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Freedman Benefits news

Correcting missed required minimum distributions

Internal Revenue Code (IRC) Section 401(a)(9) requires every qualified plan to provide required minimum distributions (RMDs) as soon as a participant reaches his or her required beginning date (RBD). Generally, the RBD is April 1 of the year after the participant reaches age 70½, though it may be later if a non-5% owner continues to work after age 70½. If an individual worked at seven jobs during his or her career and left money in seven different 401(k) plans, each plan is required to distribute RMDs to the individual. In the event of a participant's death, the plan is required to follow the minimum distribution requirements for beneficiaries.

Failure to distribute an RMD may result in plan disqualification and/or the imposition of a 50% excise tax on the participant or beneficiary. This article will explain the correction process that is available when a qualified plan fails to timely distribute an RMD.

Missed RMDs from qualified plans

Mistakes can happen. For example, an employee's date of birth may be incorrectly recorded in the recordkeeping system, inadvertently causing the employer and plan administrator to be unaware of the year that the employee attained age 70½. Or an employee's data may have been lost in an implementation, merger, or acquisition.

Upon discovery of a missed RMD, all appropriate steps should be taken to remedy the situation as soon as possible. Specifically, RMDs should be calculated for all years since the participant attained age 70½ and — to the extent the RMDs were not distributed — immediately distributed along with calculated earnings. If the employer files under the IRS's Voluntary Correction Program (VCP), the employer may request that the IRS waive the excise tax imposed on the missed RMDs.

Excise tax

As noted, a participant or beneficiary who does not receive a full RMD for a distribution calendar year is subject to an excise tax of 50% on the underpayment pursuant to IRC Sec. 4974. For example, assume an RMD is calculated to be $3,200 for 2015, but the participant received only $2,000. The underpayment of $1,200 is subject to the 50% penalty,

so a penalty of $600 must be added to the participant's taxes due for 2015. The $1,200 still has to be withdrawn, subject to income taxes (assuming the entire distribution consists of pretax funds). The participant files IRS Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, with his or her federal income-tax return for the year in which the error occurred.

Asking for waiver of the 50% penalty due to reasonable cause

If there was a reasonable cause for the failure to take the RMD, the individual

(Continued on page 2)

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2016 COLA limits

The IRS has released the cost-of-living adjustments (COLAs) applicable to the dollar limitations for pension plans (and other items) for the 2016 tax year. Many of the limits remained the same as they were for 2015.

IRS limits	2016	2015
401(k), SARSEP, 403(b), and 457 plan deferrals/catch-up	$18,000/ $6,000	$18,000/ $6,000
SIMPLE plan deferrals/catch-up	$12,500/ $3,000	$12,500/ $3,000
Compensation defining highly compensated employee*	$120,000	$120,000
Compensation defining key employee/officer	$170,000	$170,000
Defined benefit plan limit on annual benefits	$210,000	$210,000
Defined contribution plan limit on annual additions	$53,000	$53,000
Maximum compensation limit for allocation and accrual purposes	$265,000	$265,000
Individual retirement account (IRA) contributions/catch-up	$5,500/ $1,000	$5,500/ $1,000
SEP minimum compensation for an allocation	$600	$600
QLAC maximum	$125,000	$125,000
SSA compensation limit	$118,500	$118,500

* 2015 amount for use in 2016 plan year tests

Traditional IRA: AGI phaseout range for deduction		
Active participants filing a joint return (or a qualified widow(er))	$98,000 to $118,000	$98,000 to $118,000
Single or head-of-household	$61,000 to $71,000	$61,000 to $71,000
Married couples filing separately	$0 to $10,000	$0 to $10,000
Taxpayer not active participant, spouse is active participant	$184,000 to $194,000	$183,000 to $193,000
Roth IRA: AGI phaseout range for eligibility to contribute		
Married taxpayers filing a joint return (or a qualified widow(er))	$184,000 to $194,000	$183,000 to $193,000
Single taxpayers	$117,000 to $132,000	$116,000 to $131,000

Correcting missed required minimum distributions

(Continued from page 1)

may ask for the penalty to be waived on Form 5329. The IRS will review the information provided and decide whether to grant the request for the waiver.

Automatic waiver for certain beneficiaries

An automatic waiver may be available in situations where an individual is the sole beneficiary of a participant's benefit or of a separate share. If the amounts are payable under the life expectancy method and a payment is missed during the first five years, the excise taxes are waived if the total death benefit is paid under the five-year rule.

Correcting RMD failures using the Employee Plans Compliance Resolution System (EPCRS)

The EPCRS provides a streamlined procedure for correcting missed RMDs using Form 14568-H, *Appendix C Part II Schedule 8, Failure to Pay Required Minimum Distributions Timely under §401(a)(9)*. As part of the VCP submission, the plan sponsor is able to request the waiver of the participant level excise tax imposed under IRC Sec. 4974.

Fee schedule for RMD failures

IRS Revenue Procedure 2015-27 recently updated the VCP fee for missed RMDs, amending it to $500 for missed RMDs involving 150 or fewer participants. The compliance fee is $1,500 when 151 to 300 participants are involved. If more than 300 participants failed to receive RMDs, the IRS's general fee schedule, which is based on the number of participants in the plan, will be used.

Correction includes distribution of missed RMDs plus earnings

In a defined contribution plan, the permitted correction method is to distribute the missed RMDs with earnings from the date of the failure to the date of the distribution. If more than one year's RMD has been missed, the amount required to be distributed is the RMD for each year, starting with the year in which the initial failure occurred. Amounts are determined by dividing the adjusted account balance on the applicable valuation date by the applicable distribution period and then calculating the earnings for each missed RMD.

Example: A defined contribution plan missed an individual's RMDs for 2013, 2014, and 2015.

The missed RMD for 2013 would be calculated as follows:

- December 31, 2012,
  fair market value (FMV) $100,000 ÷ 25.6 (age 72) = $3,906.25*

The missed RMD for 2014 would be calculated as follows:

- December 31, 2013,
  FMV $108,000 – $3,906.25 ÷ 24.7 (age 73) = $4,214.32*

The missed RMD for 2015 would be calculated as follows:

- December 31, 2014,
  FMV $115,000 – $3,906.25 – $4,214.32 ÷ 23.8 (age 74) = $4,490.73*

* Gains/losses are calculated on each RMD from the date the funds should have been distributed until the actual distribution date.

The ADP test

Congress has devised several types of nondiscrimination tests designed to prevent qualified retirement plans from favoring highly compensated employees (HCEs) by more than *de minimis* amounts. The first test to perform is the coverage test, which ensures that the plan benefits a sufficient number of non-highly compensated employees (NHCEs). Once the coverage test is passed — or, if the test is not passed, once the necessary steps have been taken to correct the failure — then the average deferral percentage (ADP) test may be performed. The ADP test is designed to ensure that HCEs do not receive a disproportionate benefit.

Both the coverage test and the ADP test are performed annually. These tests entail the use of mathematical formulas to compare the eligibility and contribution rates of HCEs and NHCEs and to determine whether the plan is discriminating in favor of the HCEs.

Who is an HCE?

Generally, an HCE is an employee who is either:

- A more-than-5% owner of the business (also known as a 5% owner) in the year of testing or the prior year, or
- Someone who earned more than $80,000 in compensation in the prior year, as adjusted annually for cost-of-living increases. Currently, the cost-of-living adjustment limit is $120,000.

It is possible to further limit the number of HCEs to those in the top 20% pay group (which may be a particularly effective tactic in small plans, such as those used by law firms and physicians).

All in the family

The 5%-owner rule requires careful review of the ownership attribution rules for families and trusts. Based on their relationship, an owner is deemed to share in the interests held by certain other family members. The family members taken into consideration for purposes of determining attribution of ownership include spouses, parents, children (including adopted children) regardless of age, and grandchildren. *Not included* are siblings, grandparents, and in-laws.

Here's an example of how the family attribution rules work: If a husband and wife each work for a firm and the husband is actually the sole owner, the wife would also be considered a 100% owner of the business and, thus, an HCE.

Performing the test

To perform the ADP test, first determine all the employees who were eligible to make elective deferrals. It does not matter if an employee actually *made* a deferral but only whether the employee was eligible. Divide the eligible employees into HCEs and NHCEs. Then, starting with the NHCEs, determine each employee's actual deferral ratio (ADR) by dividing the employee's compensation into the amount he or she deferred. Employees who were eligible but did not defer are included in this calculation at 0%. Once each employee's ADR is determined, the ADRs are averaged to arrive at the ADP for all NHCEs. Here's an illustration:

NHCE	Compensation	Deferral	ADR
1	$70,000	$4,000	5.71%
2	$28,000	$0	0%
3	$30,000	$800	2.67%
4	$10,000	$0	0%
5	$47,000	$2,000	4.26%
NHCE ADP	(5.71% + 0% + 2.67% + 0% + 4.26%) = 12.6 ÷ 5 = **2.53%**		

The same process is used to arrive at the ADP for all HCEs.

For a plan to pass the ADP test, the amount by which the HCE ADP exceeds the NHCE ADP is limited. The limits may be summarized as follows:

NHCE ADP	Maximum HCE limit
0 to 2%	NHCE limit × 2
2% to 8%	NHCE limit + 2
> 8%	NHCE limit × 1.25

For the plan in our example to pass the ADP test, HCE ADP is limited to 2.53% (NHCE ADP) plus 2% for a maximum of 4.53%.

Timing the test

In general, the ADP test must be completed within two and a half months following the end of the plan year. The test must be made using the *entire* year's compensation and deferrals and, thus, cannot be completed before year-end. It is in the best interest of the employer and plan recordkeepers to complete the test within the allotted period so the employer has time to make any refunds or contributions that may be required to remedy a failed test. There is no penalty for failing the ADP test as long as required refunds are timely processed or additional contributions are made to the plan to remedy the failure. A 10% excise tax penalty is due on late refunds (principal amount only and not earnings) made after the two-and-a-half month period.

Other factors

This is the big picture of how the ADP test is done. There are a variety of additional factors to be taken into consideration when deciding which testing methods may lead to the most favorable results.

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RECENT developments

Changes at the IRS

The IRS will no longer answer either Employee Plans (EP) related e-mail questions or questions referred to them by the IRS customer service phone center. Due to the realignment of legal work and the reassignment of a number of the IRS's EP employees to the Office of the Associate Chief Counsel, the IRS's EP area no longer has the resources to do research and provide answers for legal topics. Effective October 1, 2015, the IRS's EP area ceased accepting technical questions through e-mail. The Private Letter Ruling process may be used to ask the IRS to address a particular fact set.

Basic information about EP forms and the status of pending applications may be obtained by calling 877-829-5500.

VCP submission kits

The IRS provides voluntary correction program (VCP) submission kits to guide plan sponsors who are making certain VCP submissions. Submission kits can be found at *www.irs.gov/Retirement-Plans/Correcting-Plan-Errors---VCP-Submission-Kits*. There are currently four VCP submission kits:

- A money purchase and target benefit plans kit — for plan sponsors who failed to make timely required contributions
- A 403(b) missing plan document kit — for plan sponsors who missed the December 31, 2009, document deadline
- A missed preapproved defined contribution Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) restatement kit
- A missed preapproved defined benefit EGTRRA restatement kit

IRS self-audit

The IRS has created a *Policies, Procedures and Internal Controls Self-Audit* web page to provide plan sponsors with methods for evaluating whether strong internal controls are in place to ensure a plan is operating properly. The web page can be found at *www.irs.gov/Retirement-Plans/Policies,-Procedures-and-Internal-Controls-Self-Audit*.

The general information provided in this publication is not intended to be nor should it be treated as tax, legal, investment, accounting, or other professional advice. Before making any decision or taking any action, you should consult a qualified professional advisor who has been provided with all pertinent facts relevant to your particular situation.

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