

employee benefits update

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Costs vs. rewards in Roth 401(k)s

The Roth 401(k) is an employer-sponsored retirement account that employees fund with after-tax dollars. Because the contributions have already been taxed, participants receive the money tax free at distribution. And the earnings are tax free if they're part of a qualified distribution. Your employees may like the sound of this, but you need to determine whether a Roth 401(k) makes sense for your company.

What are they?

Roth 401(k) is an “add-on” to the traditional 401(k) plan. Under the regulations, you can't establish a “Roth only” 401(k) plan — your plan must also allow for pretax elective contributions. Employer matching and profit-sharing contributions can be made only to the traditional 401(k) accounts. Participants can't roll over traditional 401(k) money into a Roth 401(k) account. Nor can they roll over Roth 401(k) money into a traditional 401(k) account.

Keep in mind that adding a Roth 401(k) to your retirement plan doesn't increase the total amount that employees can contribute. The contribution limits are the same for traditional and Roth 401(k) contributions, or the two combined. Roth 401(k) contributions, like traditional 401(k) contributions, are always 100% vested.



How does the tax-free treatment work?

A Roth 401(k) distribution can occur on a qualifying event:

- › Termination of employment,
- › Death,
- › Disability, or
- › Retirement.

Your plan document may also permit distributions on reaching age 59½ or for hardship.

Even though distributions are allowed for any of these qualifying events, the entire distribution — including earnings — may not be tax free. Although distributions of contributions are always tax free, a distribution of earnings is tax free only if it's a “qualified distribution.” To be a qualified distribution:

The participant must meet the five-year rule. The participant must have held the Roth 401(k) account for five years. The five-year holding period begins on the first day of the calendar year in which a participant makes his or her first Roth 401(k) contribution and ends on the completion of five consecutive calendar years. This is a one-time requirement, not a rolling requirement that separately applies to each year's Roth 401(k) contributions.

The distribution must have a qualified purpose. This means it must be made due to the participant's disability or death or after he or she reaches age 59½.

How do employees benefit?

Roth 401(k) can benefit some employees — but not all. By paying taxes on the contributions now, participants can reduce the amount of taxes they'll pay during retirement. This benefits participants who are in a higher tax bracket in retirement than when they made the contributions. With traditional 401(k) contributions, the taxes are deferred during retirement as the money is withdrawn. This benefits participants in a lower tax bracket during retirement.

Because it's hard to predict what the future will bring, participants sometimes split the amount they contribute between a Roth 401(k) and a traditional 401(k). If you choose to offer a Roth 401(k), advise your employees to consult with their financial advisor to determine whether this type of plan suits their financial profile.

What's the final analysis?

Offering a Roth 401(k) is voluntary — it's your choice to add the Roth 401(k) feature or not. Some employers choose not to because of the expense. Employers may incur costs when adding the Roth 401(k) feature to a new or existing plan, and Roth 401(k)s require some additional administrative record keeping and payroll processing. Other employers find that offering a Roth 401(k) is a good way to help attract and keep talented employees, especially high earners who aren't eligible to contribute to Roth IRAs. (For more on how Roth IRAs and

How do Roth 401(k)s compare to Roth IRAs?

Married couples with adjusted gross incomes (AGIs) exceeding \$169,000 per year or singles with AGIs exceeding \$116,000 can't contribute to the Roth IRA. On the other hand, there are no AGI limits on Roth 401(k) contributions.

Roth 401(k)s also permit higher contributions than Roth IRAs. For example, the 2009 contribution limit for the Roth 401(k) is \$16,500 (\$22,000 if the participant is 50 or older). The 2009 contribution limit for the Roth IRA is only \$5,000 (\$6,000 if the participant is age 50 or older).

The five-year holding rule applies to both. However, Roth IRAs aren't subject to required minimum distributions (RMDs) at age 70½, while Roth 401(k)s are. Currently, on a qualifying event, participants can roll over a Roth 401(k) into a Roth IRA to eliminate RMDs. But employees can't roll their Roth IRAs into your Roth 401(k).

Roth 401(k) plans compare, see "How do Roth 401(k)s compare to Roth IRAs?")

If you're not sure whether to add the Roth 401(k) feature, survey your employees to determine possible participation. Then discuss with your plan administrator whether it may be right for your business. 🕒

U.S. Supreme Court permits participants to sue for 401(k) losses

Last year, the U.S. Supreme Court issued a decision, *LaRue v. DeWolff, Boberg & Associates, Inc.*, allowing individual participants in retirement plans and 401(k) plans to sue plan fiduciaries for investment losses. Before *LaRue*, plan participants could bring actions only on behalf of a plan. With this new development, protecting yourself and your plan from a participant lawsuit should be at the top of your to-do list.

The case

In the case before the Court, 401(k) participant James LaRue instructed his employer to move the stock holdings in his account to cash. After the plan sponsor failed to make the change, LaRue's account plummeted \$150,000.

The Court found that the plan sponsor was negligent in failing to follow LaRue's instructions. As a result of this

negligence, the loss occurred. The Court stated that it didn't matter whether the fiduciary's breach diminishes plan assets payable to all participants and beneficiaries or only to persons tied to particular individual accounts. The case was sent back to the trial court for further proceedings.

2 ways to make investment changes

How plan participants are allowed to change their investment options makes a difference. It can be done in one of two ways:

1. Daily platforms. For plans invested in daily platforms, the participant may make adjustments directly into an Internet-based program that accesses the participant's account directly. Participants are free to choose from investments that the plan sponsor generally preselects. Participants can adjust their investments almost daily,



but most investment platforms place a restriction on the number and timing of purchases and sales. The participant retains the ability to change his or her investment, and generally the plan sponsor isn't involved with making changes to the participant's account.

2. Pooled investments for participant-directed plans.

For plans with funds held in a pooled investment, the participant must make an election to transfer funds. It's then the plan sponsor's responsibility to make the change. Generally, a participant will complete an election form and it's up to the plan sponsor or administrator to communicate with the broker or investment advisor to make the selected adjustments. Plan sponsors have significantly more responsibility in this scenario. Failure to follow the participant's instructions regarding a transfer can result in an investment loss, as in the *LaRue* case.

Protecting your plan

So how can you protect your plan and its fiduciaries? To begin with, make sure your plan is well organized. All responsible parties should know what's expected of them while administering the plan. Review your specific plan provisions related to the plan design to ensure that your plan is administered in compliance with the provisions. Consult with your third-party administrator or pension advisor to complete this review. Perform an annual compliance review with your legal or other ERISA counsel as well.

Additionally, hire an independent licensed advisor who's an expert at your plan's underlying investments. Select and monitor the investments for performance along with your advisor, and maintain a written investment policy statement summarizing the participants'

investment options. Hold participant education meetings and have an open line of communication between yourself and plan participants on an ongoing basis.

The Court stated that it didn't matter whether the fiduciary's breach diminishes plan assets payable to all participants and beneficiaries or only to persons tied to particular individual accounts.

If you offer employer stock, carefully consider this type of investment. Monitor the stock's valuation and give an array of investment options in addition to the employer stock. Encourage participants to diversify their investments. Finally, provide further employee education.

Planning and communication

Don't forget about retirement plan fees. Recent legislation requires that investment providers give full disclosure notices to plan sponsors detailing the plan's actual costs to sponsors and participants to eliminate any "hidden fees." Communicate this information to plan participants.

With careful planning and good communication, you can protect yourself against poor plan administration and avoid liability issues. 🕒

How to find out more about your service providers

The American Institute of Certified Public Accountants' Statement of Auditing Standards (SAS) No. 70 is an internationally recognized auditing standard for service providers, including employee benefit service providers. It demonstrates that a service provider has been through an audit of its internal control procedures, including controls over information technology and related processes. Let's take a closer look at why you should know about these audit reports.

Types of SAS 70 reports

There are two types of SAS 70 audit reports:

Type I. The Type I SAS 70 audit report contains the auditor's report on whether the provider's description of its controls is accurate and discusses whether the controls achieve specified objectives. But it doesn't determine whether the provider's controls were operating effectively at the time of the audit.

Nevertheless, it's a good starting point for service providers reporting for the first time. In fact, some will initially obtain a Type I SAS 70 report to identify and remediate any internal control deficiencies before having the internal controls tested in a Type II SAS 70 report. A Type I SAS 70 generally reflects a specific point in time (for example, Jan. 31, 2009).

Type II. With a Type II SAS 70 audit report, you'll get the same information as in a Type I report *plus* the auditor's opinion as to whether the provider's internal controls were operating effectively. The report will indicate any known weaknesses that may exist in the provider's internal operating structure.

A Type II SAS 70 covers a specified period of time (typically at least six months), such as March 1, 2008, to Feb. 28, 2009. The provider can decide when to start the period. If the reporting period doesn't coincide with the provider's fiscal year end, the auditor will issue a "gap letter." These letters are common and require someone at the provider to state that, to the best of his or her knowledge, there haven't been significant changes in the internal controls described in the SAS 70 report since it was issued. The letter must also

indicate the absence of material weaknesses that would require corrective action.

Importance of SAS 70 report

Providers use the SAS 70 audit process to identify opportunities for improvement in operational areas. Many providers also use SAS 70 reports to establish credibility with potential customers and to help differentiate themselves from competitors. Specifically, a "clean" SAS 70 report — meaning one with no reported internal control deficiencies — indicates that the provider has effective internal controls in place.

You'll want to review an SAS 70 report when using outside service organizations to perform services such as payroll processing, record keeping or trustee or custodian services. The CPA auditing your plan will review the controls section in the provider's SAS 70 report. This section outlines the controls you'll need to have in place for the outside service organization's controls to be effective. Outside auditors review these user control considerations and will verify that the outside service organization clients have controls in place to ensure operating effectiveness.

What to look for

In your contacts with employee benefit service providers, ask to see their SAS 70 audit reports. Be aware that, if the provider provides a Type I audit report, auditors haven't yet tested controls to see if they're operating as designed. And note that some accounting firms may also provide third-party administrator (TPA) services. But they won't have to have an SAS 70 audit done for their TPA practice if they don't actually process any transactions for their TPA clients. 🕒



Be prepared for QDROs

Qualified domestic relations orders (QDROs) require plan sponsors to distribute a participant's money in a qualified retirement plan to "alternate payees." They most often arise in the context of divorce and child support payments. Today, the combined assets in a couple's retirement account typically make up one of their largest assets next to the family home. So it's important for everyone who works with QDROs to understand how they work.

DROs and QDROs

A domestic relations order (DRO) is an order issued by a state authority relating to payment of alimony, child support and marital property rights to a spouse, former spouse, child or other dependent. A DRO becomes qualified — and thus a QDRO — only if it includes:

- › The name and last known mailing address of the qualified retirement plan participant and the alternate payee,
- › The amount or percentage of the participant's benefit to be paid by the plan to each alternate payee, or the formula determining the amount or percentage,
- › The number of payments or period of time to which the order applies, and
- › The plan name or names to which the order applies.

ERISA requires each employee benefit plan to have reasonable procedures in place to assist participants and potential alternate payees with the QDRO process.

State courts issue DROs under state domestic relations laws and provide for payment of all or a portion of a participant's benefits to an alternate payee. An alternate payee cannot be anyone other than a spouse, former spouse, child or other dependent.



When a plan receives a DRO

When a plan trustee receives a DRO, the following steps occur:

- 1. Notification.** The plan sponsor or trustee must notify the participant and each alternate payee in the DRO of the receipt of the DRO along with the plan's procedures for determining whether the DRO is qualified.
- 2. Determination of status.** The sponsor must determine whether the DRO is qualified and notify the participant and each alternate payee of the findings. This must occur within a reasonable time period after the receipt of the DRO. While the qualified status of the DRO is being determined, the plan administrator must separately account for the amounts that may be payable to the alternate payee if the order is found to be qualified.

3. Payment. If within the 18-month period beginning with the date on which the first payment is required to be made under the DRO it's determined that the order is a QDRO, the plan administrator will pay the segregated amounts to the entitled individuals. If it's determined not to be a QDRO, the plan administrator will pay the segregated amounts back to the person who would have been entitled to them had there not been a DRO.

Tax ramifications

The 10% penalty on early distributions doesn't apply to QDROs. If the alternate payee is a child or other dependent of the participant, the participant is responsible for any income taxes on QDRO distributions.

Spouses or former spouses, however, are responsible for paying income taxes on their QDRO distributions. Also, because benefits paid to a spouse or former spouse are eligible for rollover to his or her IRA,

they're subject to mandatory 20% withholding if they're not rolled over.

ERISA requirements

ERISA requires each employee benefit plan to have reasonable procedures in place to assist participants and potential alternate payees with the QDRO process. First and foremost, put your QDRO procedures in writing.

Be sure you're prepared to notify each person entitled to plan benefits in a DRO promptly. Your plan must also permit an alternate payee to appoint a representative, such as a lawyer, accountant, or legal or financial advisor, to receive copies of notices sent by the plan.

Don't compromise your plan

As a plan sponsor, you should always adhere to your plan's written QDRO procedures and make QDRO timely determinations. Failure to do so could compromise your plan's qualified status. 🕒

2009 vs. 2008 retirement plan limits

TYPE OF LIMITATION	2009	2008
Elective deferrals to 401(k), 403(b), 457(b)(2), and 457(c)(1) plans	\$ 16,500	\$ 15,500
Annual benefit for defined benefit plans	\$195,000	\$ 185,000
Contributions to defined contribution plans	\$ 49,000	\$ 46,000
Contributions to SIMPLEs	\$ 11,500	\$ 10,500
Contributions to IRAs	\$ 5,000	\$ 5,000
Catch-up contributions to 401(k), 403(b), 457(b)(2), and 457(c)(1) plans	\$ 5,500	\$ 5,000
Catch-up contributions to SIMPLEs	\$ 2,500	\$ 2,500
Catch-up contributions to IRAs	\$ 1,000	\$ 1,000
Compensation for benefit purposes for qualified plans and SEPs	\$245,000	\$230,000
Compensation for SEP coverage	\$ 550	\$ 500
Highly compensated employee threshold	\$110,000	\$105,000
Social Security taxable wage base	\$106,800	\$102,000