employee benefits update

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Welcome back!

BREAK-IN-SERVICE RULES AND RETURNING EMPLOYEES

If an employee leaves your company and then you rehire him or her, this may affect the employee's participation in your qualified retirement plan. You'll need to determine if there was a "break in service" that impacts his or her re-entry — or initial entry — into your plan. It doesn't matter what type of plan you sponsor because the break-in-service rules apply to all qualified retirement plans.

Defining break in service

A break in service is a 12-month period (a calendar year, plan year or other consecutive 12-month period) designated by the plan during which a plan participant completes 500 or fewer hours of service. Depending on your plan document, a break in service can occur just by reducing an employee's hours.

You can write your plan document to limit break-in-service provisions to only participants whom you terminate from employment. Check your document or with your administrator for the specifics of your break-in-service provisions.

Completing eligibility

If you do rehire a former employee, you'll need to determine if the employee is or was eligible to participate in your plan. First, find out if your plan has a written break-in-service provision. If not, the following rules apply:

- If the employee met your plan's eligibility requirements and then had a break in service, he or she re-enters the plan on the re-employment date, regardless of normal entry date procedures, such as quarterly entry dates.

- If the employee didn't meet your plan's eligibility requirements, he or she must complete those requirements. Continuous employment isn't required, so if you rehire the employee within one year of the original hire date, you must count all of the hours in your plan's eligibility computation period.
- If your plan's eligibility requirements have changed, the participant must complete the new requirements unless the plan amendment contains a "grandfather" clause. Again, if you rehire the employee within one year of the original hire date, you must count all of the hours in the eligibility computation period.

If your plan does contain break-in-service rules, verify that an actual break in service occurred according to your plan provisions. Then determine the effect this has on initial entry or re-entry into your plan. Generally, plans that include a written break-in-service provision use one of the following three types of rules:

1. One-year holdout rule. This means that prior service is temporarily disregarded until the employee completes another year of service. At that time, the plan retroactively restores entry. If your plan doesn't have this provision, re-entry is immediate.

2. Five-year rule. This rule applies only if the employee was a plan participant when the break in service began, had a break in service of at least five years and wasn't vested in any employer-provided money. If all are true, the employee permanently loses all prior-year service and has to start all over again as if he or she were a new employee.

3. Two-year rule. Two-year eligibility plans are uncommon. This rule applies only to plans with a two-year eligibility and employees who have a break in service before completing the two-year service requirement. If an employee has a break in service prior to completing the two-year service requirement, the employee loses credit for the prior service and must start over again as if he or she were a new employee.

Plans can determine eligibility using the "counting hours" or "elapsed time" method. If you use the counting hours method, you determine a break in service by the hours of service credited. If you use the elapsed time method, you determine a break in service by the length of severance.

Vesting makes a difference

If the plan credits an employee with 1,000 hours or more of service during a plan year in which his or her employment terminates, the plan must credit the employee with another year of service and, therefore, another year of vesting in the plan. You may need to credit the employee for hours of service for compensation paid to the terminated employee. For example, if the employee had two weeks of accrued vacation owed to him or her, you must add an additional 80 hours of service to the actual hours worked.

This can impact whether an employee receives credit for another year of service and thus another year of vesting. Also, nonvested hours aren't always automatically forfeited simply because of termination. Check your plan document or contact your plan administrator to find out more.

Breaking up

Rehiring an employee can be great for your company. But when your retirement plan is involved, it involves more than just saying "Welcome back." Contact your plan administrator or sponsor if you have questions.

What happens when an employee takes a leave of absence?

A break in service isn't the same as an "interruption" of service. Employers must credit service for the following leave:

Maternity/paternity leave. You must credit employees for paid hours during a maternity or paternity leave as normal hours of service. However, you can credit unpaid hours to the employee for the number of hours during the absence (up to a maximum of 501 hours). The unpaid hours you credit to the employee are used only to determine a break in service. You don't have to count them toward earning a year of service.

Family and Medical Leave Act (FMLA). Most FMLA leaves are unpaid. Because FMLA lasts only up to 12 weeks, most employees will have enough hours to prevent a break in service. But you must credit the hours for the leave if they're needed to prevent a break in service. If the employee is paid for the leave, the normal crediting of hours applies.

Military service. Employers must treat military service as continuous service when determining the employee's right to accrue benefits under the plan. Therefore, break-in-service rules don't apply to military leaves.

Don't be late

THE VOLUNTARY FIDUCIARY CORRECTION PROGRAM CAN HELP

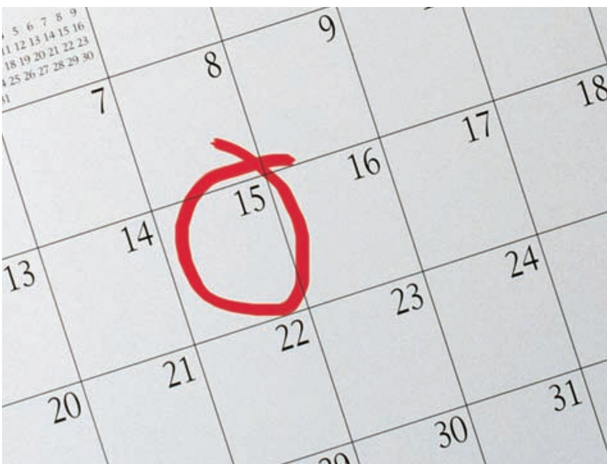
One of the most common ERISA violations is an employer's failure to timely remit participant salary deferrals or participant loan repayments to a qualified plan. Fortunately, the Voluntary Fiduciary Correction Program (VFCP) provides employers with an easy way to self-correct ERISA violations such as this. VFCP updates make the program simpler to use and expand the types of correctable transactions.

No safe harbor deadline

If you ask many employers with 401(k) plans when they're required to deposit deferrals, the most common response would be the 15th day of the following month. This understanding stems from the DOL's regulations that require an employer to deposit amounts withheld from an employee's wages for contribution to a plan as of the earliest date the employer can reasonably segregate the amounts from the employer's general assets, but no later than the 15th business day of the month following the month the employer withheld the amounts.

Most employers took that to mean they had until the 15th day of the following month to deposit *all* withheld amounts, even if they could have segregated the funds sooner. The DOL is now emphasizing that the outside deadline isn't a safe harbor.

According to the DOL, if the employer *can* deposit the deferrals before the 15th business day of the month following, that earlier date is the maximum time period.



In other words, the time period is set by how soon you can segregate the amounts from general assets and deposit them into the plan trust.

In addition, employers that have different payroll frequencies, such as weekly for some employees and monthly for others, can't hold the weekly assets and deposit them with the monthly payroll. With most payroll systems, plan administrators can segregate deferral amounts in a matter of days, if not almost immediately.

Use the VFCP

So what happens if you fail to make a timely deposit? The process under the VFCP consists of four steps:

1. Identify violations and determine if the VFCP covers the transaction.
2. Follow the procedures outlined in the program for correcting the specific violation.
3. Calculate and restore profits or losses with interest and distribute residual benefits to participants no longer in the plan.
4. File an application with your region's Employee Benefits Security Administration (EBSA) office documenting the corrections you made.

So what are some ways to correct a violation? Let's take a closer look.

Correct the late deposit

To correct for the late deposit of participants' funds, the plan sponsor must first determine the earliest date the amounts could have reasonably been segregated from the company's general assets. Then, for participant contributions or loan repayments deposited after this date, you have to calculate lost earnings on all delinquent deposits. The sponsor must pay the greater of:

1. Lost earnings on the delinquent participant contributions or loan repayments, or
2. Profits resulting from the employer's use of the delinquent amounts.

With most payroll systems, plan administrators can segregate deferral amounts in a matter of days, if not almost immediately.

You'll be able to calculate profits only if you used the amounts for a specific purpose and you can determine a profit. This isn't normally the case. In almost all situations, the plan sponsor deposits lost earnings.

The lost earnings calculation approximates the amount that would have been earned under the plan if the sponsor had made the deposit on time. You calculate the earnings from the lost date (the date the sponsor should have made the deposit) through the recovery date (the date the sponsor made the deposit). In addition to the lost earnings, the sponsor must pay any penalties, late fees or other charges the participant incurs because of the late deposit.

The VFCP now makes it easy for plan sponsors to calculate the lost earnings and any interest on the lost earnings. The DOL/EBSA Web site provides an online calculator for both lost earnings and any interest on those earnings.

Qualify for relief

After you fully comply with the correction methods and properly file under VFCP, the DOL will issue a no-action letter. The letter states that the DOL won't initiate a civil investigation under ERISA and won't assess any penalties.

In addition, VFCP offers relief from excise tax provisions of the Internal Revenue Code under a class exemption. Sponsors don't have to apply for the relief but qualify if they have met all requirements under the VFCP and have received a no-action letter from the DOL.

Additional information

The VFCP updates also provide detailed information on what corrections are eligible, examples on how to correct violations, information on how to apply and the documentation required. You can find complete information on the VFCP on the DOL/EBSA Web site, http://www.dol.gov/ebsa. Even if you choose not to file with the DOL, you should always correct the violation and restore the lost earnings to the plan.

2008 vs. 2007 retirement plan limits

Type of limitation	2008	2007
Elective deferral limit for 401(k), 403(b), 457(b)(2), 457(c)(1)	$ 15,500	$ 15,500
Annual benefit limit for defined benefit plans	$ 185,000	$ 180,000
Annual contribution limit for defined contribution plans	$ 46,000	$ 45,000
Annual compensation limit for benefit purposes for qualified plans and SEPs	$ 230,000	$ 225,000
Highly compensated employee threshold	$ 105,000	$ 100,000
SIMPLE contribution limit	$ 10,500	$ 10,500
Catch-up contribution limit for 401(k), 403(b), 457(b)(2), 457(c)(1)	$ 5,000	$ 5,000
SIMPLE catch-up contribution limit	$ 2,500	$ 2,500
SEP coverage	$ 500	$ 500
IRA contribution limit	$ 5,000	$ 4,000
IRA catch-up contribution limit	$ 1,000	$ 1,000
Social Security taxable wage base	$ 102,000	$ 97,500

What's on the menu?

CHANGES IN SECTION 125 CAFETERIA PLANS

Section 125 plans, better known as cafeteria plans, offer employees an opportunity to participate in health insurance and other employer benefits on a pretax basis. Pretax means the contributions are deducted from the employee's paycheck before payment of federal income tax. Starting in January 2009, new regulations will apply to these types of plans.

What are cafeteria plans?

Sec. 125 plans allow employees to pay medical, dental and vision premiums on a pretax basis, so that these amounts are excluded from the gross income of the employee. Plans can include benefits such as health insurance, dental insurance, long-term and short-term disability insurance and life insurance, to name a few. Such plans can also provide dependent care benefits on a pretax basis.

Employers can offer participants three options for having money deducted from their pay: They can pay the insurance premiums on a pretax basis, participate in a flexible spending account, or offer a dependent care arrangement. Employees may choose any of these options. With a flexible spending account, also known as a medical reimbursement feature, participants elect to make deferrals on a pretax basis and get reimbursed for out-of-pocket healthcare-related expenses. Plans may also have a pretax dependent care component where participants elect to have dependent care expenses reimbursed.

Participants can change their elections only for major life events.

What do you need to know?

The regulations clarify many prior rulings that were somewhat vague. The major areas impacting sponsors include:

One of a kind. A Sec. 125 plan is the only program that allows an employer to offer employees a choice of taxable and nontaxable benefits. Any election made outside of a Sec. 125 plan will result in gross income to the participant.

Change in status. Employees elect to participate in the Sec. 125 plan and choose their benefit options before the beginning of the plan year. Participants can change their elections only for major life events such as change in marital status, birth, or change in working hours such as full time to part time.

Time of reimbursements. Plans can reimburse participants for only qualified benefits that correspond to the participant's current plan-year elections. The coverage period must equal the current plan-year elections for any payments to be qualified benefits.

Forfeiting unused money. Participants will forfeit unused amounts at the end of the plan year. Plans with a flexible spending component may allow for a grace period of up to two-and-a-half months after the plan year. During this time a participant may incur expenses for amounts deferred in the previous plan year.

Plan document. The regulations reiterate that a cafeteria plan must have a written plan document and the plan must operate in accordance with plan terms. Plan sponsors must provide election forms and a summary plan description to participants.

Debit cards. Plans may use a debit card system to reimburse employees for medical costs. The regulations state that employees must sign a written election agreeing to use the card for unreimbursed medical expenses and can't seek reimbursement from another health plan. You can limit the card use to certain providers or merchants.

The menu looks good

The new regulations also further clarify discrimination testing issues and define key and highly compensated employees so that they are more in line with the qualified plan definition. These regulations should help clarify the gray areas in the legislation and provide a framework for an effective Sec. 125 program.

The final word on Roth 401(k) plan distributions

Although Roth 401(k) deferrals were allowed as early as January 2006, questions on the taxation of distributions from these accounts weren't answered until the IRS issued its final regulations. Some highlights of the final regulations address:

The five-year period. To maintain a distribution's qualified (tax free) status, a participant cannot take a Roth 401(k) distribution before the end of the fifth consecutive year following the first day of the year in which the participant made the first Roth 401(k) deferral to the plan. Plan administrators will have to track this five-year period to make sure the participant has the Roth account in the plan for the required time. Roth 401(k) deferrals that are returned in full due to failed testing don't start the period.

Rollovers. A rollover from a Roth 401(k) account that includes nontaxable amounts must be direct. The distributing plan must report the five-year period start date to the new plan. The receiving plan must permit Roth deferrals and satisfy separate accounting requirements. A participant's Roth accounts don't need to be kept separate; the earlier of the five-year periods applies to all.

If a Roth 401(k) account is first distributed to the participant, only the taxable portion can be rolled (within 60 days) into another plan account, with the five-year period starting over. The receiving plan administrator must report the acceptance of this rollover to the IRS.

Participants can roll over a Roth 401(k) plan account directly or indirectly to a Roth IRA, regardless of the participant's income. Unless a Roth IRA was previously established, a new five-year period begins. A Roth IRA can never be rolled to a Roth 401(k) plan.

Hardship distributions. Although the distribution may not necessarily be qualified, plans can allow for hardship distributions from Roth 401(k) accounts. The total amount of all deferrals — traditional and Roth — may be available. As long as the participant doesn't exceed this cumulative deferral amount, the hardship may be made from either or both accounts, including earnings, if desired.

This brief summary presents just a few highlights of the Roth 401(k) regulations. Due to the tax implications, make sure your participants are knowledgeable about Roth 401(k)s before choosing to defer this way.

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