1) **Has your plan document been updated within the past few years to reflect recent <u>law changes</u>?**

If your plan has not been updated to reflect EGTRRA, the plan needs to be revised.

Laws related to retirement plans change frequently. Ten major changes in the past 25 years and numerous smaller changes mean that what worked in the past may not work today. Or law changes might mean you can simplify some areas of plan administration or improve benefits. Changes to pension law in the future are a good bet. Plan language and operation will need to be changed to keep the plan within the law and to take advantage of increased benefit limits.

Knowing your plan has been properly updated may not be a simple process. Certain plans must be individually amended for each change, while others may have a specimen document that is amended. We recommend you maintain contact, on at least a yearly basis, with the company that sold you the plan. If they send you a set of amendments to formally adopt, make certain you timely execute the documents per their instructions. Keep signed and dated copies of your plan document and any amendments.

At some point in the plan's existence, it's likely you'll be asked to demonstrate your plan has been in compliance with current and prior law. This request may come from a financial institution, third party administrator (TPA), or other plan servicer attempting to do their job. Or it may come from the IRS during an audit or if you file a Determination Letter request. We will ask you to demonstrate the plan has been in compliance with all current and prior law, sometimes reaching back ten years or more. Following is a list of documents you should keep in order to prove the plan has been timely amended:

- Original plan document.
- All subsequent amendments or restatements to the plan document.
- All Adoption Agreements - Some plans will have an adoption agreement to go with the basic plan document.
- Any Opinion Letter or Advisory Letter issued by the Service.
- Any Determination Letter issued by the Service.
- Board of Director's Resolutions and Minutes, or similar records related to the plan.

The most recent law making major changes to 401(k) plans was the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Generally effective for plan years beginning after 12/31/2001, EGTRRA brought a host of changes intended to simplify plan administration while improving benefits. Among the EGTRRA changes are:

- Tax credits for plan start-up costs
- Tax credits for contributions toward retirement for some low-income participants
- Catch-up contributions for participants age 50 and over
- Increased contribution limits
- Increased compensation limits
- Higher deduction limits

Now comes the hard part. Certain portions of EGTRRA were required to be adopted, while certain provisions were optional. These required provisions should have been adopted starting in 2002 with Good Faith amendments. Optional provisions required an amendment by the end of the plan year in which those provisions were used in the operation of the plan; also via a Good Faith amendment. Plans meeting EGTRRA by adopting these Good Faith amendments received an extended remedial amendment period before they have to be completely restated for these EGTRRA changes.

Prior to EGTRRA, there was GUST. GUST is a grouping of major and minor law changes combined into one extended remedial amendment period with varying effective dates depending on the type of plan you have. And don’t forget about the required 401(a)(9) amendment. Due to the complicated nature of this discussion, we won’t provide the details here. It’s likely your plan should have been amended several times in just the last five years. We recommend you contact the person who sold you the plan to discuss the status of your plan document.

If you find your plan hasn’t been amended timely for the various law changes, you may be a non-amender. You’re not alone. Non-amenders are the number one issue seen by our agents on audit, in determination letter requests, and in our Voluntary Compliance operation. What can you do? Our Voluntary Compliance group may be able to help. By paying a small sanction, it’s possible to bring your plan back into compliance and even reestablish an extended EGTRRA remedial amendment period. Visit the Voluntary Compliance section of our website for more information or contact your benefit professional.

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2) Have you notified the people who service your plan of any plan changes?

Notify plan servicers right away with any changes in the form or operation of your plan, including acquisition or ownership changes affecting the employer.

The plan sponsor/employer is ultimately responsible for keeping the plan in compliance with applicable tax laws; however, there may be many different employees, vendors, and tax professionals who service your plan. This retirement team may include more than a dozen people in a large plan or as few as one in a small plan.

Any changes made to your plan document or to the operation of your plan should be conveyed to everyone providing service to your plan. For example, assume your plan document is amended to change the definition of compensation. That change should then be communicated to all persons involved in determining deferral amounts to be withheld from the participant's pay, performing your plan's ADP and ACP tests, or allocating employer contributions. Communication among the people who service your plan is essential for a compliant plan.

a. If you made any changes to your plan document, all persons who service your plan should be informed of those changes and what they mean to the operation of your plan
b. If you amend your plan document, you should also amend your summary plan description (SPD). If a plan is materially modified, a summary of the material modifications (SMM) must be given to the plan participants within 210 days after the end of the plan year in which the modification was adopted.
c. If you've changed the way you operate your plan, those changes should also be communicated to the persons providing service to your plan. You may need to reflect these changes in your plan document through a plan amendment.
d. If you've changed the trustees for your plan, those changes also need to be conveyed and your plan document and SPD may need to be updated.
e. Any changes in the ownership interests may affect the discrimination testing for the plan and should be conveyed to your plan servicers.
f. An acquisition of a company should be shared with your plan servicers. The addition of another company under the employer's umbrella may affect plan coverage and discrimination tests, along with which employees become participants in the plan.

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3) Is your plan's operation based on the definitions and requirements (terms) written in your plan document?

Failure to follow the terms of the plan is a common problem encountered on audit.

Operation of your plan must conform to the terms of the plan document. The plan document defines what are employees and employers, how to become a participant, and how much and what compensation is used for allocations under the plan, for limitations, discrimination tests, etc. Your plan document also describes how contributions are limited, what discrimination tests must be performed, and explains how and when accounts may be distributed. Most everything you need to know to operate your plan should be contained in the plan document.

That being said, it's not unusual for an employer to have difficulty finding an up to date copy of their plan document. Many times an employer may have a "cheat sheet" listing some plan requirements, rarely consulting their document. Over time, as changes are made to the plan document, the persons in charge of the plan's day-to-day operation continue to operate the plan as they've done for many years. In this scenario, the plan may not be operating in accordance with the plan document.

Plan sponsors need to review the plan document on a yearly basis to ensure it conforms to the plan's operation and applicable tax rules.

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4) Were all eligible employees identified and given the opportunity to make an elective deferral election?

By supplying your third party administrator (TPA) or advisor with information regarding all employees who receive a Form W-2, you may reduce the risk of omitting eligible employees.

Your plan document contains a specific definition of *employee* and provides requirements for when those employees become plan participants eligible to make salary deferrals into your 401(k) plan. Employers sometimes assume certain employees, such as part-timers, are not covered by the plan. Similarly, employees who elect not to make salary deferrals are often mistakenly treated as ineligible employees. To reduce the risk of omitting eligible employees, the persons servicing your plan should be provided with a list of all employees employed during the year, along with dates of birth, dates of hire, dates of termination, number of hours worked, compensation for the plan year, 401(k) election information, and any other information necessary to properly administer the plan.

Generally, each employee who receives a Form W-2 should be treated as an eligible employee unless they can be properly excluded by the plan's terms. Using the plan's definition of eligible employee along with the plan's age and service requirements, a determination of eligibility should be made for each employee receiving a Form W-2. That can be a fairly simple process; however, if the employer uses leased employees, contract labor, or has shared ownership of other enterprises, determining eligible employees can become very complicated. If you find yourself in one of these complex situations, please seek a retirement plan professional to help with the determination of who is eligible for your retirement plan.

In addition to identifying eligible employees, they must also be given the opportunity to make a salary deferral election. You should have procedures in place to notify these employees of their eligibility and how and when they may participate.

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5) Is the plan's definition of compensation used for all deferrals and allocations?

Because your plan may use different definitions of compensation for different purposes, it's important that you apply the proper definition in a consistent manner when dealing with deferrals and allocations.

A plan's definition of compensation must satisfy applicable rules for the purpose of determining the amount of contributions. This compensation cannot exceed $220,000 in 2006, and is subject to cost-of-living adjustments for later years. The definition of compensation stated in the plan document must be followed in the operation of the plan. Compensation generally includes the pay a participant received from the employer for personal services for a year including:

1) Wages and salaries.
2) Fees for professional services.
3) Other amounts received (cash or non-cash) for personal services actually rendered by an employee, including, but not limited to, the following items.
    a. Commissions and tips
    b. Fringe benefits.
    c. Bonuses.

Plan sponsors may not be aware their plans contain different definitions of compensation for different plan purposes. In some cases, the sponsor or administrator will use the incorrect definition of compensation when determining the compensation eligible to be deferred, computing the matching contribution, and when calculating the ADP or ACP test. We also see plans where the plan administrator fails to limit the definition of compensation as required under IRC section 401(a)(17).

Plan sponsors and administrators need to be familiar with the terms of the plan document to ensure they use the proper definition of compensation for contributions, limitations, and nondiscrimination testing purposes. It is important to know (i) whether certain types of compensation are excluded, (ii) whether compensation is limited for certain purposes, and (iii) if compensation is determined using different computation periods (e.g., plan year vs. calendar year).

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6) **Have you timely deposited employee deferrals each pay period?**

You are required to deposit deferrals as soon as they can be segregated from the employer's assets. Most employers deposit salary deferrals when making payroll tax deposits.

The employer makes contributions to the trust for the amounts of the salary deferrals made by the plan's participants. Department of Labor rules require that contributions be made on the *earliest date that the plan sponsor is able to segregate the amounts from the employer's general assets.* This can usually be done on the date that the employee's paycheck is issued. In no event can the amount be deposited later than the 15th day of the following month. Keep in mind that the rules regarding the 15^{th} day of the following month do not provide a safe harbor for depositing deferrals. Rather, it sets the maximum deadline. A deposit not made timely is treated as a use of trust assets by the employer and constitutes a prohibited transaction. Prohibited transactions are subject to a 15% excise tax payable here at the IRS. In both instances, a Form 5330 may be required to be filed.

Even though correction of this prohibited transaction, along with the excise tax for deposits being a few days late may be small, the costs associated with calculating lost earnings and allocating those amounts may be substantial. This Department of Labor rule does not provide for a de minimis exception, so move those salary deferrals into a plan account as soon as possible! Not only will timely deposits keep your plan in compliance, lost earnings for contributions that are just a week late may become substantial over the working lifetime of a participant.

Contributions made by the employer to match part or all of the participant's salary deferral may be made at the time of the salary deferral contribution or later, but in no event later than the due date of the employer's income tax return, including extensions. Contributions made by the employer that are not tied to salary deferral amounts must be made no later than the due date of the employer's income tax return, including extensions. Review your plan document for the timing and amount of your matching contributions and other employer contributions.

If you haven't been depositing employee deferrals timely, the Department of Labor's Employee Benefits Security Administration (EBSA) has a Voluntary Fiduciary Correction Program available for late deposits. For more information, visit www.dol.gov/ebsa/vfcp.

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7) **Have you identified all your highly compensated employees and key employees, including owners and their family members, so that your TPA can perform your nondiscrimination tests**?

Failure to provide this information prevents your TPA from properly performing your nondiscrimination tests.

An important aspect of performing the ADP and ACP tests is to properly identify the highly compensated employees (HCEs). HCEs are defined under Internal Revenue Code (IRC) section 414(q) and generally include any employee who was either:

- A 5% owner at any time during the year or preceding year,
- For the preceding year had compensation from the employer in excess of $100,000 (for 2006) and, if the employer elects, was a member of the top-paid group (top 20%) of employees.

To properly determine if the plan is top heavy, it's important to identify key employees. A key employee is an employee (including former or deceased employees), who at any time during the prior plan year was:

- An officer whose annual compensation from the employer exceeds $140,000 (2006); or
- An employee owning more than 5% of the employer; or
- An employee owning more than 1% of the employer, and whose compensation exceeds $150,000 for the plan year.

Remember when you're determining ownership interests, family aggregation rules apply. These family aggregation rules may affect the treatment of stock owned directly or indirectly by family members. Any individual who is a spouse, child, grandparent, or parent of someone who is a 5% owner, or who together with that individual would own more than 5% of a company's stock, is treated as a 5% owner. As a 5% owner, each of these individuals would also be considered HCEs and key employees for the plan year. It's important to identify the family ownership interests of all company stock and to forward that information to the TPA, advisor, or persons performing the appropriate nondiscrimination tests.

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8) **Have the 401(k) <u>nondiscrimination tests</u> (ADP, ACP, and Top Heavy) been performed counting all eligible employees?**

You may not need to - find out how a safe harbor 401(k) plan may allow you to completely avoid these tests.

There are only a few situations in a 401(k) plan that would permit an employer to avoid performing the 401(k) nondiscrimination tests (ADP and ACP).

- Your plan contains only properly identified highly compensated employees and no non-highly compensated employees, or
- Conversely, your plan contains only properly identified non-highly compensated employees and no highly compensated employees, or
- Your plan is a safe harbor 401(k) plan, or
- Your plan is a SIMPLE 401(k) plan.

All 401(k) plans that do not meet one of the exceptions must perform the proper 401(k) nondiscrimination tests. Plans that fail to perform the required nondiscrimination tests have not met an important responsibility. Many times, this occurs when the employer has no one in the company responsible for conducting the nondiscrimination testing or ensuring the testing is conducted each year by a third-party administrator.

Plan sponsors/employers shoulder ultimate responsibility for ensuring the plan operates in compliance with the rules under IRC sections 401(k) and 401(m). Practices and procedures should be in place to ensure all required nondiscrimination testing is properly completed.

When conducting the ADP and/or ACP tests, certain plan participants are often incorrectly excluded. When identifying eligible employees for the ADP/ACP tests, plan administrators often incorrectly exclude part-time employees, employees who begin or terminate participation during a plan year, employees who are only eligible for a short time during the plan year, or those who simply choose not to defer.

The plan administrator must include all eligible employees for purposes of ADP and/or ACP testing. Eligible employees include all employees who are directly or indirectly eligible to make a cash or deferred election under the plan for all *or a portion* of the plan year. This means that an employee who can defer at any time during a plan year must be included in the testing, including part-time employees who satisfy the eligibility requirements.

Employees with a W-2 that are not on the ADP/ACP tests should be reviewed to determine if they have been properly excluded, using the plan's definition of eligible employee along with the plan's age and service requirements. That simple step will lead to a more compliant plan. Again, if the employer uses leased employees, contract labor, or has shared ownership of other enterprises, determining eligible employees can become very complicated and may require the help of a benefits professional.

If you would like to avoid the complexities of the ADP and ACP tests, a safe harbor 401(k) plan may be right for you. A safe harbor plan provides many benefits for the employer:

- No ADP or ACP testing requirement.
- Reduced administrative costs will offset some of the costs associated with the required matching or non-elective contribution.
- Highly compensated employees may contribute up to the IRC section 402(g) limit ($15,000 for 2006) no matter what amounts were contributed by the rank-and-file employees.

Under a safe harbor plan, two different contribution formulas are available to satisfy the safe harbor.

- Matching Formula – A formula that is at least as good as: An employer matches 100% of salary deferrals up to 3% of compensation and then 50% of salary deferrals on the next 2% of compensation, or
- Non-elective Formula - Alternatively, an employer may make a non-elective contribution of at least 3% of each eligible employee's compensation.

Remember, under the Matching Formula, the match is made for all eligible employees who choose to make a salary deferral. Under the Non-elective Formula, all eligible employees receive the non-elective contribution, regardless of whether they choose to make a salary deferral.

A safe harbor plan may avoid the ADP and ACP tests, but not without some additional complexities. Here are just a few of the new requirements a safe harbor plan must follow:

- Plan document must include safe harbor plan language.
- Eligible participants must receive written notice 30 days prior to the beginning of the plan year that the plan is intended to be a safe harbor plan for the coming plan year. This notice must be provided for each year the plan will be a safe harbor plan.

- An allocation requirement such as 1,000 hours of service or employment on the last day of the plan year may not be imposed on safe harbor contributions.
- Safe harbor contributions are always 100% vested.
- Safe harbor contributions may not be eligible for in-service withdrawals prior to age 59 ½.
- An ongoing 401(k) plan may only be amended to a safe harbor plan for the beginning of the next plan year.

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9) Have you filed a Form 5500 series return, and have you distributed a Summary Annual Report (SAR) to all plan participants this year?

Responsibility for filing the Form 5500 and distributing the SAR lies with you, the plan sponsor.

A common explanation for not filing a Form 5500 series return is that the plan administrator thought the TPA, the financial institution, or the CPA were taking care of it. The plan sponsor has responsibility for filing the return; although, most have someone else prepare it. Make certain you know who is doing this, that it is being done, and that it is being timely filed.

Under the Employee Retirement Income Security Act (ERISA), plan administrators are required to submit reports to government agencies and furnish certain plan information to participants. A Form 5500 return is generally required to be filed each year for an employee benefit plan subject to ERISA. Virtually every qualified retirement plan, such as a 401(k), is required to file this return. For an expanded explanation of how to file your Form 5500 return, along with the EFAST electronic filing requirements, please visit www.efast.dol.gov. For a quick look at the different tax returns a 401(k) plan may be required to file, visit http://www.irs.gov/retirement/sponsor/article/0,,id=151928,00.html.

In addition to the Form 5500, certain other plan information must be made available to participants. Following is a list of documents that must be furnished to participants and beneficiaries:

- **Summary Plan Description (SPD)** – This plain language explanation of the plan must be comprehensive enough to apprise participants of their rights and responsibilities under the plan. Among other things, the SPD must include information about:
    - When and how employees become eligible to participate,
    - The source of contributions and contribution levels,
    - Vesting – the length of time an employee must be in the plan to receive benefits,
    - How to file a claim for those benefits,
    - Participant's basic rights and responsibilities under ERISA.

  This document must be given to employees after they join the plan and to beneficiaries after they first receive benefits. SPDs must also be redistributed periodically and provided on request.

- **Summary of Material Modification (SMM)** – Apprises participants and beneficiaries of changes to the plan or to information required to be in the SPD. The SMM or an updated SPD must be provided to the participants and beneficiaries within 210 days after the end of the plan year in which the change was adopted.

- **Summary Annual Report (SAR)** – Outlines in narrative form the financial information in the plan's Annual Report, the Form 5500, and must be furnished annually to participants.

- **Individual Benefit Statement** – Provides participants with information about their account balances and vested benefits. For plans sponsored by a single employer, the statement must be provided when a participant submits a written request, but no more than once in a 12-month period, and automatically to certain participants who have terminated service with the employer.

- **Blackout Period Notice** – For profit sharing and 401(k) plans, requires at least 30 days (but not more than 60 days) advance notice before a plan is closed to participant transactions. During blackout periods, participants and beneficiaries cannot direct investments, take loans, or request distributions. Typically, blackout periods occur when plans change recordkeepers or investment options, or when plans add participants due to a corporate merger or acquisition.

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10) **Are elective deferrals limited to the amounts under IRC 402(g) for the calendar year?**

Elective deferrals are limited to $15,000 for 2006, including any designated Roth contributions made by participants, and exclusive of any catch-up contributions.

Roth 401(k)

Beginning in 2006, a 401(k) or 403(b) plan (but not a SARSEP or SIMPLE IRA plan) may permit an employee to irrevocably designate some or all of his or her elective contributions under the plan as designated Roth contributions. The plan must contain language that allows for these Roth contributions. Notice 2006-44 provides a sample plan amendment for sponsors, practitioners, and employers (plan sponsors) who want to provide for designated Roth contributions in their section 401(k) plans. The sample amendment will help those plan sponsors comply with the requirement to timely adopt a discretionary amendment by the end of the plan year in which the amendment is effective.

Designated Roth contributions are elective contributions that, unlike pre-tax elective contributions, are currently includible in gross income. If a 401(k) plan is going to provide for designated Roth contributions, it must also offer pre-tax elective contributions.

A **designated Roth account** is a separate account under a 401(k) or 403(b) plan to which designated Roth contributions are made, and for which separate accounting of contributions, gains, and losses is maintained.

Designated Roth contributions are treated the same as pre-tax elective contributions for most purposes, including:

- The annual individual elective contribution limit (aggregate of all designated Roth contributions and traditional, pre-tax contributions) - $15,000 in 2006, with an additional $5,000 if age 50 or over, and subject to cost-of-living adjustments for future years,
- Determining the maximum employee and employer annual contributions - the lesser of $44,000 or 100% of compensation for 2006 and subject to cost-of-living adjustments thereafter (Code section 415),
- Nondiscrimination testing,
- Required distributions (Code section 401(a)(9)), and
- Code section 404 - Elective deferrals not taken into account for purposes of deduction limits.

A **qualified distribution** of designated Roth contributions is excludable from gross income. A qualified distribution is one that occurs at least 5 years after the year of the participant's first designated Roth contribution (counting such first year as part of the 5) and is made:

- On or after attainment of age 59½,
- On account of the participant's disability, or
- On or after the participant's death.

If the distribution is not a qualified distribution, then the accumulated earnings will be subject to tax, and additional taxes may apply. Designated Roth accounts are subject to the same required minimum distribution rules as other accounts. Funds in Roth 401(k) accounts may be rolled over to another Roth 401(k) account or a Roth IRA, but not to any other account in a plan or to a traditional IRA.

Designated Roth contributions are permitted under Code section 402A, which was added to the Code by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16, 115 Stat. 38) (EGTRRA). Final Regulations under section 401(k) on designated Roth contributions were published on January 3, 2006, with an effective date of January 1, 2006. Proposed Regulations addressing distribution, taxation, rollover and recordkeeping of designated Roth contributions were issued on January 26, 2006. These proposed regulations generally have an effective date of January 1, 2007.

Automatic enrollment is permitted with designated Roth contributions just as with pre-tax elective contributions.

Forfeitures and matching contributions may not be allocated to a designated Roth account. Designated Roth contributions are subject to the nonforfeitability and distribution restrictions applicable to other elective contributions and may serve as the basis for a participant loan.

Comparing designated Roth contributions with Roth IRA contributions: While designated Roth contributions bear some similarity to Roth IRA contributions (Code section 408A), there are several differences between the types of contributions, including:

- Designated Roth contributions are not limited by income.
- A pre-tax elective contribution account may not be converted to a designated Roth account.
- Designated Roth contributions do not have the specific ordering rules for distributions that apply to Roth IRAs.

Additional Resources for Roth 401(k):

Designated Roth Accounts FAQs
Comparison Chart
Notice 2006-44
CODA List of Required Modifications (LRMs)
Roth 401(k) final regulations
Proposed regulations under sections 402(g), 402A, 403(b) and 408A relating to designated Roth accounts
Roth 401(k) and Tips - 2006 IRS Nationwide Tax Forum presentation

IRC 402(g) Limits

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

- Elective deferrals are limited to $15,000 for 2006.
- This limit is subject to cost-of-living increases after 2006.

Generally, all elective deferrals made by a participant to all plans in which they participate must be considered to determine if the dollar limits are exceeded. Elective deferrals also include amounts deferred as designated Roth contributions.

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

- SIMPLE 401(k) deferrals are limited to $10,000 for 2006.
- This limit is subject to cost-of-living increases after 2006.

General rules for 401(k) plans provide for the dollar limits described above; however, the amount a plan participant is entitled to defer is also subject to other limits as described in the plan document. For example, a plan document may place its own lower limit on the amount of the deferral or on the percentage of pay that may be deferred. Additionally, the plan may need to further limit a plan participant's elective deferrals in order to meet certain nondiscrimination requirements.

Catch-up Contributions

A 401(k) plan may permit participants who are age 50 or over at the end of the calendar year to make additional salary 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 allows catch-up contributions, it must allow all participants who are eligible for the catch-up to make the same election with respect to catch-up contributions.

If an employee participates in a traditional or safe harbor 401(k) plan:

- The catch-up contribution limit for 2006 is $5,000.
- The limit is subject to cost-of-living increases after 2006.

If an employee participates in a SIMPLE 401(k) plan:

- The catch-up contribution limit for 2006 is $2,500.
- The limit is subject to cost-of-living increases after 2006.

The catch-up contribution a participant may make for a year cannot exceed the **lesser** of the following amounts.

- The catch-up contribution limit.
- The excess of the participant's compensation over the salary deferrals that are *not* catch-up contributions.

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 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 $20,000 for 2006 (the $15,000 limit for 2006 plus the $5,000 catch-up maximum). If the plan didn't permit catch-up contributions, the most he could defer would be $15,000. However, if Joe participates in two 401(k) plans each maintained by unrelated employers, he can defer a total of $20,000 even if neither plan contains catch-up provisions. Of course, Joe couldn't defer more than $15,000 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.

Timely Withdrawal of Excess Contributions by April 15. Excess deferrals withdrawn by April 15, are taxable in the calendar year contributed. Earnings through the date of correction are taxable in the year they are distributed. There is no 10% early distribution penalty, no 20% withholding, and no spousal consent requirement on amounts timely distributed.

Excess Not Withdrawn by April 15. Excess deferrals not withdrawn by April 15 are subject to double taxation. They are taxed both in the year contributed and in the year distributed. These late distributions are subject to the 10% early distribution penalty, 20% withholding, and spousal consent requirements.

Reporting Requirements for Excess Deferrals. The plan must report corrective distributions of excess deferrals (including earnings) on Form 1099-R. Excess deferrals distributed during the year the excess occurred should be reported on one Form 1099-R (Code 8) for the excess plus earnings. Excess deferrals distributed between January 1 and April 15 of the following year may have to use two Forms 1099-R. One Form 1099-R (Code P) should be issued for the excess, and one Form 1099-R (Code 8) should be issued for the earnings. Excess deferrals distributed after April 15 should be reported on one Form 1099-R (Code 8) for the year they are distributed.

Effect of Excess Deferrals on Related Tests. Excess deferrals distributed to HCEs are included in the ADP test for the year deferred. Excess deferrals arising under one or more plans of one employer that are distributed to NHCEs are not included in the ADP test. Excess deferrals not timely distributed by April 15 are included in annual additions for the year deferred.

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 accounts of a participant - 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 $44,000 in 2006. In addition, the amount of compensation that can be taken into account when determining employer contributions is limited to $220,000 for 2006.

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