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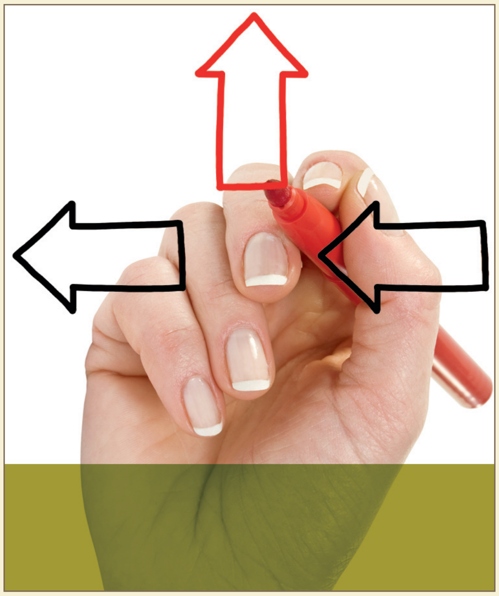
Retirement PLAN news

Midyear changes to safe harbor 401(k) plans

Long-awaited relief regarding midyear amendments to safe harbor 401(k) plans arrived when the IRS released Notice 2016-16 on January 29, 2016. The new rules were immediately effective and apply to both 401(k) and 403(b) traditional safe harbor plans and qualified automatic contribution arrangement (QACA) safe harbor plans.



Scope of the new rule

Rather than the very short list of permitted midyear changes that we had before the guidance, we now have a short list of what are prohibited midyear changes, leaving all other midyear changes now available. Notice 2016-16 generally defines a "midyear change" as — (i) a change that is first effective during a plan year but not effective as of the beginning of the plan year, or (ii) a change that is effective as of the beginning of the plan year but adopted after the beginning of the plan year.

The Notice further provides that a midyear change to either a safe harbor plan or to a plan's safe harbor notice won't violate the safe harbor rules merely because it is a midyear change, *provided that* (1) if the change to the plan affects anything in the plan's required safe harbor notice content, the applicable notice and election opportunity conditions are satisfied, and (2) the midyear change is not a prohibited midyear change.

Notice and election opportunity conditions

Midyear changes affecting anything in the safe harbor notice require that participants receive an updated safe harbor notice. The updated safe harbor notice must describe the midyear change and its effective date. Timing requirements will generally be deemed satisfied if the notice is given to participants at least 30 days and not more than 90 days ahead of the change. If it is not practicable to provide the notice before the effective date of the change, such as for amendments retroactive to the beginning of the plan year, the notice is treated as timely provided it is given no later than 30 days after the change is adopted.

Whenever an updated safe harbor notice is provided, participants must have a reasonable opportunity to update their deferral and after-tax contribution elections before the effective date of the change. Notice 2016-16 deems a 30-day election period as a reasonable allowance to make a deferral change.

Prohibited midyear changes

Notice 2016-16 also provides IRS prohibited midyear changes, including those that:

- Violate the anti-cutback, anti-abuse, or nondiscrimination rules.
- Increase the number of years of vesting service required for vesting in QACA safe harbor contributions.

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Changes to the Voluntary Correction Program

The Voluntary Correction Program (VCP) is available to qualified retirement plan sponsors to obtain IRS approval for proposed plan corrections that — if not addressed in a timely fashion — could result in the loss of the plan's tax-favored status or substantial sanctions for noncompliance. By submitting a written proposal to the IRS along with a compliance fee, plan sponsors can bring their plans back into compliance with federal tax law while continuing to provide employees with all the benefits of the plan.

The new fee schedule is in effect for submissions made from February 1, 2016, through January 31, 2017. It is generally applicable for all VCP submissions by 401(k) and 403(b) plan sponsors. To encourage plan sponsors to correct plan "failures" through the VCP, the new fees are reduced for almost all corrections. (Only the fees for plans with 101 to 500 participants remain unchanged.)

New general VCP fees

Number of participants	Fee
20 or fewer	$500
21 to 50	$750
51 to 100	$1,500
101 to 1,000	$5,000
1,001 to 10,000	$10,000
More than 10,000	$15,000

In addition, plan sponsors should continue to refer to IRS guidance contained in Revenue Procedure 2013-12, as modified by Rev. Procs. 2015-27 and 28, for additional information on VCP fees and eligibility for reduced fees for certain submissions.*

PPA restatement deadline looms

The VCP applies to many types of qualified retirement plan failures, including the failure to restate a plan. The IRS requires that all preapproved plans, including master and prototype plans, as well as volume submitter plans, be restated once every six years.

The second six-year restatement cycle for preapproved defined contribution (DC) plans — known as the "PPA restatement" because many of the changes are required by the Pension Protection Act of 2006 — ended on April 30, 2016. We have been in touch many times regarding this. Any preapproved DC plans that missed the restatement deadline are no longer in compliance. For them, a PPA document must be adopted and the plan sponsor must make a VCP submission to the IRS with the appropriate fee. Note that if you submit under VCP by April 30, 2017, the fee will be discounted by 50%.

* Internal Revenue Service, "Changes to Voluntary Correction Program Compliance Fees, Including Reduced Fees for Most 401(a) and 403(b) Plans," January 6, 2016

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- Reduce the number or otherwise narrow the group of employees eligible for safe harbor contributions.
- Change the type of safe harbor arrangement — e.g., from a traditional to a QACA safe harbor.
- Increase a safe harbor benefit by modifying (or adding) a formula used to determine matching contributions (including the definition of "compensation" that is used to determine matching contributions) or permitting a discretionary matching contribution. However, this prohibition will not apply if, at least three months prior to the end of the plan year, the change is adopted, the updated safe harbor notice and election opportunity are provided, and the change is made retroactively effective for the entire year.

Existing 12-month plan year exceptions unaffected

Existing guidance regarding exceptions to the 12-month safe harbor 401(k) plan year requirement is not affected by Notice 2016-16. Specifically, the following exceptions to the 12-month plan year requirement are unaffected by the notice:

- Change of the plan year, by use of a short plan year, provided that the safe harbor short plan year is preceded and followed by a 12-month safe harbor plan year.
- Adoption of a brand-new safe harbor 401(k) plan, provided there are at least three months of the plan year remaining.
- Reduction or suspension of safe harbor contributions midyear, which would require the safe harbor contribution and the ADP and ACP test.
- Midyear plan termination of a safe harbor 401(k) plan.

Examples of permissible changes

The guidance presents seven examples of permissible midyear changes, including the following two:

Example: The sponsor of a safe harbor plan makes a midyear amendment to add an age 59½ in-service withdrawal feature. The midyear change is deemed permissible if both an updated notice describing the withdrawal feature and an appropriate election opportunity are provided to the employees required to be provided with a safe harbor notice.

Example: The sponsor of a safe harbor plan makes a midyear plan amendment with two new provisions — one changing the entry date for commencement of participation of employees who meet the plan's minimum age and service eligibility requirements from monthly to quarterly and the other changing plan rules regarding arbitration of disputes. The amendment is effective with respect to employees who are not already eligible to participate in the safe harbor plan. Because the safe harbor notice is not required to include the plan entry date or information on arbitration procedures, neither an updated notice nor an additional election opportunity is required.

Should your plan offer in-plan Roth rollovers?

In conjunction with offering a Roth deferral option, plan sponsors may want to consider an in-plan Roth rollover (IRR) feature. This feature allows participants to roll over tax-deferred amounts — including pretax salary deferrals and matching and nonelective employer contributions — from their traditional 401(k) accounts into designated Roth 401(k) accounts within the plan, as well as after-tax amounts.

Which participants might benefit from a Roth 401(k)?

From the participant's perspective, the relative tax advantages of Roth versus pretax contributions will depend on individual circumstances, including age, length of time before anticipated distribution, and marginal tax rates at the time of contribution and anticipated distribution. For example, an older participant who expects to be in a lower tax bracket when plan funds are withdrawn in retirement may have little to gain from making designated Roth contributions, whereas a participant who plans on passing on the Roth assets to his or her grandchildren may have much to gain by the potential for long-term, tax-free compounding.

Which plan sources qualify for an IRR?

It depends on the plan design you select. The plan could be designed to require that IRRs are only available when a participant has a distributable event that is an eligible rollover distribution within the meaning of Internal Revenue Code Section 402(c)(4). Generally, any amounts eligible for rollover, including both vested matching and nonelective contributions, may be part of an IRR. The plan could also be designed to permit an IRR without the participant having a distributable event, provided the funds are vested. Any withdrawal restrictions on the original funds must be maintained after the IRR. An IRR may also include after-tax contributions.

Administrative considerations

Before implementing an IRR feature, consider that it will impose some additional administrative burdens on the plan.

Plan amendment. Before a 401(k) plan sponsor can amend the plan to provide an IRR feature, the plan must contain provisions permitting designated Roth contributions as well as pretax deferrals. A plan that does not otherwise have a designated Roth program is not permitted to establish designated Roth accounts solely to accept rollover contributions from nondesignated Roth accounts. An IRR may be made only if, at the time of the rollover contribution to the designated Roth account, the plan has a qualified Roth contribution program in place.

Taxation of the rollover. The IRR is treated as a taxable distribution. The taxable amount is generally equal to the fair market value of the distribution minus any basis the participant has in the distribution. Although the 20% mandatory withholding on eligible rollover distributions does not apply to an IRR, the participant should be prepared to pay the income taxes associated with the rollover.

No recharacterization. If the participant makes use of the IRR feature to convert pretax contributions to Roth contributions, such action is irreversible. In contrast, a taxpayer who completes a Roth conversion in a Roth IRA has until the tax-filing deadline, plus extensions, to reverse, or "recharacterize," the transaction.

Recapture tax. The 10% early distribution penalty does not apply to an IRR, even if the participant is under age 59½. However, if an amount allocable to a taxable IRR is withdrawn prior to the end of the fifth year after the year of the conversion — and no exception to the penalty applies, such as being over age 59½ — then the participant would owe the 10% penalty on the taxable amount of the IRR that has been withdrawn.

Notices. In the event an IRR feature is added, participants will need to receive timely notification of its availability. A plan that offers IRRs must include a description of this feature in the Section 402(f) written explanation to individuals receiving eligible rollover distributions.

Recordkeeping. Plan sponsors must have adequate recordkeeping procedures in place to administer the designated Roth accounts and to satisfy applicable Form 1099-R reporting requirements.

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RECENT developments

IRS compliance questions

The IRS announced that, since proposed 2015 IRS compliance questions on Forms 5500 and 5500-SF and Schedules H, I, and R were not approved by the Office of Management and Budget prior to publication of the forms in December, these questions should not be answered for the 2015 plan year.

The questions have been added to existing schedules to Form 5500, and address the following:

Schedules H and I:

- The plan's unrelated business taxable income (UBTI)
- In-service distributions
- Identity of plan's trustee or custodian

Schedule R:

- Nondiscrimination testing and methodology
- Plan amendments to address recent tax law changes
- Plan's domicile

Nevertheless, sponsors may want to review the questions now so they can take steps to prepare for next year, when the new questions may be required. Some could involve time-consuming documentation or internal analyses that would need to be started in advance.

To access the 2015 Form 5500, which includes the questions, visit *https://www.dol.gov/ebsa/forms.html*.

Determination letters

In IRS Announcement 2015-19, the IRS has ended the individually designed plan determination letter process known as the five-year restatement cycle, effective January 1, 2017. The last year of the five-year restatement cycle, which started February 1, 2016, and ends January 31, 2017, is the restatement window for Cycle A. Other than that, determination letters will only be issued when the plan is originally qualified and when the plan terminates or if the IRS issues a future requirement for a determination letter.