STIFEL

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NEED A 2016 TAX DEDUCTION? IT'S NOT TOO LATE FOR A SEP

An employer must establish a Qualified Retirement Plan (QRP) by the end of the tax year for which a tax deduction is taken. If an employer's tax year is based upon the calendar year, December 31, 2016, was the last day a QRP could be established for 2016. However, employers have until the due date of their federal income tax return for the business, **including extensions**, to establish a Simplified Employee Pension (SEP) Plan and make SEP contributions for 2016.

Contributions

The maximum amount that can be contributed for 2016 on behalf of SEP participants is the **lesser** of:

- 25 percent of compensation up to the compensation cap of $265,000 (increased to $270,000 for 2017) or
- $53,000 (increased to $54,000 for 2017) (IRC Sec. 415(c) dollar limitation)

Closing comment

A SEP plan is a very attractive plan for small business owners, considering such benefits as the ease of establishment and little or no IRS reporting. In addition, it is the only plan that can be established in 2017 to take advantage of a 2016 tax deduction.

TWO IMPORTANT DEADLINES IN OCTOBER

October 1 Deadline For New SIMPLE IRA Plans

The SIMPLE IRA is a retirement plan that is maintained on a calendar year basis only (IRC Sec. 408(p)(6)(C)). It is an employer-sponsored plan that allows eligible employees to make pre-tax salary deferrals into an IRA and requires the employer to make annual contributions into the IRA of each eligible employee. Within a 60-day period preceding a plan year, the employer of all SIMPLE IRA plans must allow eligible employees to make deferral elections (IRC Sec. 408(p)(5)(C)) for the following year.

New plans

October 1 is an important date for new SIMPLE IRA plans too, as there is a requirement that all new plans be established by **October 1** of the year for which deferrals will be made. **The initial 60-day election period for new plans must begin by October 1, 2017, in order to include 2017 deferrals.**

October 16 deadline for IRA re-characterizations

After an IRA is converted to a Roth, there may be situations where the individual wants to reverse the conversion. One example would be when a tax-filer converts a Traditional IRA to a Roth and afterwards the market value of the converted securities decreases in value. In this case, an individual may re-characterize (reverse) the conversion back to a traditional IRA and do so without taxation or penalty.

Re-characterization between IRAs

In addition to reversing conversions, the IRS allows taxpayers that contribute to either a Traditional or Roth IRA the opportunity to re-characterize (move) that contribution (plus earnings or less the loss) to the other type of IRA. This may be a good strategy for those who discover their Traditional IRA contribution is not deductible and therefore elect to make it a Roth IRA contribution, or that they exceeded the income limit for Roth contribution eligibility and therefore elect to make it a non-deductible Traditional IRA contribution. Note that in order to move a Traditional IRA contribution to a Roth IRA, the taxpayer's modified adjusted gross income (MAGI) must be under the allowable limit for the year the contribution is intended ($132,000 for a single filer and $194,000 for married couples filing a joint return for 2016). However, there are no MAGI limits for non-deductible contributions to Traditional IRAs, and therefore, taxpayers may re-characterize Roth contributions to a Traditional IRA if the IRA owner is under the age of 70½ for the intended contribution year.

Deadline

Note that to qualify for a re-characterization of contributions between IRAs, the reversal must be completed by October 15 of the year following the year the contribution was made and the individual must have filed his or her Federal income tax return by the normal filing deadline, plus extensions. However, since October 15 falls on a Sunday this year, the deadline to re-characterize 2016 conversions and contributions is October 16, 2017.

EXTENSION DEADLINE FOR EMPLOYER CONTRIBUTIONS

Employers may wait until the company's tax filing due date plus extensions to make company contributions to Qualified Retirement Plans, SEP IRAs, and SIMPLE IRAs.

For fiscal year business owners, the standard tax filing date is the 15th day of the third month after the end of the corporation's tax year. Extensions can stretch the employer funding and filing deadline an additional six months following the normal filing deadline.

For calendar year filers, March 15, 2017, was the 2016 tax filing deadline for Corporations and for S-Corps. The 2016 tax filing deadline for the self-employed was April 18, 2017 (April 15 fell on Saturday and Emancipation Day was observed on Monday, April 17, 2017).

Extension deadlines

Business owners may request automatic extensions for tax filing, which includes plan contributions, by submitting appropriate forms before their normal filing date. If an extension was granted, September 15, 2017, is the final day a corporation may make company contributions. For the self-employed, October 16, 2017 (October 15 falls on Sunday) is the final day employer contributions may be accepted and tax returns filed.

ROLLING COMPANY STOCK INTO AN IRA? CONSIDER THE "NUA" STRATEGY

There is a little known strategy available to participants in employer-sponsored retirement plans (401(k)s, profit sharing, ESOP) who hold shares of employer stock as part of their retirement plan assets. In certain situations, the strategy may result in significant tax savings. If a plan participant is eligible to take a distribution and is considering a rollover of these shares into an IRA, he or she should be educated on how this strategy could be a benefit before making a decision to do a rollover. Once the shares are rolled to an IRA, this election is no longer available.

Net Unrealized Appreciation (NUA)

The NUA election is an alternative to an IRA rollover. Instead of rolling the shares into an IRA, the shares are distributed directly to the individual or transferred to a non-IRA account. The individual will owe just a portion of the tax at the time of the distribution, as only the cost basis of the shares is subject to ordinary income tax (and potentially an early withdrawal penalty) at this time. The value of the appreciation (from the date of purchase of the shares in the plan to date of distribution from the plan) is not taxable until the shares are liquidated as explained in detail below.

How it works

To qualify for the special tax treatment, the following requirements must be met:

1. *An individual must receive the stock as part of a lump-sum distribution made within a single tax year.*
2. *The non-employer stock investments in the plan may be rolled into an IRA to avoid current taxation on that portion of plan assets.*
3. *The employer stock must be distributed (in-kind) from the qualified retirement plan.*
4. *The shares are held in certificate form or on deposit in a taxable (not IRA) account.*
5. *The individual pays ordinary income tax on the basis for the year of the distribution (the basis is the value of the stock at the time it was acquired by the plan). The employer/plan record keeper will calculate the basis.*
6. *If the individual is not yet age 59½ (or 55 or older in the year he or she separated from service), a 10% penalty will be due on the value of the cost basis of the stock.*
7. *The value of the securities at the point of distribution, minus the original basis, is the NUA. No tax will be due on the NUA until the securities are liquidated. Upon liquidation, the NUA will be taxed at the applicable long-term capital gains rate no matter how long the stock was held outside of the plan.*
8. *Any additional appreciation of the stock, after the date distributed from the plan, is taxed at the long-term or short-term capital gains rate, depending upon how long the stock was held outside of the plan. To qualify for the long-term rate, the stock must be held for one year or longer.*
9. *If the individual dies while still owning the distributed stock, upon liquidation of the shares, the heirs will pay the applicable long-term capital gains rate on the original NUA. Gains realized from the time the stock was distributed from the plan until the date of death receive a stepped up basis. Gains after the date of death are subject to normal tax treatment after the step up.*

Other considerations

In addition to the requirements listed above, there are other issues to consider, such as:

- Will the individual have sufficient funds outside of the distribution to pay the income tax without having to sell the employer securities?
- How long does the individual intend to hold the stock?
- Will the individual's portfolio become too heavily concentrated in the employer's stock?
- How volatile is the stock, and does the volatility match the individual's risk profile?
- Will tax rates change in the future?
- Will state taxes, which have to be taken into consideration, be an issue?

Closing Comment

Even though the NUA strategy may seem like a tax-wise move for those who have highly appreciated employer securities, it's not for everyone, as the rules are complex. It can result in tax savings by assessing NUA at the capital gains rates, rather than ordinary income tax rates. It also gives the individual control over when taxes are paid (when the shares are liquidated). However, it's also important to consider that there may be a 10% early withdrawal penalty if not rolled over, and dividends are taxable while the stock is held outside of the plan or an IRA.

Should employer stock be rolled to an IRA or distributed in order to utilize the NUA election? Individuals should consult with a professional tax advisor before any decisions are made.

IRS CHANGES PRE-APPROVED PLAN OPINION LETTER PROGRAM FOR QUALIFIED PLANS

The Internal Revenue Service (IRS) recently announced changes to its opinion letter program by releasing Revenue Procedure 2017-41. The release seeks to streamline procedures for both the employer and IRS and also to encourage employers to move away from using Individually Designed Plan (IDP) documents. The policy will go into effect on October 2, 2017.

IRS opinion letters are used to validate a plan document's status under Section 401(a) of the Internal Revenue Code (IRC). Having a favorable opinion letter on a plan document also demonstrates that a plan adopting the document is tax exempt, based on IRS Section 501(a), which allows the employer to make tax-deductible contributions and for participants to defer income taxes on contributions, as well as allowing the contributions to grow tax-deferred until the point of distribution.

All qualified retirement plans are required to have a written plan document, but not all would necessarily require an IRS opinion letter. Documents are either Pre-Approved plan documents or IDP documents. More than 80% of all plans use a Pre-Approved plan document. Employers who adopt a Pre-Approved plan document can rely on a favorable opinion letter already obtained by the document provider and would not need to request their own letter. Pre-Approved plan documents are further broken down into either Master and Prototype (M&P) or Volume Submitter (VS) documents. The new Revenue Procedure seeks to combine both the M&P and VS types of documents into the same program.

The less common Individually Designed Plan (IDP) document is a plan document that is drafted by an attorney for a specific employer and tailored to meet that employer's specific needs. IDPs are the most flexible type of plan document but come with a cost. The charge to draft an IDP is generally more than adopting a Pre-Approved document. Additionally, IDPs must be updated, or restated, every five years, while Pre-Approved documents only need to be restated every six years.

The reason the IRS prefers the Pre-Approved document over the IDP is that each IDP only covers one employer, whereas one Pre-Approved document can be adopted by hundreds or even thousands of employers. Thus, the more employers who adopt Pre-Approved plan documents, the less the IRS has to review plan documents. Officially, the IRS states that it is modifying the program "in order to expand the provider market and encourage employers that currently maintain Individually Designed Plans to convert to the Pre-Approved format." Over the past few years, it's become increasingly clear that the IRS does not have the resources to efficiently run all of its programs, so a move to reduce its workload makes sense.

In addition to combining the M&P and VS programs and replacing them with a single opinion letter program, Revenue Procedure 2017-41 also makes specifications for non-standardized plans. Non-standardized plans offer more choices for adopting employers but may not meet nondiscrimination requirements, whereas standardized plans contain more required plan provisions and are more likely to meet nondiscrimination requirements. The new procedure allows non-standardized plans to adopt minor modifications, such as non-standardized Employee Stock Ownership Plans (ESOPs) including a 401(k) provision and non-standardized cash-balance plans using a rate to determine an interest credit to be based on the actual return on plan assets. Both examples were not allowed previously. Also, any non-standardized plan can now provide for either safe harbor or non-safe harbor hardship distributions.

Revenue Procedure 2017-41 also eliminates the prohibitions against combining a money purchase plan with a 401(k) or profit sharing plan in the same pre-approved plan document and for submitting an application for an opinion letter for a non-electing church plan.

Also new is that Pre-Approved plans may use either a basic plan document with an adoption agreement or a single plan document. The new Revenue Procedure also addresses plan amendments submitted by the plan document providers and adopting employers. Essentially, the provider must certify that all interim amendments on the applicable cumulative list in Revenue Procedure 2017-41 have been made and must also include a cover letter that summarizes the changes to the plan from the interim amendments.

And finally, please note that Revenue Procedure 2017-41, while official on October 2, 2017, may be modified in the near future. The IRS expects to update it as necessary, in whole or in part, largely based on comments it receives from interested parties. Comments may be submitted by e-mail to notice.comments@irscounsel.treas.gov. To see Revenue Procedure 2017-41 in its entirety, visit the following site: https://www.irs.gov/pub/irs-drop/rp-17-41.pdf

SHAPING PARTICIPANT OUTCOMES

When evaluating retirement savings, it seems apparent that an investment's rate of return should not be the sole factor upon which individuals rely to fund their retirement. There are investment strategies and goals that must be implemented to establish a diligent plan in preparing for the future. Often times, an employer-sponsored retirement plan is the only savings vehicle that individuals have available to funnel their compensation, aside from a personal savings account. For the average participant, it is often the case that participants make their initial elections and let it ride. So, how do we make inertia work in their favor?

Re-enrollment is a plan design strategy that can be implemented to increase participation and deferral rates and/or improve investment allocations. With the potential to improve participant outcomes in such aspects, why is it the case that 89% of plan sponsors surveyed for the 2016 PLANSPONSOR Defined Contribution (DC) Survey said they hadn't re-enrolled employees or participants in the past 12-18 months? This statistic suggests that re-enrollment is a relatively new concept for many plan sponsors. Re-enrollment can be accomplished through various formats to accomplish multiple savings goals.

In its earliest form, re-enrollment was primarily focused towards reallocating participant balances to the plan's qualified default investment alternative (QDIA). Under this approach, re-enrollment was not implemented to help participants save more but rather to move them into an appropriate asset allocation.

A case study on re-enrollment released by Vanguard in March of 2017 shows the effects of re-enrollment for a large plan where the primary motivation was investment-focused. The study looks at the outcome of the plan design strategy over a one-year period. Over the span of one year, investment diversification improved tremendously, with only 7% of participants holding only an aggressive equity position(s). The vast majority, eighty-one percent, of plan assets remained in the default target date funds (TDFs). Of the remaining population of participants, 12% did a partial opt-out, leaving a significant portion of their assets in the QDIA while directing new money to other plan investments.

Aon Hewitt has also divulged studies showing that the idea of defaulting existing participants into a plan's QDIA, when the employees had previously made their own affirmative elections, has the tendency to create considerable pause for plan sponsors implementing such a strategy. Why is this the case with such positive outcomes? Aon further reports that the reason behind this reaction involves the perception that the sponsor is basically telling the participants they know the best approach to investing for their future. For the sponsors that are able to overcome this concern, a clear message to plan participants of the chance to opt-out of the re-enrollment is paramount when relaying the details of the program.

Another focus for launching a re-enrollment strategy is geared towards improving deferral rates for employees. Re-enrollment is sometimes incorporated with a record keeper transition or merger/acquisition. However, this tactic is typically focused on re-enrolling those employees that are saving below the default deferral rate required to receive the maximum match contribution available under the plan. One consideration to make when engaging this type of re-enrollment is the potential increase to an employer's match costs. The impact to the plan sponsor is driven by the plan design and the population of employees that are low savers. Retirement readiness reports can be incredibly helpful in identifying the usefulness of re-enrollment. Such reports will illustrate the percentage of participants that are on track to retire at an appropriate age while factoring in Social Security.

If cost is a concern for employers that wish to increase deferral rates through re-enrollment, there are options to consider in order to control such a recourse. Changes to the employer's match contribution formula can be reviewed to determine an appropriate modification. Shifting a match contribution formula to a stretch match or adjusting the timing of the employer contribution to the end of the year, so employees who depart before year-end do not get the match contribution, can help manage increased costs to the employer. Another avenue to control employer costs is to attach a vesting schedule to match contributions so that longer service is required to get 100% vesting of employer contributions.

Finally, an employer must determine how often re-enrollment should be enacted. There is some flexibility afforded, as it can be implemented as a one-time sweep or engage an annual re-enrollment cycle. Principal Financial Group has outwardly proclaimed that plans should do a backsweep of eligible employees every year – re-enrolling eligible nonparticipants – since employees' reasons for not saving tend to get eliminated or change over time. The record keeping firm goes on to state, "Participant research has shown that 80% of participants said they had a neutral or positive reaction to plan sponsors re-enrolling employees who had opted out of the plan." Among Principal's clients, the average participation rate tends to be 7% higher for plans utilizing a backsweep in collaboration with an auto-enrollment feature for new employees. The firm reports a 17% higher average deferral rate for plans implementing a re-enrollment sweep.

The key in relaying the strategy for re-enrollment to participants lies in showing them where they are and where they should be with regard to retirement readiness. There isn't a retirement plan tool, calculator, or seminar that accomplishes for employee outcomes what can be accomplished through best-practice plan designs. If a plan sponsor cares about the financial well-being of its employees and their transition into retirement, re-enrollment is a strategy that should be considered. Adding auto-enrollment and annual re-enrollment simultaneously ensures that new employees are taking advantage of the retirement plan while helping current participants save more for their future.

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