employee benefits update

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IN-SERVICE DISTRIBUTIONS
Show them the money

"WRAP" welfare benefit plan documents

Why a cash balance plan may be right for you

Make corrections before they cost you

Show them the money

When are active employees eligible to take an "in-service" distribution from a qualified retirement plan? Participants may think that, because the money is "theirs," they can get to it at any time. So that you're ready the next time a participant asks about distributions from their account, let's review when in-service distributions are allowed.

Follow the lingo

An in-service withdrawal is the distribution of vested money from a qualified plan to a participant who is still actively employed by the employer sponsoring the plan. Various types of in-service withdrawals may be available to participants, including:

Withdrawals of after-tax employee contributions. After-tax employee contributions are always 100% vested. Most plans allow participants to withdraw these contributions, along with earnings. But, Roth 401(k) and Roth 403(b) contributions are subject to the same distribution restrictions that apply to elective deferrals. For a plan to distribute elective deferrals there must be a distributable event, such as when a participant reaches age 59½ or hardship.

Withdrawals of rollover funds. Rollovers are always 100% vested. Plans that accept rollovers may allow in-service withdrawals of rollover funds. But some plans may restrict when participants can withdraw these funds, such as prohibiting withdrawals if an employee rolls funds into the plan before the employee has met the plan's eligibility requirements.

Plans that allow hardship withdrawals must define what qualifies as a hardship event.

Financial hardship withdrawals. Plans may allow participants who have an immediate and heavy financial need resulting from an unforeseen circumstance to take an in-service hardship withdrawal. The plan must define what qualifies as a hardship, and it's the plan sponsor's responsibility to determine if the participant has a hardship. The withdrawal may not exceed the lesser of the participant's vested account balance under the plan or the cost of the financial need. A participant cannot withdraw the earnings on their own salary deferral money, but rather only what they have contributed. So additional recordkeeping will be required.

Withdrawals based on age or service. Some plans give participants the option to withdraw their benefits after completing a certain number of years of service of plan participation or reaching a certain age, such as 59½. (Setting the age at 59½ eliminates the additional 10% income tax penalty applicable to most early distributions.)

Withdrawals related to divorce. A qualified domestic relations order (QDRO) is issued under state law and provides for payment of a participant's plan benefits to an alternate payee. The alternate payee can be a spouse, former spouse, children or other dependents. QDROs may be necessary for payment of child support, alimony payments or property settlement.

Normal retirement age distributions. Once a participant reaches normal retirement age (as defined by the plan), plans may permit in-service withdrawals. The Internal

Revenue Code (IRC) and ERISA require that normal retirement age cannot be greater than age 65 or the fifth anniversary of the participant's entry date into the plan.

Required minimum distributions (RMDs). Participants must begin receiving RMDs by April 1 following the later of the year they reach 70½ or the year in which they retire, and receive them each year thereafter. Participants who are 5% owners must begin receiving RMDs by April 1 of the calendar year following the year they reach age 70½, even if they haven't retired. If the participant is still employed and not a 5% owner, he or she may defer the distribution until retirement.

Corrective distributions. Plan sponsors may need to make corrective distributions to participants to ensure that the plan complies with the IRC. For example, if a participant exceeds the elective deferral limit for a given year, the plan will make a corrective distribution to that participant in the amount that the participant deferred over the limit.

Loans. If your plan allows, participants can borrow from their own account and repay the loan back with interest. The maximum amount a participant can borrow is the lesser of 50% of the participant's account balance or $50,000. The loan term is limited to five years unless the participant uses it to purchase a principal residence. The DOL requires plans offering participant loans to have a loan program document that formally states the plan's loan policies and procedures.

Be in the know

Depending on your plan, certain distributions mentioned may or may not be available to your employees. And several of the withdrawals discussed above may create ordinary income tax liability to the participant. Plan sponsors and administrators need to be up-to-date as to what distributions are permissible under their plan. Check your plan document so you're prepared the next time a participant inquires.

"WRAP" welfare benefit plan documents

When an employer provides several "welfare" benefits, such as health, dental and vision coverage, the Department of Labor (DOL) considers each benefit its own separate plan. These individual plans require separate Form 5500 filings.

A common technique for reducing the number of Forms 5500 an employer needs to file is for the employer to "wrap" its welfare plans into a single plan.

To create a WRAP plan, the employer must incorporate the various benefits or policies into one comprehensive plan. Although the DOL hasn't provided specific language, generally all that's necessary in a WRAP document is incorporation language. The plan document generally should list the employer, identify who's responsible for fees and plan claims, and describe the administrator's role, plan eligibility and other employee rights. A mere contract with the insurance carrier isn't enough to satisfy the WRAP requirements.

You'll also need to provide a summary plan description to participants. This contains all the necessary language that translates the plan into layman's terms so employees can understand it.

Beware, however: Using a WRAP document may transform several small welfare plans that are otherwise exempt from filing Form 5500 into a single large plan that must file a Form 5500. Generally, a WRAP plan that has 100 or more participants at the beginning of the plan year must file Form 5500, even if each underlying welfare plan has fewer than 100 participants and is unfunded or fully insured.

Although creating a WRAP plan will cost money, it can be an effective way to consolidate Form 5500 filings and to provide the necessary ERISA information to employees. If your company has several welfare plans, contact your plan administrator to find out if a WRAP plan is right for you.

Why a cash balance plan may be right for you

Before the Pension Protection Act of 2006 (PPA), cash balance plans operated basically without official IRS approval because the agency didn't issue many determination letters for them. Provisions in the PPA gave these plans the green light, however, and cash balance plans can stand up and take a bow. Here's a closer look at what these plans are and the types of organizations that can benefit from them.

What is a cash balance plan?

The underlying cash balance plan design is a defined benefit plan, but participants receive statements with actual balances and summaries like a defined contribution plan, such as a 401(k) plan.

Cash balance plans generally must make a mandatory contribution each year. Employers can't make the contributions on a discretionary basis. This means you can't decide from year to year if you want to make a contribution.

But the contribution can vary based on the investment activity in the plan. In some instances, the plan will have enough earnings so that a contribution isn't required. This occurs when there are significant gains due to the investment earnings in the plan.

How do you fund the plan?

Like other defined benefit plans, cash balance plans must meet certain funding rules, known as the "accrual rules." The rules require that accruals in later years be compared to accruals in earlier years. This is to prevent "backloading," meaning that participants can't receive greater benefits at the end of their employment than they would early in employment.

In cash balance plans, both the employer contribution and investment earnings are credited to participants based on a plan contribution formula. It's generally either a percentage of the participant's pay or a flat dollar amount. The plan document typically sets an annual interest credit with a guaranteed rate of return, independent of the plan's investment performance.

Cash balance plans provide plan sponsors with a number of accrual formulas. Your plan document must state the formula and you must test it to ensure that it doesn't discriminate in favor of highly compensated employees.

The testing is age-dependent, so a cash balance plan's success depends on the sponsoring employer being able to align its demographics with its goal regarding whom it wishes to benefit in the plan.

Other plans of the sponsor are considered in nondiscrimination testing (such as an existing 401(k) or profit sharing plan). You can set up your cash balance plan to cover some, but not all, of your employees, but you must meet minimum participation requirements. For example, your plan must cover at least 50 employees or the greater of two employees or 40% of all employees. You can't aggregate plans for the purpose of meeting the minimum participation requirement. However, you can aggregate your plans for purposes of coverage and other nondiscrimination testing once you meet the participation test.

As with all defined benefit plans, an enrolled actuary must review the calculations in your cash balance plan.

How do participants benefit?

Because cash balance contributions are age-dependent for nondiscrimination testing, the older the participant, the higher the potential contribution amount is. The reason for this difference is that an older person has fewer years to save toward retirement.

Cash balance plans work well for the employer who wants to provide higher benefits than defined contribution plans offer. For example, companies may be able to fund annual contributions as high as $100,000 to $200,000 for owners and key employees — much more than under a defined contribution plan, which is subject to the Internal Revenue Code Section 415 limit ($46,000 for 2008). And other employees generally receive contributions of 3% to 4% of their salaries under cash balance plans.

Participants are entitled, on termination of employment, to receive the vested portion of their retirement balance (as determined by the plan's vesting schedule) as a lump sum distribution. Cash balance plans must also allow the participant to receive the distribution in the form of an annuity if certain conditions are met. Generally, the plan document will require the participant's account balance to be at least $5,000 to qualify for this option.

Cash balance assets are portable. So if a participant leaves your employment, he or she can roll over the lump sum distribution to an IRA or another qualified retirement plan.

Can you convert your existing plan?

A plan sponsor may convert a current defined benefit plan to a cash balance plan through a plan amendment. The participant's conversion balance is often the present value of the prior defined benefit plan.

A new cash balance plan can grant prior service credit in the form of an opening cash balance account. The participant's retirement benefit is provided by the hypothetical account balance. This balance is converted to a monthly benefit based on the actuarial equivalence basis. This provides a report that shows the current value of the participants' accounts and the projected amount of retirement benefit.

Unlike a defined contribution plan, the risk of the investment loss is the employer's responsibility, not the participant's.

Should you consider a cash balance plan?

Cash balance plans aren't for every employer. In fact, they benefit certain sponsors more than others. Because you'll need to fund the plan every year, companies that have had consistent earnings and profits and have available cash flow each year generally do well with cash balance plans.

Cash balance plan benefits are easier to clearly summarize for employees than defined benefit plan benefits. And you may be able to maximize benefits compared with a defined contribution plan, thus providing a more sound retirement for your employees.

Make corrections before they cost you

Retirement plans must achieve and maintain qualified plan status to avoid plan disqualification and surrendering tax-advantaged status. Both the Department of Labor (DOL) and IRS take into consideration that mistakes happen for various reasons. So, provided the mistakes aren't deliberate, the DOL and IRS have created programs that plan sponsors can use to correct violations — with relatively low or no fees.

Audit basics

The DOL can investigate a plan if it suspects an ERISA violation or if a plan participant contacts them. The IRS reviews annual DOL Form 5500 filings and checks answers to certain questions that serve as audit flags (such as a "yes" response to failure to remit deferrals and loan payments). And the agencies share information.

Keep in mind that there is ***no*** statute of limitations on plan disqualification. Normally, the statute of limitations for IRS review is three years from the filing date of the Form 5500. The tax effects of disqualification apply only to years within the statute of limitations. But the plan can still be disqualified even if the event causing the disqualification happened outside the statute of limitations.

Plan disqualification consequences include the following:

- The IRS can disallow employer contribution deductions to the extent participants aren't vested.
- Plan asset earnings may become currently taxable to the trust.
- Participants may have to include vested benefits in their gross income.
- The IRS may disallow tax-free rollovers of distributions.

IRS correction programs

The IRS Employee Plans Compliance Resolution System (EPCRS) is a series of correction programs that allow plan administrators to voluntarily correct certain plan failures, such as:

- Ineligible employer defects,
- Plan document failures,
- Demographic issues, and
- Operational defects.

Three EPCRS programs are available:

1. Self-correction program (SCP). Under the SCP, plan sponsors can self-correct insignificant operation failures at any time without contacting the IRS and without paying fees or sanctions. You can avoid penalties and other EPCRS actions by following the procedures for fixing the failure, documenting the steps you took to comply with the SCP in the event of a future audit and having an administrative procedure in place so that it doesn't happen again.

You can't use the SCP to correct certain failures. These include egregious failures, plan document failures, demographic failures, ineligible employer failures and failures involving misuse of plan assets.

2. Voluntary correction program (VCP) with service approval. Plan sponsors can use this program to correct failures that don't meet SCP eligibility. You'll need IRS approval, and the fee for using the program is based on the number of plan participants. The fees can be as low as $750 for a small plan and as high as $25,000 for a larger plan, but you can avoid significant penalties.

3. Audit Closing Agreement Program (Audit CAP). If you're already under audit or in the determination letter process and qualification defects are found, under this program the IRS and plan sponsor can negotiate a fair settlement. But you can't use this program if plan assets were misused. And because the Audit CAP isn't voluntary (like the other EPCRS programs), it usually results in higher sanctions. However, the cost of Audit CAP sanctions is much lower than the cost of plan disqualification.

DOL correction programs

The DOL has the following two programs available:

1. The delinquent filer voluntary compliance (DFVC) program. This program allows plan administrators to bring their plans into compliance by filing any and all delinquent Form 5500s. The Employee Benefits Security Administration (EBSA) can waive all or a portion of the penalties and sanctions that may be assessed. Sanctions can be quite substantial. For example, you can be fined up to $1,100 a day for each day the Form 5500 is late. The penalty amount is based on the number of plan participants, with a per-plan cap.

Keep in mind that there is no statute of limitations on plan disqualification.

2. The voluntary fiduciary correction program (VFCP). This allows plan administrators to correct 15 specific financial transactions involving fiduciary liability. Plan fiduciaries can avoid penalties and other ERISA actions by following the procedures for fixing specific violations. This generally includes calculating and restoring plan assets or any lost plan benefits to participants and submitting an application to the DOL documenting the correction.

Among the violations allowable for correction under the program are:

- Delinquent participant contributions to pension plans, insured welfare plans and welfare plan trusts,
- Fair market or below market interest rate loans with parties-in-interest,
- The purchase of assets by or sale of assets to plans from parties-in-interest,
- Purchase of assets from or sale of assets to non-parties-in-interest at other than fair market value,
- Benefit payments based on improper valuation of plan assets, and
- Payment of duplicate, excessive or unnecessary compensation.

For a complete list of correctable violations under the VFCP, contact your plan administrator.

Don't take a chance

Mistakes are bound to happen for a variety of reasons. Plan sponsors should use the DOL and IRS correction programs rather than taking a chance and waiting for an audit to reveal the mistake. If you correct the problem before an audit, any fees will be far less than the sanctions resulting from an audit or the cost of disqualification.

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