



A publication of Retirement Plan Advantage, LLC

It's RMD Time

Fall is the time for plan sponsors to review their plans in preparation for making required minimum distributions (RMDs) to retired employees and other beneficiaries. Below, we answer some common questions about RMDs and employers' responsibilities concerning these distributions.

Who Receives RMDs?

In general, plans must make RMDs to retired employees who have reached age 70½ and to any current employees who own more than 5% of the company and are age 70½ and older. RMDs also must be paid to beneficiaries of a deceased employee's qualified plan account.

When Do RMDs Have To Be Made?

RMDs must begin by the "required beginning date." The tax law provides that the required beginning date is April 1 of the year after a retired employee or a more-than-5% owner turns age 70½. If an employee (other than a 5% owner) continues to work for the sponsoring employer after age 70½, the plan can allow the employee to wait until April 1 of the year after retirement to start taking RMDs.

For beneficiaries of employees who die before their required beginning date, minimum distributions usually must start on or before December 31 of the year after the year of the employee's death. However, a surviving spouse who is the sole account beneficiary and leaves the money in the plan has the option to wait until December 31 of the year the employee would have turned age 70½.

Plans must make subsequent RMDs by December 31 of each year.

How Are an Employee's RMDs Calculated?

Generally, an employee's RMDs are calculated each year based on the employee's age using the IRS's Uniform Lifetime Table. The account balance at the end of the preceding year is divided by the applicable age-based factor found in the IRS table. However, the uniform table isn't used if the account owner's spouse is the sole beneficiary and he or she is more than 10 years younger than the owner. In that case, a joint life expectancy table is used instead. Using this table will result in a lower RMD than would be computed using the uniform table.

How Are Beneficiaries' RMDs Calculated?

If the employee had designated an individual beneficiary and the employee dies before his or her required beginning date, RMDs generally are calculated based on the beneficiary's life expectancy (unless the five-year rule applies). When the employee has designated more than one beneficiary, the life expectancy of the oldest beneficiary should be used. If the employee dies after his or her required beginning date, the remaining balance must be paid out over the longer of the beneficiary's or the employee's remaining table life expectancy.

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Timing and Order of QDROs

The U.S. Department of Labor's Employee Benefits Security Administration (EBSA) recently issued guidance that answers many questions employers have asked about qualified domestic relations orders (QDROs).

QDRO Review

A QDRO is a judgment, decree, or order made pursuant to state domestic relations law relating to child support, alimony payments, or marital property rights that creates or recognizes the right of an "alternate payee" to all or part of an employee's retirement plan benefits. It must include specific information and must meet various pension law requirements to be considered qualified.

For example, a domestic relations order will fail to qualify as a QDRO if it requires a plan to provide any benefit or payment option not already provided under the plan, to increase benefits (as determined actuarially), or to pay benefits that an earlier QDRO required to be paid to a different alternate payee. Plan administrators are responsible for determining whether an order received by a plan is a QDRO.

Helpful Examples

The EBSA's guidance contains several examples that may be helpful in determining whether an order is qualified. These examples show that timing or order of issuance alone won't disqualify a domestic relations order. Here are the points illustrated:

- ▶ A domestic relations order won't fail to be a QDRO simply because it is issued after, or revises, a QDRO that was previously issued to the same individual(s), even if it reduces the benefits payable under the first QDRO.

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- ▶ A QDRO can be issued to an employee's spouse from a second or subsequent marriage after the spouse from a previous marriage has already been issued a QDRO, as long as the new order doesn't assign any of the benefits already payable under the original QDRO.

- ▶ A QDRO can direct that a former spouse be treated as a "surviving spouse" under the plan, even if the former spouse no longer meets the plan's definition of surviving spouse.

- ▶ An order received after an employee's death, divorce, or annuity start date can be a

QDRO. For instance, a plan administrator determines that an order is not a QDRO. A second order is written to correct the defects, but the plan doesn't receive it until after the employee's death. The corrected order can be a valid QDRO.

- ▶ A QDRO issued after an employee has started receiving benefits can change a previously elected payment option. For example, an employee is receiving benefits as a single-life annuity. The spouse has waived surviving spousal rights. They divorce. A domestic relations order directing that the spouse receive half of future benefit payments can be a QDRO.

Note, however, that orders issued under these or similar circumstances could fail to be qualified under other requirements for determining QDROs. ▼

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What if a Trust Is Named as Beneficiary of the Plan Account?

Where a trust is named as the beneficiary, the beneficiaries of the trust will be treated as the designated beneficiaries for RMD purposes if (1) the trust is a valid trust under state law, (2) the trust is irrevocable or will become irrevocable at the employee's death, (3) the beneficiaries can be identified from the trust instrument, and (4) required documentation is timely provided to the plan administrator.

What Happens if RMDs Are Not Made?

An excise tax will be imposed on the payee equal to 50% of the amount that should have been distributed but wasn't. For example, if the plan was required to distribute \$12,000 to a retired employee, but paid out only \$10,000, the excise tax would be \$1,000 ($\$12,000 - \$10,000 = \$2,000 \times 50\% = \$1,000$). The IRS can waive the excise tax if it can be established that the shortfall was due to reasonable error and reasonable steps were taken to correct the shortfall. ▼

New Automatic Enrollment Safe Harbor Choice

Employers that sponsor 401(k) plans have long had the opportunity to avoid the required annual nondiscrimination tests and top-heavy rules by adopting a safe harbor plan design. Now, starting in 2008, plans that have an automatic enrollment feature or are willing to add automatic enrollment have a choice of safe harbor designs.

Choice #1: Basic Safe Harbor Plan Design

For many employers, the major benefit of a safe harbor design is that owners and other highly compensated employees can contribute the maximum amount allowed by law to their 401(k) plan accounts. Without a safe harbor design, if the plan fails one of the nondiscrimination tests, "overcontributions" by highly compensated employees have to be refunded to the employees or recharacterized as after-tax contributions, or additional employer contributions have to be made.

However, there's a tradeoff for bypassing the nondiscrimination tests. You have to make either 3%-of-compensation nonelective contributions on behalf of each nonhighly compensated employee who is eligible to participate in your plan or dollar-for-dollar matching contributions of elective deferrals up to 3% of compensation plus matching contributions of 50 cents for every dollar on elective deferrals between 3% and 5%. An enhanced matching formula is also available.

Choice #2: New Automatic Enrollment Safe Harbor Design

As with the basic safe harbor design, the automatic enrollment safe harbor rules relieve employers of the burdens of conducting annual nondiscrimination testing. Unlike the older rules, this new safe harbor design requires your plan to have a "qualified automatic contribution arrangement."

With this arrangement, eligible employees who don't elect otherwise are enrolled in the plan at an initial deferral rate of at least 3% of pay for the first full plan year of participation. The minimum deferral rate is 4% for the second year, 5% for the third year, and 6% after the third year. It can't exceed 10%.

Employers have to make contributions for nonhighly compensated employees. These contributions can be either nonelective contributions or matching contributions. Nonelective contributions must be at least 3% of compensation and must be made on behalf of all nonhighly compensated employees who are eligible to participate in your plan whether or not they

participate. For matching contributions, you must match 100% of the first 1% of salary deferred by nonhighly compensated employees and 50% of the next 5% deferred, for a maximum match of 3.5% of compensation.

Compared to the matching formula of the basic safe harbor design, the matching contribution safe harbor available with a qualified automatic contribution arrangement is generally less expensive for employers.

New Default Investment Protection

To go along with the new automatic enrollment safe harbor, the Pension Protection Act of 2006 also introduced new default investment rules. For plans that allow employees to direct their own investments, these rules relieve employers of fiduciary liability for investing an employee's account assets in a default investment. Employees and beneficiaries are considered to have exercised control over a default investment for protection under Section 404(c) where they were notified of their rights to direct investments but chose not to do so.

Default investments proposed by the U.S. Department of Labor (DOL) include lifecycle funds, targeted retirement date funds, balanced funds, and professionally managed accounts. The DOL may sanction other options in final regulations. At press time, these had not yet been released.

Required Notices

With a basic safe harbor plan design, you generally must provide all eligible employees with a written notice describing the safe harbor provisions between 30 and 90 days before the beginning of each plan year. Similarly, to take advantage of the new automatic enrollment and default investment safe harbors, you have to provide employees with notices explaining the qualified automatic enrollment arrangement and default investment alternative before the first investments are made and within a reasonable time before the start of each plan year. ▼

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The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

Retirement Plan Advantage

Consultants • Administrators • Recordkeepers

AN ELLIOTT DAVIS AFFILIATE

P.O. Box 6286
Greenville, SC 29606-6286

ADDRESS SERVICE REQUESTED

Elliott Davis Office Locations:

Aiken, SC (803) 649-1500

Anderson, SC (864) 226-9514

Augusta, GA (706) 722-9090

Columbia, SC (803) 256-0002

Galax, VA (276) 238-1800

Greenville, SC (864) 242-3370

Greenwood, SC (864) 229-4951

Laurens, SC (864) 984-6618

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► Benefit Notes

Normal Retirement Age for In-service Distributions

Historically, in-service distributions from defined benefit plans generally are prohibited. However, participants have been allowed to take in-service distributions if they worked past their “normal retirement age.” New IRS guidance makes it clear that a normal retirement age of 62 or higher is deemed to meet this definition. These final regulations define normal retirement age as an “age that is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered work force is employed.”

401(k) Wrap Plans

Participants in nonqualified deferred compensation plans generally cannot change their contribution elections during the year. When a participant is making both 401(k) and nonqualified contributions to a 401(k) wrap plan, changing the participant’s 401(k) elective deferral could force a nonqualified contribution change in order to keep the participant’s total contribution within plan limits. New regulations exempt wrap plan participants from penalties in this situation — as long

as the participant’s total contributions to both plans don’t exceed the law’s annual contribution cap (for 2007, \$15,500, or \$20,500 with catch-up).

Sick Days Turn Sunny

A recent online survey by Kronos® Incorporated and Harris Interactive found that 39% of Americans who work full-time have called in sick simply to take a summer day off. Their most frequent explanations were: to have a mental health day, to enjoy great weather, and to take a break from a heavy workload. Yet, another recent Kronos study found that 98% of full-time employees have gone to work when they were sick. ▼

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