) feature was actually adopted.

Requesting a determination letter. To ensure that the form of the plan document complies with the Internal Revenue Code, the plan sponsor may request that the IRS review the document and issue a favorable determination letter on its qualified status. Requesting a determination letter is not legally required; nevertheless, many plan sponsors choose to do so.

Revenue Procedure 2006-6 contains information relating to the determination letter program, including the scope of the program and the procedures that a plan sponsor needs to follow when requesting a letter. In most cases, payment of a "user" fee is required for the processing of the determination letter application.

Sharing information with employees. Eligible employees need to be notified about the plan, including who may participate and how it works. This information is generally provided to them in a Summary Plan Description or SPD. In addition to the Summary Plan Description, the plan administrator must automatically give participants a copy of the plan's Summary Annual Report each year. This is a summary of the Form 5500, Annual Return/Report of Employee Benefit Plan, that most plans must file with the Department of Labor. The Summary Annual Report must be provided at no cost. Participants may request a copy of the plan's Form 5500 in its entirety. The participant may be charged a reasonable fee to cover the cost of providing this information.

Participants in the plan must also receive regular notification about their plan accounts and must be notified of any significant changes in the terms of the plan. If the terms of the plan are changed, participants must be informed of those changes, either through a revised Summary Plan Description, or in a separate document, called a Summary of Material Modifications.

Trusts and trustees. 401(k) plans are funded through a trust established to hold and invest the plan's assets. At least one trustee is appointed to have responsibility for the activities of the trust and its assets. This is a serious responsibility with considerable potential for liability. Trustees might include the business owner, an employee, or a financial or trust institution.

Contributions made to the trust. The employer makes contributions to the trust for the amounts of the elective deferrals made by the plan participants. The Department of Labor requires that the contributions must be made on the earliest date that the employer is able to segregate the amounts from the employer's general assets but no later than the15th day of the month following the month in which the participant would have received the amount in cash if not for the deferral election. This can usually be done on the date that the employer pays payroll taxes. Keep in mind that the rule regarding the 15th day of the following month does not provide a safe harbor for depositing deferrals. Rather, it sets the maximum deadline. If the employer does not make the deposits timely, the failure constitutes a prohibited transaction. Prohibited transactions are subject to a 15% excise tax, payable with the filing of Form 5330, Return of Excise Taxes Related to Employee Benefit Plans. More information on Prohibited Transactions can be found in Publication 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans).

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

Employee elective deferrals. In general, employees participating in the plan must inform the employer of how much of their wages they are electing to defer and when they want the deferrals to start. A participant may only make that election before the wages would otherwise be paid.

In some cases, 401(k) plans may include an automatic enrollment feature. Under this feature, an employee's pay can automatically be reduced by a fixed percentage or amount and that amount contributed to the 401(k) plan on his or her behalf unless the employee affirmatively chooses not to have his or her pay reduced or chooses to have it reduced by a different percentage or amount. For more information about the automatic enrollment feature, refer to Income Tax Regulations section 1.401(k)-1(A)(3)(ii).

# 401(k) Guide - Plan Sponsors - Plan Qualification Requirements

A retirement plan that meets the requirements of Internal Revenue Code (IRC) section 401(a) is referred to as a “qualified plan.” This IRC section sets standards for retirement plans including:

Who is eligible for plan participation,

When participants have a nonforfeitable right to their plan benefits,

How much may be contributed to the plan by both participant and employer, and

When and how distributions from the plan may be made.

Both employers and participants in “qualified plans” may take advantage of significant tax benefits that include taking a deduction for contributions to the plan (employer) and sheltering income and plan earnings from income tax until distributed (participant).

In general, a qualified plan can include a 401(k) feature only if the qualified plan is one of the following types of plans:

A profit-sharing plan

Stock bonus plan

A money purchase pension plan in existence on June 27, 1974, that included a salary reduction arrangement on that date

Rural cooperative plan.

401(k) plan qualification rules. General plan qualification information rules can be found in Publication 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans) and Publication 4222, 401(k) Plans for Small Businesses.

To qualify for the tax benefits available to qualified plans, a plan must both contain language that meets certain requirements (qualification rules) of the tax law and be operated in accordance with the plan's provisions. The following is a brief overview of important qualification rules. It is not intended to be all-inclusive.

Plan assets must not be diverted. The plan must make it impossible for its assets to be used for or diverted to, purposes other than the benefit of employees and their beneficiaries. As a general rule, the assets cannot be diverted to the employer.

Contributions or benefits must not discriminate. Under the plan, contributions or benefits must not discriminate in favor of highly compensated employees. Generally, employees with compensation of $95,000 ($100,000 in 2006) or more from the employer in the prior year are considered highly compensated for 2005. In order to satisfy this requirement with regard to elective deferrals and employer matching contributions, 401(k) plans may provide (safe harbor) minimum employer contributions or meet the Actual Deferral Percentage and Actual Contribution Percentage tests

Contributions and allocations are limited. Contributions to a 401(k) plan must not exceed certain limits described in the Internal Revenue Code. The limits apply to the employer contributions, employee elective deferrals and forfeitures credited to the participant's account during the year.

Elective deferrals must be limited. In general, plans must limit 401(k) elective deferrals to the amount in effect under IRC section 402(g) for that particular year. In 2005, $14,000 is the limit on elective deferrals (the limit increases to $15,000 in 2006 and is subject to cost-of-living adjustments). However, a 401(k) plan might also allow participants age 50 and older to make catch-up contributions in addition to the amounts contributed up to the regular 402(g) dollar limitation, provided those contributions satisfy the requirements of IRC section 414(v). These limits apply to the aggregate of all retirement plans in which the employee participates.

Minimum vesting standard must be met. A 401(k) plan must satisfy certain requirements regarding when benefits vest. To "vest" means to acquire ownership. The vested percentage is the participant's percentage of ownership in his or her account. All participants must be fully (100%) vested in their 401(k) elective deferrals. A traditional 401(k) plan may require completion of a specific number of years of service for vesting in employer discretionary or matching contributions. For example, a plan may

require 2 years of service for a 20% vested interest in employer contributions and additional years of service for increases in the vested percentage. Matching contributions must vest at least as rapidly as a 6-year graded vesting schedule. A safe harbor and SIMPLE 401(k) plan must provide for 100% vesting in employer and employee contributions at all times.

Participation. In general, an employee must be allowed to participate in a qualified retirement plan if he or she meets both of the following requirements:

Has reached age 21

Has at least 1 year of service

(A traditional 401(k) plan may require 2 years of service for eligibility to receive an employer contribution if the plan provides that after not more than 2 years of service the participant is 100% vested in all plan account balances. However, the plan must allow the employee to participate by making elective deferral contributions after no more than 1 year of service.)

A plan cannot exclude an employee because he or she has reached a specified age.

Leased employee. A leased employee is treated as an employee of the employer for whom the leased employee is providing services for certain plan qualification rules. These rules apply to:

Nondiscrimination requirements related to plan coverage, contributions, and benefits.

Minimum age and service requirements.

Vesting requirements.

Limits on contributions and benefits.

Top-heavy plan requirements.

Certain contributions or benefits provided by the leasing organization for services performed for the employer are treated as provided by the employer.

Restrictions on 401(k) distributions. Generally, distributions cannot be made until a “distributable event” occurs. A “distributable event” is an event that allows distribution of a participant’s plan benefit and includes the following situations:

The employee dies, becomes disabled, or otherwise has a severance from employment.

The plan ends and no other defined contribution plan is established or continued.

The employee reaches age 59½ or suffers a financial hardship.

Benefit payment must begin when required. Unless the participant chooses otherwise, the payment of benefits to the participant must begin within 60 days after the close of the latest of the following periods:

The plan year in which the participant reaches the earlier of age 65 or the normal retirement age specified in the plan.

The plan year which includes the 10th anniversary of the year in which the participant began participating in the plan.

The plan year in which the participant terminates service with the employer.

Loan secured by benefits. If survivor benefits are required for a spouse under a plan, the spouse must consent to a loan that uses the participant’s account balance as security.

Involuntary cash-out of benefits. In certain circumstances, the plan administrator must obtain the participant’s consent before making a distribution. Generally, consent is required if the participant’s account balance exceeds $5,000. Depending on the type of benefit distribution provided for under the 401(k) plan, the plan may also require the consent of the participant’s spouse before making a distribution. The plan may provide that rollovers from other plans are not included in determining whether the participant’s account balance exceeds the $5,000 amount.

If a distribution in excess of $1,000 is made, and the participant (or designated beneficiary) does not elect to (i) receive the distribution directly or (ii) make an election to roll over the amount to an eligible retirement plan, the plan administrator must transfer the distribution to an individual retirement plan of

a designated trustee or issuer and must notify the participant (or beneficiary) in writing that the distribution may be transferred to another individual retirement plan.

Benefits must not be assigned or alienated. The plan must provide that its benefits cannot be assigned or alienated. A loan from the plan to a participant or beneficiary is not treated as an assignment or alienation if the loan is secured by the participant's account balance and is exempt from the tax on prohibited transactions under IRC 4975(d)(1) or would be exempt if the participant were a disqualified person. See Publication 560 for additional information on prohibited transactions. A loan is exempt from the tax on prohibited transactions under IRC section 4975(d)(i) if it:

Is available to all such participants or beneficiaries on a reasonably equivalent basis,

Is not made available to highly compensated employees (within the meaning of IRC section 414(q)) in an amount greater than the amount made available to other employees,

Is made in accordance with specific provisions regarding such loans set forth in the plan,

Bears a reasonable rate of interest, and

Is adequately secured.

Also, compliance with a qualified domestic relations order (QDRO), does not result in a prohibited assignment or alienation of benefits.

Top-heavy plan requirements. A plan is top-heavy for any plan year for which the total value of accrued benefits or account balances of key employees is more than 60% of the total value of accrued benefits or account balances of all employees. Additional requirements apply to a top-heavy plan, including the requirement that non-key employees receive a minimum contribution and the requirement to satisfy an accelerated vesting schedule for employer contribution accounts.

Most qualified plans, whether or not top-heavy, must contain language that meets the top-heavy requirements and that will take effect in plan years in which the plans are top-heavy. These qualification requirements for top-heavy plans are explained in section 416 of the Internal Revenue Code.

The top-heavy plan requirements do not apply to SIMPLE 401(k) plans. Additionally, the top-heavy rules do not apply to a plan that consists solely of safe-harbor 401(k) contributions.

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## 401(k) Resource Guide - Plan Sponsors - Limitation on Elective Deferrals

There is a limit on the amount of elective deferrals that a plan participant can contribute to a traditional or safe harbor 401(k) plan.

The limit is $14,000 for 2005, and increases to $15,000 for 2006.

The limit is subject to cost-of-living increases after 2006.

Generally, all elective deferrals made by a participant to all plans in which he or she participates must be considered to determine if the dollar limits are exceeded.

Limits on the amount of elective deferrals that a plan participant can contribute to a SIMPLE 401(k) plan are different from those in a traditional or safe harbor 401(k).

The limit is $10,000 for 2005 and 2006.

The limit is subject to cost-of-living increases after 2006.

Although, general rules for 401(k) plans provide for the dollar limit described above, that does not mean that a plan participant is entitled to defer that amount. Other limitations may come into play that would limit a plan participant's elective deferrals to a lesser amount. For example, the plan document may provide a lower limit or the plan may need to further limit a plan participant's elective deferrals in order to meet nondiscrimination requirements.

Catch-up contributions. For tax years beginning after 2001, a plan may permit participants who are age 50 or over at the end of the calendar year to make additional elective deferral contributions. These

additional contributions (commonly referred to as catch-up contributions) are not subject to the general limits that apply to 401(k) plans. An employer is not required to provide for catch-up contributions in any of its plans. However, if a plan does allow catch-up contributions, it must allow all eligible participants to make the same election with respect to catch-up contributions.

If a plan participant participates in a traditional or safe harbor 401(k) plan and is age 50 or older:

The elective deferral limit increases by $4,000 for 2005 and $5,000 for 2006.

The limit is subject to cost-of-living increases after 2006.

If a plan participant participates in a SIMPLE 401(k) plan and is age 50 or older:

The elective deferral limit increases by $2,000 for 2005 and $2,500 for 2006.

The limit is subject to cost-of-living increases after 2006.

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

The catch-up contribution limit, above, or

The excess of the participant's compensation over the elective deferrals that are not catch-up contributions.

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

Example: If Joe Saver, who's over 50, has only one employer and participates in that employer's 401(k) plan, the plan would have to permit catch-up contributions before he could defer the maximum of

$18,000 for 2005 (the $14,000 regular limit for 2005 plus the $4,000 catch-up limit for 2005). If the plan didn't permit catch-up contributions, the most Joe could defer would be $14,000. However, if Joe participates in two 401(k) plans, each maintained by an unrelated employer, he can defer a total of $18,000 even if neither plan has catch-up provisions. Of course, Joe couldn't defer more than $14,000 under either plan and he would be responsible for monitoring his own contributions.

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

Treatment of excess deferrals. If the total of a plan participant's elective deferrals is more than the limit, a plan participant can have the difference (called an excess deferral) returned to the participant from any of the plans that permit these distributions. A plan participant must notify the plan by April 15 of the following year of the amount to be paid from the plan. The plan must then pay the participant that amount plus allocable earnings by April 15 of the year following the year in which the excess occurred.

Excess withdrawn by April 15. If a plan participant withdraws the excess deferral for 2005 by April 15, 2006, it is includable in the participant's gross income for 2005, but not for 2006. However, any income earned on the excess deferral taken out is taxable in the tax year in which it is taken out. The distribution is not subject to the additional 10% tax on early distributions.

Excess not withdrawn by April 15. If a plan participant does not take out the excess deferral by April 15, 2006, the excess, though taxable in 2005, is not included in the participant's cost basis in figuring the taxable amount of any eventual distributions from the plan. In effect, an excess deferral left in the plan is taxed twice, once when contributed and again when distributed. Also, if the entire deferral is allowed to stay in the plan, the plan may not be a qualified plan.

Reporting corrective distributions on Form 1099-R. The plan must report corrective distributions of excess deferrals (including any earnings) on Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

Refer to Publication 525, Taxable and Nontaxable Income, for more information about limits on elective deferrals.

Additional limits. There are other limits that restrict contributions made on a plan participant's behalf. In addition to the limit on elective deferrals, annual contributions to all of a participant's accounts - this includes elective deferrals, employee contributions, employer matching and discretionary contributions and allocations of forfeitures to participant accounts - may not exceed the lesser of 100% of the participant's compensation or a specific dollar limitation. The dollar limitation is $42,000 in 2005, $44,000 in 2006. In addition, the amount of compensation that can be taken into account when determining employer and employee contributions is limited. In 2005, the compensation limitation is $210,000; for 2006, the limit is $220,000.

Plan definitions. The rules for compliance with the above limits are complex and may be subject to different definitions. For example, a plan may define "compensation" for certain limitations as "W-2 compensation." For other purposes, the plan may use a definition of compensation that excludes bonuses and overtime.

It is important for the employer to become familiar with the definitions contained in the plan to ensure that plan provisions with respect to contributions, deferrals and limitations are properly applied in operation!

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## 401(k) Resource Guide - Plan Sponsors - General Distribution Rules

Generally, distributions of elective deferrals cannot be made until one of the following occurs:

The participant dies, becomes disabled, or otherwise has a severance from employment.

The plan terminates and no successor defined contribution plan is established or maintained by the employer.

The participant reaches age 59½ or incurs a financial hardship.

Depending on the terms of the plan, distributions may be:

Nonperiodic, such as lump-sum distributions or

Periodic, such as annuity or installment payments.

In certain circumstances, the plan administrator must obtain the participant's consent before making a distribution. Generally, consent is required if the participant's account balance exceeds $5,000. Depending on the type of benefit distribution provided for under the 401(k) plan, the plan may also require the consent of the participant's spouse before making a distribution. A plan may provide that rollovers from other plans are not included in determining whether the participant's account balance exceeds the $5,000 amount.

If a distribution in excess of $1,000 is made, and the participant (or designated beneficiary) does not elect to (i) receive the distribution directly or (ii) make an election to roll over the amount to an eligible retirement plan, the plan administrator must transfer the distribution to an individual retirement plan of a designated trustee or issuer and must notify the participant (or beneficiary) in writing that the distribution may be transferred to another individual retirement plan.

Required distributions. A 401(k) plan must provide that each participant will either:

Receive his or her entire interest (benefits) in the plan by the required beginning date (defined below), or

Begin receiving regular periodic distributions by the required beginning date in annual amounts calculated to distribute the participant's entire interest (benefits) over his or her life expectancy or over the joint life expectancy of the participant and the designated beneficiary (or over a shorter period).

These required distribution rules apply individually to each qualified plan. The required distribution from a 401(k) plan cannot be satisfied by making a distribution from another plan. The plan document must provide that these rules override any inconsistent distribution options previously offered.

Minimum distribution. When the participant's account balance is to be distributed, the plan administrator must determine the minimum amount required to be distributed to the participant each calendar year. Information to help the administrator figure the minimum distribution amount is included in Publication 575, Pension and Annuity Income.

The required beginning date is April 1 of the first year after the later of the following years:

Calendar year in which the participant reaches age 70½.

Calendar year in which the participant retires.

However, a plan may require that the participant begin receiving distributions by April 1 of the year after the participant reaches age 70½, even if the participant has not retired.

If the participant is a 5% owner of the employer maintaining the plan, then the participant must begin receiving distributions by April 1 of the first year after the calendar year in which the participant reaches age 70½. Additional information to help determine a participant's required beginning date is included in Publication 575.

Distributions after the starting year. The distribution required to be made by April 1 is treated as a distribution for the starting year. (The starting year is the year in which the participant reaches age 70 ½ or retires, whichever applies, to determine the participant's required beginning date, above.) After the starting year, the participant must receive the required distribution for each year by December 31 of that year. If no distribution is made in the starting year, required distributions for 2 years must be made in the next year (one by April 1 and one by December 31).

Distributions after participant's death. Publication 575 includes information regarding the special rules covering distributions made after the death of a participant.

Hardship distributions. A 401(k) plan may allow employees to receive a hardship distribution because of an immediate and heavy financial need. Hardship distributions from a 401(k) plan are limited to the amount of the employee's elective deferrals and generally do not include any income earned on the deferred amounts. If the plan permits, certain employer matching contributions and employer discretionary contributions may also be included in hardship distributions. Hardship distributions cannot be rolled over to another plan or IRA.

A distribution is treated as a hardship distribution only if it is made on account of the hardship. For purposes of this rule, a distribution is made on account of hardship only if the distribution is made both on account of an immediate and heavy financial need of the employee and is necessary to satisfy that financial need. The determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan.

A distribution on account of hardship must be limited to the distributable amount. The distributable amount is equal to the employee's total elective contributions as of the date of distribution, reduced by the amount of previous distributions of elective contributions.

Immediate and heavy financial need. Whether an employee has an immediate and heavy financial need is to be determined based on all relevant facts and circumstances. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.

A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for:

Expenses for medical care previously incurred by the employee, the employee's spouse, or any dependents of the employee or necessary for these persons to obtain medical care;

Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

Payment of tuition, related educational fees, and room and board expenses, for the next 12 months of postsecondary education for the employee, or the employee's spouse, children, or dependents; or

Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence.

Note: The final 401(k) regulations were published in December 2004, and apply for plan years beginning on or after January 1, 2006. However, plan sponsors are permitted to apply these final regulations to any plan year that ends after December 29, 2004, provided the plan applies all the rules of the final regulations, to the extent applicable, for that plan year and all subsequent plan years. Caution! A

decision to apply these regulations in the middle of a plan year can only be successfully implemented if the plan has been operated in accordance with the regulations for that year.

The final regulations add the following expenses to those deemed to be immediate and heavy financial needs:

Funeral expenses

Certain expenses relating to the repair of damage to the employee's principal residence.

Distribution necessary to satisfy financial need. A distribution may not be treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the amount of the distribution is in excess of the amount required to relieve the financial need or to the extent the need may be satisfied from other resources that are reasonably available to the employee.

This determination generally is to be made on the basis of all relevant facts and circumstances. The employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

An immediate and heavy financial need generally may be treated as not capable of being relieved from other resources reasonably available to the employee if the employer relies upon the employee's written representation, unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved:

Through reimbursement or compensation by insurance or otherwise;

By liquidation of the employee's assets;

By cessation of elective contributions or employee contributions under the plan; or

By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

A need cannot reasonably be relieved by one of the actions listed above if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if all of the following requirements are satisfied:

The distribution is not in excess of the amount of the immediate and heavy financial need of the employee.

The employee has obtained all distributions, other than hardship distributions, and all nontaxable (at the time of the loan) loans currently available under all plans maintained by the employer.

The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution.

Rollovers from a 401(k) plan. A rollover occurs when the participant receives a distribution of cash or other assets from one qualified retirement plan and contributes all or part of the distribution within 60 days to another qualified retirement plan or traditional IRA. This transaction is not taxable but it is reportable on Form 1099-R and the participant's federal tax return. A participant can roll over most distributions except for:

A distribution that is one of a series of payments based on life expectancy or paid over a period of ten years or more,

A required minimum distribution,

A corrective distribution of excess deferrals or contributions (including income allocable to these amounts),

A hardship distribution, or

Dividends on employer securities.

After-tax employee contributions can only be rolled over to a traditional IRA or to certain defined contribution plans.

Any taxable amount that is not rolled over must be included in income in the year received. If the distribution is paid to the participant, he or she has 60 days from the date received to roll it over. Any taxable distribution paid to a participant that is eligible for rollover is subject to mandatory withholding of 20%, even if the participant indicates that he or she intends to roll the distribution over later.

If the participant is under age 59 ½ at the time of the distribution, any taxable portion not rolled over may be subject to a 10% additional tax on early distributions (described below).

For further information about rollovers and transfers, refer to Publication 575, and Publication 560 , Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans).

Tax on early distributions. If a distribution is made to a participant before he or she reaches age 59½, the participant may be liable for a 10% additional tax on the distribution. This tax applies to the amount received that the employee must include in income.

Exceptions. The 10% tax will not apply if distributions before age 59½ are made in any of the following circumstances:

Made to a beneficiary (or to the estate of the participant) on or after the death of the participant.

Made because the participant has a qualifying disability.

Made as part of a series of substantially equal periodic payments beginning after separation from service and made at least annually for the life or life expectancy of the participant or the joint lives or life expectancies of the participant and his or her designated beneficiary. (The payments under this exception, except in the case of death or disability, must continue for at least 5 years or until the employee reaches age 59½, whichever is the longer period.)

Made to a participant after separation from service if the separation occurred during or after the calendar year in which the participant reached age 55.

Made to an alternate payee under a qualified domestic relations order (QDRO).

Made to a participant for medical care up to the amount allowable as a medical expense deduction (determined without regard to whether the participant itemizes deductions).

Timely made to reduce excess contributions.

Timely made to reduce excess employee or matching employer contributions.

Timely made to reduce excess elective deferrals.

Made because of an IRS levy on the plan., or

Made on account of certain disasters for which IRS relief has been granted.

Reporting the tax. To report the tax on early distributions, a participant may have to file Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. See the Form 5329 instructions for additional information about this tax.

Loans from 401(k) plans. Some 401(k) plans permit participants to borrow from the plan. The plan document must specify if loans are permitted. A loan from the 401(k) plan is not taxable if it meets the criteria below.

Generally, if permitted by the plan, a participant may borrow up to 50% of his or her vested account balance up to a maximum of $50,000. The loan must be repaid within 5 years, unless the loan is used to buy the participant's main home. The loan repayments must be made in substantially level payments, at least quarterly, over the life of the loan.

The participant must reduce the $50,000 amount, above, if he or she already had an outstanding loan from the plan (or any other plan of the employer or related employer) during the 1-year period ending the day before the loan. The amount of the reduction is the participant's highest outstanding loan balance during that period minus the outstanding balance on the date of the new loan.

Certain participant loans may be treated as taxable distributions. For more information, refer to the section, "Loans Treated as Distributions," in Publication 575.

## 401(k) Guide - Plan Sponsors - Plan Termination

Although a 401(k) plan must be established with the intention of being continued indefinitely, an employer may (fully) terminate its 401(k) plan at its discretion. In certain cases, a partial plan termination is deemed to occur. Whether a partial termination occurs depends on individual facts and circumstances of a given case. In general, a partial termination is deemed to occur when an employer-initiated action results in a significant decrease in plan participation. As an example, a partial termination may be deemed to occur when an employer reduces its workforce (and plan participation) by 20%.

For purposes of the Internal Revenue Code, a 401(k) plan is not fully terminated unless:

The date of termination is established,

The benefits and liabilities under the plan are determined as of the date of plan termination, and

All assets are distributed as soon as administratively feasible.

”Administratively feasible” is determined under all the facts and circumstances of a given case, but generally the IRS views this to mean within one year after the date of plan termination.

The law requires that all affected participants be fully vested in their account balance upon the date of plan termination or partial plan termination. Under a 401(k) plan, a participant’s elective deferrals are required to be fully vested at all times. Generally, matching contributions and any other employer contributions are not required to be fully vested but may be subject to a graduated vesting schedule. Upon full or partial plan termination, however, matching contributions and other employer contributions must be fully vested for all affected participants, regardless of the vesting schedule in the plan document.

An “affected participant” in a plan termination, generally, is any one who has an accrued benefit under the plan as of the date of the plan’s termination. Certain terminated employees are also treated as affected participants.

Unless the plan is qualified (i.e., meets the standards set forth in the Internal Revenue Code) upon plan termination, participants will not have tax-favored status of their benefits upon distribution. Plans must be amended for all qualification requirements in effect on the date of plan termination. An employer may wish to file Form 5310 with the IRS, requesting a determination letter as to whether the plan termination affects the qualified status of the plan. Prior to filing the application, the law requires that the employer provide notice to Interested Parties that it intends to file the application. The notice must be given not less than 10 days or more than 24 days prior to the day the application for a determination is made. Refer to Rev. Proc. 2006-6 for a complete explanation of the required notice.

Interested parties in a plan termination generally include:

- All present employees of the employer with accrued benefits under the plan,
- All former employees with vested benefits under the plan, and
- All beneficiaries of deceased former employees currently receiving benefits under the plan.

Interested party comments may be submitted to the IRS or to the Department of Labor. These comments will be considered by the IRS when reviewing the determination letter application. Interested party comments are not entitled to confidentiality. The law specifically requires that all interested party comments will be made available to the employer.

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## 401(k) Guide - Plan Sponsors - Filing Requirements

The plan sponsor is responsible for ensuring that its plan operates in compliance with the rules related to qualified plans. The plan sponsor is also subject to certain filing requirements. A list of those requirements is included here. Penalties may apply for the late filing or non-filing of required returns and reports.

This checklist may be used as a tool to help you meet 401(k) filing requirements. Please see the instructions to the applicable forms or the references for detailed information. This checklist is not intended to be all-inclusive and does not apply to government plans or non-electing church plans

| Required to be file annually: | | |
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| Item | Explanation | Due to: |
| Form 5500, Annual Return/Report of Employee Benefit Plan or Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan with applicable schedules and independent auditor's report, if applicable.<br><br>Form 5500 Instructions<br>Form 5500-EZ Instructions<br><br>Required Schedules | An administrator or sponsor of an employee benefit plan subject to ERISA must file information about each plan every year.<br><br>A Form 5500-EZ may generally be filed for a plan that provides benefits solely for an individual (and spouse) who wholly owns a trade or business; or partners or partners (and spouses) in a partnership. | IRS/DOL: By the last day of 7th month after the end of the plan year. |
| Form W-2, Wage and Tax Statement and Form W-3 Transmittal of Wage and Tax Statements<br><br>Instructions | Reports wages and the amount of elective deferrals for a 401(k) plan. | Employees: By January 31st following the calendar year.<br><br>IRS: by February 28th following the calendar year. |

| Required to be file when applicable: | | |
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| Item | Explanation | Due to: |
| Form 945, Annual Return of Withheld Federal Income Tax<br><br>Instructions | Used to report income tax withheld from distributions made from qualified plans.<br><br>Deposits of the tax with a Form 8109 to an authorized depositary must be made at | IRS: By January 31st of the year following the calendar year in which the distribution was made. |

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| | specified times during the tax year. | |
| Form 990-T, Exempt Organization Business Income Tax Return<br><br>Instructions | Used to report gross unrelated business income of $1,000 or more.<br><br>Generally deposits of the tax with a Form 8109 to an authorized depositary must be made at specified times during the tax year. | IRS: By the 15th day of the 4th month after the end of the tax year. |
| Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.<br><br>Instructions | Used to report distributions, including direct rollovers, from qualified plans. | Participant: by January 31st following the calendar year of the distribution.<br><br>IRS: By February 28th of the year following the calendar year of the distribution. |
| Form 5310-A, Notice of Plan Merger or Consolidation, Spinoff or Transfer of Plan Assets or Liabilities; Notice of Qualified Separate Lines of Business (QSLOB)<br><br>Instructions | Used to inform the IRS of plan merger or consolidation, spinoff or transfer of plan assets or liabilities, or QSLOB. | IRS: At least 30 days prior to plan merger, consolidation, spinoff or transfer of plan assets to another employer.<br><br>For QSLOB: By the later of October 15th of the year following the testing year, or the 15th day of the 10th month after the end of the plan year of the plan of the employer that begins earliest in the testing year. |
| Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts<br><br>Instructions | Used to report and pay additional taxes. | IRS: As an attachment to the Individual Income Tax Return. (Note: filed by participant) |
| Form 5330, Return of Excise Taxes Related to Employee | Used to report tax on the following IRC sections: | IRS: For taxes due under:<br><br>4971 - later of the last day of the 7th |

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| Benefit Plans<br><br>Instructions | 4971 - minimum funding deficiency<br><br>4972 - nondeductible contributions to qualified plans<br><br>4973(a)(3) - excess contributions to a 403(b)(7) custodial account<br><br>4975 - prohibited transactions<br><br>4978, 4978A - certain ESOP dispositions<br><br>4979 - excess contributions to plans with cash or deferred arrangements<br><br>4979A - certain prohibited allocations of qualified securities by an ESOP<br><br>4980 - reversion of qualified plan assets to employers<br><br>4980F - failure of applicable plans reducing future benefit accruals to satisfy notice requirements | month after the end of the employer's tax year or 8 1/2 months after the last day of the plan year that ends with or within the filer's tax year.<br><br>4972, 4973(a)(3), 4975, 4978, 4978A, and 4979A - last day of the 7th month after the end of the tax year of the employer or other person who must file this return.<br><br>4979 - last day of the 15th month after the close of the plan year to which the excess contributions or excess aggregate contributions relate.<br><br>4980 - last day of the month following the month in which the reversion occurred.<br><br>4980F - last day of the month following the month in which the failure occurred. |
| Form 5558, Application for Extension of Time to File Certain Employee Plans Returns | Provides a 2 1/2 month extension to file the Form 5500 or 5500-EZ; a 6 month extension to file Form 5330. | IRS: By the last day of the 7th month after the end of the plan year for a 5500 extension; before otherwise due for a 5330 extension. |

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## 401(k) Guide - Plan Sponsors - What if Your Plan is Audited?

Authority and responsibilities of the Internal Revenue Service (IRS) and the Department of Labor (DOL). The Employment Retirement Income Security Act of 1974 (ERISA), as amended, provides the legal basis for the IRS Employee Plans (EP) compliance program. The jurisdiction over the rules for 401(k) plans is divided between the IRS and the DOL.

The IRS has primary jurisdiction over the qualified status of 401(k) plans, which includes examining plans and processing requests for determination letters.

The DOL has primary jurisdiction over the fiduciary standards, reporting and disclosure requirements and other rules that do not affect the qualified status of 401(k) plans.

The IRS' EP examination program is the enforcement arm for the statutory and regulatory compliance requirements that apply to qualified 401(k) plans. The overriding objective of the EP examination program is to develop and integrate appropriate compliance and enforcement programs that will have the greatest positive impact on the retirement system. The EP examination program has a high stake in maintaining a successful private retirement system.

Overview of the IRS audit process. A notice of a plan audit can generate anxiety. Plan sponsors may wonder why their plan was selected for audit and what to expect. In order to address these concerns, EP developed a document designed to provide the plan sponsor with an overview of the EP examination process. This overview is intended to give the plan sponsor a better understanding of EP's compliance efforts.

EP Examination Process Guide. In response to the results of the Customer Satisfaction Surveys, EP Examinations developed the EP Examination Process Guide to help customers through the examination process. The guide clarifies the various steps in the examination process and introduces available resources.

Internal Revenue Manual sections related to 401(k)/(m) rules. The Internal Revenue Manual (IRM) contains sections that describe the compliance rules relating to a plan that contains 401(k) and 401(m) features. A 401(m) feature permits employer matching and/or employee contributions. These sections also contain suggested examination steps to guide the EP examiner through the audit of a 401(k) plan

and may help the plan sponsor or representative prepare for the examination. The 401(k) IRM section is included here. The 401(m) IRM section is also available.

Audit Closing Agreement Program. During the course of the audit, the EP examiner may identify areas of non-compliance that would jeopardize the plan's qualified status. To the extent possible and consistent with the EP Compliance Resolution System (EPCRS), disqualifying plan defects discovered on audit should be corrected voluntarily by agreement between the IRS and the plan sponsor.