401(k) Plan Tip Sheet – How to Avoid IRS Qualification Failures

The top 10 qualification failures from recent IRS exams are listed below, along with tips on how to avoid them:

1) **Failure to properly amend the plan**

This is the most common issue that the IRS finds in its examinations of 401(k) plans. Laws related to retirement plans change frequently and there are statutory deadlines for which many provisions must become effective. Plan language and operation of plans need to change to comply with new laws.

Tip: The best way to avoid this type of failure is to obtain and review the list of required plan amendments that is published annually and use a calendar (tickler) that notes when amendments must be completed. The plan document should also be reviewed annually to ensure that all required amendments have been adopted. Another best practice is to update the IRS determination letter at least every 3 years.

2) **Failure to follow plan definition of compensation**

Tip: Compensation is defined in the plan document. Read and refresh your memory on this definition annually and review payroll records early in the year to validate that contributions are being calculated based on the correct wage base and in a manner consistent with the plan document.

3) **Failure to include eligible employees or failure to exclude ineligible employees**

Tip: Eligibility requirements are also defined in the plan document. Read and refresh your memory on this definition annually. Review the first quarter trust or custodian statements, select a sample of new participants and validate that they have met the appropriate eligibility requirements. Also, review the correspondence between HR and new hires to validate that the correct eligibility requirements are communicated to employees.

4) **Failure to properly calculate matching contributions**

Tip: This plan failure can be detected and prevented by reviewing the plan document at least annually to determine the correct matching contribution formula and comparing it to what is used in operation.

5) **Failure to satisfy loan provisions**

Tip: Review and follow the plan provisions related to loans, including the amount of loan, term of the loan and repayment terms. Make sure there are procedures in place to prevent loans that are prohibited transactions. Another good control is to review all outstanding loans at least annually to ensure the loans comply with the plan's terms and that the employees are repaying their loans timely. Many plan sponsors develop and follow a loan policy that is separate from their plan document to ensure that loans are made and administered properly.

6) **Impermissible in-service withdrawals**
Tip: Be familiar with your plan document's hardship provisions. Implement procedures to ensure you follow the provisions in operation and ensure that your plan administrators and payroll offices share the plan's hardship distribution information.

Another good control is to review all in-service distributions annually in order to determine that they met the plan's hardship requirements. (Sadly – needing a new bike or pair of skis is not considered a hardship.)

7) **Failure to satisfy minimum distribution rules**
401k Minimum Required Distributions (MRDs) are established by the Internal Revenue Code to make sure that retirees actually withdraw their money upon retirement (and use it for their day to day expenses) as opposed to passing on this wealth to their heirs. Every year, you must take the MRD at or before December 31st and failure to do so will result in penalties and taxes.

Tip: Ensure that the plan administrator has determined the minimum amounts required to be distributed to participants each calendar year. Information to help the administrator calculate the minimum distribution amount is included in IRS Publication 575, Pension and Annuity Income.

8) **Failure to pass ADP/ACP nondiscrimination tests**
Tip: Consider a safe harbor plan to avoid issues in this area. If you do not have a safe harbor plan, communicate with the plan administrator to ensure proper employee classification and consider performing an annual review to determine if highly compensated and non-highly compensated employees are properly classified.

9) **Failure to properly provide top heavy contributions**
Tip: Review the rules and definitions for top-heavy found in your plan document. Then perform a top-heavy test and make a determination whether your plan is top-heavy for the year.   If the plan is top-heavy, work with plan administrators to ensure that top heavy contributions are made as necessary.

10) **Exceeding annual contribution limits**
The IRC 402(g) limitation is the maximum annual amount of deferrals that an individual can make to a 401(k) plan. The limit was $16,500 in 2010 (and remains the same in 2011).

Tip: Ensure that payroll service providers have controls in place to stop contributions once participants reach the annual limits. Another control is to perform a review of participant accounts right after the end of the year to validate that limits were not exceeded.

If you have questions about any of the failures listed above or suspect that your plan might have issues, give K Financial a call at (303) 665-8060 and we can help. The IRS has published a "Fix-It Guide" which addresses several of the plan failures identified above. You can download it for free at www.IRS.gov.

If you would like more information about K Financial's employee benefit plan audit practice or a fee quote for your 401(k) plan audit, please email Jamie@kfinancial.com. We will likely be able to reduce your audit fee and improve the level of service you receive at the same time.