Benefit Financial Services Group

Quarterly Newsletter

Retirement PLAN News

Quarter Ending December 31, 2018

Markets in Review

Domestic equity markets declined significantly during the fourth quarter of 2018, wiping out the gains from the first three quarters and ending the year with negative calendar year returns for the first time since 2008. The S&P 500 Index fell 13.5% during the quarter, its worst quarterly return since the third quarter of 2011.

Large-cap stocks outperformed their small-cap counterparts during the quarter, with the Russell 1000 Index and Russell 2000 Index declining 13.8% and 20.2%, respectively. In contrast to the last two years, value-oriented stocks outperformed their growth-oriented counterparts across all market-caps. Defensive sectors faired best during the quarter, with the Utilities sector providing the only positive returns. Energy was the worst performing sector, declining 23.8% as oil prices collapsed, followed by the growth-oriented Technology, Industrials and Consumer Discretionary sectors.

Despite broad declines, international equity markets generally outperformed domestic markets during the fourth quarter. After struggling for most of 2018, Emerging Markets were one of the strongest performers, with the MSCI EM Index declining only 7.5% during the quarter, boosted by strong returns from Brazil. Conversely, Chinese markets continued to weigh on relative returns as concerns over trade and an economic slowdown intensified. Japanese stocks were some of the worst performers, with the MSCI Japan Index falling 14.2% as exporters suffered from increased strength in the yen. The S&P 500 Index significantly outperformed the rest of the world, as measured by the MSCI ACWI Ex USA Index, in 2018, returning -4.4% compared to -14.2%.

The Federal Open Market Committee ("FOMC") lifted its federal funds target rate by 25 basis points to a range of 2.25% to 2.50% during its December meeting, but lowered forecasts for rate increases in 2019, citing recent market volatility, tame inflation, and slowing global growth. The U.S. yield curve moved marginally closer to inversion during the fourth quarter, with the yield on the 2-year Treasury declining 0.33% and the yield on the 10-year Treasury declining 0.36%, finishing the quarter at 2.48% and 2.69%, respectively. There was a flight to safety within fixed income markets with Treasury bonds and Mortgage-backed Securities providing greater than 2% returns, while High Yield bonds, historically more correlated with equity returns, declined 4.5%.

The initial estimate of fourth quarter gross domestic product (GDP), delayed by the government shutdown, is scheduled to be released February 28, 2019. Current expectations are for 1.5% annualized growth in the fourth quarter, a significant step down from the 4.2% and 3.4% growth experienced in the second and third quarter of 2018, respectively. Expectations for growth are lower as the positive impacts from tax reform wear off and the effect of the U.S.-China trade dispute deepens.

The unemployment rate increased from 3.7% to 3.9% during the fourth quarter of 2018. A tight labor market attracted a significant number of entrants to the labor force, with the labor force participation rate rising from 62.7% to 63.1%, accounting for a large proportion of the increased unemployment rate. The U.S. economy added an average of 232,000 jobs per month during the quarter.

The year-over-year headline inflation rate fell from 2.3% to 1.9% during the quarter, with a sharp decline in gas prices during December having the largest impact. During the same period, core inflation, which excludes food and energy, remained flat at 2.2%. Increases in the indexes for shelter, recreation, and medical care helped to offset declines in the indexes for airline fares, used cars/trucks, and vehicle insurance during December.

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In This Issue

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It's Testing Season!

Qualified plans must perform annual testing to be sure that the plan doesn't unfairly discriminate in favor of "highly compensated employees" (HCEs) or exceed the contribution limits set forth by the IRS. Depending on your plan provisions, it isn't just one calculation, but a series of tests that show that your plan is not discriminatory. If your plan is audited, the auditor is looking for proof of this compliance.

Since most retirement plans operate on a calendar year basis, testing season is now! If a testing failure occurs, correcting the failure by March 15th can save the plan sponsor excise taxes and additional filings. Getting year-end data in early, including complete census information, is paramount. Here are some key testing considerations:

Is an HCE the same as a Key Employee?

An HCE and a Key employee are two separate definitions used to test different aspects of a retirement plan. Who qualifies as an HCE is determined on an annual basis. An employee is an HCE if:

- they own more than 5% of the company (including family attribution rules), or
- they received compensation exceeding a threshold set by the IRS in the prior plan year ($120,000 in 2017 for the 2018 plan year HCE determination).

An employee is a "Key" employee if they meet any of the following criteria:

- They own more than 5% of the company (including family attribution rules).
- They own more than 1% of the company (including family attribution rules) and have an annual compensation greater than $150,000.
- They are an officer of the company and have compensation of at least $175,000.

What do the different compliance tests mean?

- **Annual Non-Discrimination Testing (ADP/ACP)** – If your plan is a 401(k) plan, the ADP and ACP tests are a comparison between the average rates of deferral and matching contributions of HCEs to non-HCEs. Regulations generally allow for a 2% disparity between the two groups. If your plan has opted for a safe harbor election in any given year, it automatically satisfies the ADP and ACP testing.
- **Annual Deferral Limit** – Regulations restrict the amount that an individual can defer into a retirement plan in any calendar year. For 2018, an individual could have deferred a maximum of $18,500 and for those who attain or are over age 50 by December 31, 2018, an additional $6,000 can be contributed. Any amounts in excess of the limits must be returned with the appropriate allocation of investment gains by April 15, 2019.
- **Minimum Coverage** - Minimum coverage testing determines if the plan benefitted the required percentage of non-HCEs. This test is applied, not to the plan as a whole, but to each type of contribution; 401(k) contributions, matching, and employer profit sharing. Generally, each contribution type must meet 70% of the total number of non-HCEs that are not otherwise excludable. Examples of excludable employees are those governed under collective bargaining or non-resident aliens.
- **Top-Heavy Testing** - A plan is considered top-heavy if more than 60% of the benefits belong to "key employees." An annual test must be performed to determine if the key employees have more than 60% of the benefits or assets in the plan after certain allowable adjustments. If it is determined that the plan is top heavy, it must meet the top-heavy minimum contribution and vesting requirements.
- **Annual Additions** – Like most other aspects of retirement plans, the IRS sets the limit of how much can be contributed to any individual's account for a plan year. Contributions would include amounts from all sources such as 401(k), matching, and employer profit sharing, but also includes any amounts allocated as forfeitures. For 2018, the limit is $55,000 for those under age 50 and $61,000 for those eligible for catch-up contributions.
- **Allowable Deduction Limit** – Regulations restrict an employer's ability to contribute more than 25% of the sum of all participants' compensation to a retirement plan. This restriction only pertains to employer contributions. Employee contributions are disregarded.
- **General Non-Discrimination Testing** – This testing only applies to plans that allocated contributions on a formula which weights contributions in favor of certain employees. These types of plans are commonly referred to as "cross-tested" or "new comparability plans." If a plan uses a "uniform allocation formula," this testing may not apply.

Plan sponsors should be aware that sometimes other companies or plans must be aggregated to satisfy the tests listed above. If you have any questions about the tests, be sure to contact your testing provider for further information.

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Know Your Options

As the availability of Roth options in retirement plans and Roth contribution percentages continue to rise, it's important to be able to distinguish the differences between pre-tax and Roth contributions. Employer-sponsored retirement plans offer many advantages to participants; the ability for accounts to grow on a tax-deferred basis, the chance of receiving employer contributions in the form of a match or non-elective contribution, the ability to contribute even after attaining age 70 ½, and protections from bankruptcy. These benefits are consistent whether a participant chooses traditional or Roth contributions, or even both! So, what makes Roth and traditional routes different and what are the advantages and disadvantages of each?

Traditional 401(k) contributions, or those contributed on a pre-tax basis, have been the mainstay of the 401(k) plan since its inception in 1978. Today, more than 50 million workers are active participants in their employer's 401(k) plan and, until 2001, all contributed on a pre-tax basis. Pre-tax contributions are deducted from an employee's paycheck before the application of federal and state income taxes. (Pennsylvania is the only state that does not exempt 401(k) contributions from personal income tax.) These contributions, along with any employer contributions and investment gains, remain tax-deferred until withdrawal. At the time of withdrawal, the participant will pay all appropriate income taxes due. If withdrawals occur before age 59 ½, disability, or death, an additional early withdrawal penalty of 10% will apply.

On the contrary, Roth deferrals are contributed on an after-tax basis with the employee paying all current federal and state taxes. Once contributed to, these accounts accumulate in the same fashion as traditional 401(k) accounts until withdrawal. With a Roth account, your contributions and their investment earnings can be withdrawn tax-free, provided the withdrawal does not occur before age 59 ½, disability, or death. Even with an early withdrawal, only the investment gains and employer contributions will be taxed as income and subject to the 10% penalty.

Participants don't have to choose one option over the other. Many participants choose to split their deferrals by contributing some on a pre-tax basis and some on a Roth basis, thereby hedging their bets on what future tax rates might bring.

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The 401(k) Turns 40

In 2018, the 401(k) plan celebrated its 40th birthday! Though extremely popular today, 401(k) plans came about almost by accident. IRC Section 401(k) was passed into law as part of the Revenue Act of 1978 and was included to limit executive compensation. However, in 1980, Ted Benna of the Johnson Companies used the provision to create and get IRS approval of the first 401(k) plan for his company. For this he is often referred to as the father of the 401(k).

A lot has changed with 401(k) plans in the last 40 years. In September of 2018, 401(k) plans held an estimated $5.6 trillion in assets! This represents nearly 20% of the $29 trillion in US retirement assets (total of both public and private sector plans). In 2018, the Plan Sponsor Council of America (PSCA) released their 61st Annual Survey. The survey includes the data of over 600 defined contribution plan sponsors with over 40% of responders sponsoring plans with 200 participants or less. While packed with great statistics regarding its findings, the survey highlights some interesting trends in the retirement plan industry.

The good news for 401(k) plan participants: contributions to retirement plans are on the rise. The survey showed that participants saved an average of 7.1% of pay in 2017, up from 6.8% in 2016. This, combined with an increased employer contribution percentage of 5.1%, gives a total savings rate of more than 12%! Roth contributions keep rising with 70% of companies offering this option, especially among plans with fewer than 50 employees. Additionally, the survey showed a trend toward more generous matching formulas with the use of dollar-per-dollar matching contributions above 3% of pay, increasing from 24.1% to 35.8%.

You can learn more about the PSCA or obtain a copy of the full survey on their website at www.PSCA.org.

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Upcoming Compliance Deadlines

February 2019

28th: Form 1099-R – The Form 1099-R is due for any distributions that occurred during the 2018 calendar year. Note: Participant Loans that are in default may be considered "deemed" distributions and are reportable on Form 1099-R.

March 2019

15th: ADP/ACP Corrective Testing - This is the deadline for distributing contributions and earnings to participants as corrective measures to ADP and ACP testing for calendar year plans.

15th: Employer Contributions - Profit Sharing and matching contributions must be deposited for 2018 amounts that will be deducted on the employer's tax return (unless employer returns are on extension).

April 2019

1st: Required Minimum Distributions - Regulations require that a participant must receive a required minimum distribution (RMD) by April 1st of the year following the year in which the participant attains age 70 ½. Distributions may be delayed until actual retirement unless the participant is a 5% or more owner.

15th: Excess Deferral Amounts - If a participant makes salary deferral contributions in excess of the IRS-issued limits in any calendar year, the plan must return the excess amount plus earnings to the participant by April 15 of the year following the year in which the excess occurred. The limits for 2018 were $18,500, or $24,500 for those age 50 and over if the plan allowed for catch-up contributions.

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