

employee benefits update

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**When your plan year
isn't the calendar year**

ESOP basics

Set-up, distribution and diversification rules

It doesn't have to be confusing

Distributions of Roth 401(k) contributions

**Does your small plan have
the right fidelity bond?**



When your plan year isn't the calendar year

Although the majority of retirement plans run on a calendar year cycle, others do not. For example, some companies' fiscal year is off the calendar year and they may find it advantageous to have their retirement plan's plan year consistent with their fiscal year. Those who choose "off-calendar year" plans experience a lot of challenges. Let's take a closer look at what employers with off-year plans face.

Testing limit challenges

Which testing limits should you use, calendar year or plan year? And are you supposed to use the testing limits in effect at the beginning of your plan year or at the end of the plan year? Here are some answers:

Annual additions testing. Each year, the plan cannot exceed the "annual additions" limit for each participant. The total annual additions (employee contributions, employer contributions and forfeitures) for each participant cannot exceed the lesser of:

1. The annual additions dollar amount in effect for the year, or
2. 100% of the participant's compensation for the year.

This limit is tested on a plan year basis. So which annual additions dollar amount is used: the one in effect at the beginning of the plan year or at the end? The answer is the limit in effect at the *end* of the plan year. For example, if a plan year runs from July 1, 2006 through June 30, 2007, the annual additions dollar limit is \$45,000 (the limit for 2007).

An off-calendar year plan will determine who is an HCE based on the look-back limit in effect on the first day of the look-back plan year.

Highly compensated employee (HCE) determination. An HCE is a 5% owner of the company or an employee with compensation of at least the HCE compensation limit for the look-back year. For a 2007 calendar year plan, that limit is determined from 2006 earnings. In 2006, the HCE compensation amount was \$100,000. So



in a plan that follows that calendar year, HCEs for the 2007 plan year include employees who exceeded the compensation limit of \$100,000.

But, an off-calendar year plan will determine who is an HCE based on the look-back limit in effect on the *first day* of the look-back plan year. Thus, the 2005 limit of \$95,000 will apply for determining HCEs for the plan year that runs from July 1, 2006, to June 30, 2007. The plan applies the \$95,000 limit to the HCE's compensation earned in the period from July 1, 2005, to June 30, 2006.

401(k) plan issues

Running your 401(k) plan off-calendar will affect additional areas:

Elective deferral limits. The 401(k) plan limit and catch-up limit are on a calendar year basis regardless of the plan year. For 2007, the deferral limit is \$15,500 with catch-up contributions of an additional \$5,000 permitted to anyone age 50 or older during the plan year. If a participant makes contributions to more than one plan subject to this limit, you must combine the deferrals to determine whether the participant has exceeded the limit.

Failed 401(k) nondiscrimination testing catch-up contributions. Each plan year, a 401(k) plan must pass — or correct — a nondiscrimination test. If the plan fails, one of the correction methods is to distribute the excess contributions to certain HCEs. For each employee who is age 50 or older, the plan can reclassify part or all of the excess amounts as a catch-up contribution to avoid a distribution.

For a calendar year plan, the amount of the catch-up allowed for reclassification is the catch-up limit for that year. For example, Betty is 55 years old and an HCE. She has an excess contribution of \$6,000 because of a failed discrimination test for 2006. Of that amount, \$5,000 (the 2006 limit) can be reclassified as catch-up, reducing the excess to \$1,000.

Off-calendar year plans can reclassify the catch-up amount limit in effect at the *end* of the plan year. In the example above, if the plan year was Oct. 1, 2006, through Sept. 30, 2007, the catch-up limit is \$5,000 (the 2007 limit).

Payroll and filing challenges

One administrative challenge with off-calendar year plans arises when it's time to submit data to the company performing your plan administration and testing, usually your third-party administrator. For calendar year plans, the third-party administrator can use the payroll reports and W-2s either in electronic format or as a check on a manually inputted spreadsheet.

For off-calendar year plans, the third-party administrator may have to use special payroll runs and manually add them together to obtain the plan year data. For example, if a plan year runs from April 1, 2006, through March 31, 2007, the third-party administrator will need to add together one payroll run for April 1, 2006, through Dec. 31, 2006, and a second run for Jan. 1, 2007, through March 31, 2007, to get the plan year data.

Each year, certain plans must file the Form 5500. For off-calendar year plans, the plan must use the Form 5500 for the year containing the beginning of the plan year. For example, for an off-calendar plan year of July 1, 2006, to June 30, 2007, the plan would file a 2006 Form 5500.



Tax year implications

If your company's tax year is different from your benefit plan year, you must deduct the plan year contributions in the tax year that contains the plan year end. For example, suppose your company's tax year is July 1 to June 30, and your company has a profit-sharing plan in which the plan year is the calendar year. If a profit-sharing contribution of \$100,000 is made for the July 1, 2006, through June 30, 2007, tax year, you cannot deduct that \$100,000 until you file your 2007 calendar year tax return.

Same time next year

Companies have various reasons for not using the calendar year for the plan year. But they may simplify accounting and reporting matters by making the "calendar year" election in the plan document. ⌚

ESOP basics

SET-UP, DISTRIBUTION AND DIVERSIFICATION RULES

An employee stock ownership plan (ESOP) is a qualified plan, similar to a profit-sharing plan. Like other qualified plans, ESOPs have specific rules governing how to set up a plan, the diversity of the plan's assets and the way distributions are made.

Types of ESOPs

Generally, to start an ESOP a company will set up a trust fund and contribute new shares of its own stock into the trust. It can also contribute cash to buy existing shares. The company then makes annual contributions in either stock or cash to individual employee accounts within the trust.

There are two types of ESOPs:

- 1. Unleveraged.** In this scenario, a company sets up a trust fund and contributes to the trust. The trust uses this money to buy new or existing shares of the company's stock.
- 2. Leveraged.** The ESOP borrows money from a financial institution and uses the loan money to buy new or existing shares. The company then makes cash contributions to the plan to repay the loan.

Regardless of how the plan acquires stock, company contributions to the trust are tax-deductible, within certain limits.

An ESOP must predominantly invest in "qualifying" employer securities. A qualifying security is any common stock of the company or a member of its controlled group (a participant who is a 50%-or-more owner) that is traded on a stock exchange. If no common stock is traded, more complex rules govern what is considered a qualifying security.

Distributions after termination

There are rules governing distributions and the repurchase of stock from a participant or beneficiary. One states that, when employees leave the company, they receive their stock, which the company must buy back from them at its fair market value (unless there is a public market for the shares). Private companies must have an annual valuation, conducted by a third party, to determine the share price based on the company's value.

Distributions are handled differently depending on how the participant leaves the plan. There is an important distinction between retiring, death or disability and simply leaving the company due to other reasons.

When a participant retires, becomes disabled or dies, the ESOP generally must begin to distribute vested benefits during the plan year following the event — unless one of the exceptions for a termination for other reasons or an in-service distribution applies.

When a participant's employment terminates for reasons other than retirement, disability or death, the ESOP must distribute the shares before the sixth plan year after the plan



year in which termination occurred (unless the participant is reemployed by the same company before then). There's an exception if the ESOP is leveraged: Plans can delay distributions of ESOP-held shares acquired through the loan until the plan year after the ESOP loan is fully repaid.

ESOP distributions may be made in a lump sum or in substantially equal payments (at least annually) over a five-year period. But this time frame may be extended another one to five years if a participant's benefits exceed a statutory amount (\$170,000 or a fraction of the amount by which a participant's benefit exceeds \$850,000). The ESOP can make cash or stock distributions on termination.

Distributions while still employed

In some circumstances, participants may receive ESOP benefits while they are still employed. The plan must generally begin distributing benefits to a participant who is a 5%-or-more owner after the participant reaches age 70½ — even if the participant is still employed. There are other circumstances where the ESOP may provide for in-service distributions, such as after a fixed number of years, on attainment of a specified age or for “hardship” reasons.

In some circumstances, participants may receive ESOP benefits while they are still employed.

ESOP participants may diversify their accounts after a certain period and receive cash or stock directly while still employed. In addition, the employer may choose to pay dividends directly to ESOP participants by allocating company stock to their accounts.

Diversification rules

Public companies with ESOPs must allow participants to diversify out of the employer stock investment. For employer nonelective or matching contributions, the

diversification requirements apply after the participant has completed at least three years of service. For elective deferrals and after-tax (Roth) contributions, the diversification requirements apply immediately.

The diversification rules are generally effective for plan years beginning after Dec. 31, 2006. Existing plans with employer stock that was acquired in a plan year beginning before 2007, and that is attributable to employer contributions, may phase in the diversification rule over three years. However, ESOPs cannot use the phase-in option for participants who are age 55 or older and who have at least three years of service.

ESOPs without elective employee or matching contributions aren't subject to the diversification rule. Although the rule generally applies only to employer stock that is readily tradable on an established securities market, it may also apply to nonpublicly traded employer stock held by a plan if any member of the employer's controlled group (using a 50% ownership threshold) has issued publicly traded stock.

Notice to participants

The Pension Protection Act of 2006 added a new diversification notice requirement. ESOPs must give participants notice at least 30 days before they're eligible to exercise their diversification rights to divest themselves of employer stock. The notice must include:

- 1 A description of the diversification right, and
- 1 A description of the importance of diversifying the investment of retirement account assets.

If the ESOP doesn't comply with this rule, it will face a stiff fine of \$100 per day. The notice requirement is generally effective for plan years beginning after 2006, but no earlier than 90 days after enactment of PPA. As a result of this act, many companies were required to provide the diversification notice before the end of 2006.

Keep up-to-date

When and how you can make ESOP distributions and implement the diversification rules are just a few important aspects to keep in mind. But as onerous as the rules may seem, ESOPs provide excellent tax benefits for both employers and employees, and one may be right for your business. 🕒

It doesn't have to be confusing

DISTRIBUTIONS OF ROTH 401(K) CONTRIBUTIONS

The Pension Protection Act of 2006 made Roth 401(k)s permanent. So now participants can make Roth contributions in qualified retirement plans regardless of the adjusted gross income limit for Roth IRA contributions and without worry that their tax-free distribution provision will disappear after 2010. Proposed regulations regarding Roth 401(k) account distributions affect plan years that began after Jan. 1, 2006.

Qualified vs. nonqualified distributions

Distributions from Roth 401(k) plans are either qualified or nonqualified:

- 1 Qualified distributions result in a nontaxable distribution of both earnings and the Roth 401(k) contributions.
- 1 Nonqualified distributions don't include the Roth 401(k) contributions in the participant's gross income, but do include the earnings on those contributions. The earnings will be subject to income tax and a 10% early withdrawal penalty.

Qualified distributions result in a nontaxable distribution of both earnings and the Roth 401(k) contributions.

To avoid the penalty tax and make sure the Roth 401(k) distribution is qualified, the Roth 401(k) account must satisfy a five-year holding requirement. The five-year period begins with the first taxable year in which the participant makes designated Roth 401(k) contributions and ends after five consecutive taxable years. And the distribution must be taken after the participant reaches age 59½, is disabled or dies. Your plan document must permit an in-service distribution at age 59½.



The five-year period follows the participant from plan to plan only if he or she rolls over the designated Roth 401(k) contributions from one qualified plan to another. Without the rollover feature, a new five-year period is determined for each plan. Additionally, rules require that the five-year holding periods track separately for Roth IRA and Roth 401(k) accounts.

Allowable distributions

Roth 401(k) contributions are subject to the same in-service distribution restrictions as pretax employee 401(k) contributions. So it's best for your employees to not take an in-service distribution before age 59½ unless it's for a hardship distribution. If a participant does make a hardship withdrawal, the distribution will be taxed, prorated between earnings and the Roth contributions.

Participants can take loans from their Roth 401(k) account. But if they default on the loan, it becomes taxable — even if the participant has already paid taxes on the contribution. Talk with your plan sponsor about limiting loan contributions to pretax deferrals.

Rollover distributions

Participants can roll over a Roth 401(k) account into another qualified plan that allows designated Roth contributions or into a Roth IRA. A participant can make a direct plan rollover from one Roth 401(k) plan to another Roth 401(k) plan or from a Roth 403(b) plan to another Roth 403(b) plan. But they can't roll over an account between a Roth 401(k) and a Roth 403(b) plan.

The distributing plan must report the Roth 401(k) account's basis and earnings and also include the start date of the five-year holding period. Coordinate with your plan administrator about how they keep records that track contributions and earnings accurately each year.

If an individual rolls a designated Roth 401(k) account into a Roth IRA, he or she isn't limited by typical Roth account limits. A qualified rollover into an IRA either starts the five-year period for a new Roth IRA or assumes the Roth IRA's already established five-year period. Participants cannot roll a Roth IRA into a qualified plan. These rules have not changed.

Discrimination testing

A failure due to discrimination testing will result in a distribution in the form of a refund. Roth 401(k) contributions are treated like pretax deferrals when applying the Section 402(g) contribution limit. If the plan makes refunds because it failed the Sec. 402(g) limits, the earnings — but not the Roth 401(k) contributions — are taxed.

Under average deferral percentage (ADP) and average contribution percentage (ACP) testing, you don't include excess Roth 401(k) contributions, including matching contributions, in the participant's income. But the earnings are taxable.

Advantages outweigh complexities

The Roth 401(k) distribution rules do present record-keeping challenges for plan sponsors and third-party administrators of qualified plans. But with the right system, the advantages of having a Roth source in a qualified plan far outweigh the recordkeeping complexity. 🕒

Does your small plan have the right fidelity bond?

A fidelity bond protects your retirement plan against loss due to dishonesty or fraud. ERISA requires a bond for protecting both qualifying and nonqualifying plan assets, and it plays a role in small plan audits.

According to the Department of Labor, a small plan is one that has fewer than 100 participants at the beginning of the plan year, or has between 100 and 120 participants at the beginning of the plan year that was filed as a small retirement plan for the previous year. If your plan meets this requirement, it may be exempt from annual audit requirements.

To qualify for audit exemption, at least 95% of your small plan's assets must be qualified. Qualifying plan assets include employer securities, participant loans and assets held in financial institutions, and assets in participant-directed accounts. For plans that qualify for the exemption, plan sponsors must purchase bonds covering only 10% of plan assets, up to a maximum of \$500,000. (This amount increases to \$1 million for

plan years after Dec. 31, 2007.) And these qualifying plan assets must be valued at the beginning of the plan year.

If less than 95% of your small plan's assets are qualified, the plan must purchase a bond for any person handling the *nonqualifying* assets in an amount at least equal to the value of those assets. Nonqualifying assets include trust deeds, limited partnership real estate and collectibles that aren't held in trust by a corporate trustee. In addition, the plan sponsor must have a bond that is at least equal to 100% of the nonqualifying plan assets' value.

Whether the plan consists of qualifying or nonqualifying plan assets, the bond must come from a company approved by the Treasury Department. The federal government publishes a list of approved bond companies annually in the Federal Register. You can find it at www.fms.treas.gov/c570/index.html.