

Employee Benefits ◀ ◀

A publication of Retirement Plan Advantage, LLC

Default Investment Protection

The long-awaited and much-debated final regulation governing default investment alternatives is here. For plans that allow employees to direct their own investments, following the regulation's rules will relieve an employer of fiduciary liability for investing an employee's account assets in a default investment if the employee has not given investment directions.

General Requirements

To qualify for fiduciary relief, the employee's account must be invested in a qualified default investment alternative (QDIA) as defined by the U.S. Department of Labor (DOL). In the regulation, stable value funds, money market funds, and guaranteed investment contracts (GICs) generally do not meet the definition.

So, many employers may need to choose a different default investment to take advantage of the protection.

The regulation outlines several additional conditions that must be met for a plan fiduciary to be relieved of liability for losses that are the "direct and necessary result" of a plan's default investment for a participant. For example, the plan must offer a "broad range of investment alternatives." The plan participants must have been given the opportunity to provide investment direction, but failed to do so. Participants also must have the opportunity to direct investments out of the default investment at least quarterly or with the same frequency as from other plan investments, if more frequent.

The plan generally must furnish a notice to employees before the first investment in the default investment occurs and annually thereafter. The regulation describes the information that must be included in the notice. The plan also must provide employees with any materials, such as investment prospectuses, provided to the plan for the default investment.

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Qualified Default Investment Alternatives

A QDIA must be managed by an investment manager, plan trustee, or plan sponsor who is a named fiduciary or by an investment company registered under the Investment Company Act of 1941. A QDIA generally cannot invest employee contributions in employer securities, and it must be diversified so as to minimize the risk of large losses. A QDIA may be offered through variable annuity contracts or other pooled investment funds. Plan fiduciaries are still liable for prudently selecting and monitoring QDIAs.

The regulation lists the following investment options as possible QDIA choices:

- ▶ **Lifecycle funds, targeted retirement date funds,** and similar products that take into account the individual's age or retirement date
- ▶ **Balanced funds** and similar products with a mix of investments that take into account the characteristics of the group of employees as a whole, rather than each individual
- ▶ **Professionally managed accounts** and similar investment services that allocate contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date

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Roth 401(k) Distributions

Now that the provisions allowing employees to make designated Roth contributions to 401(k) plans are permanent, more employers are considering adding this feature to their plans. If your company already offers or you are considering offering Roth contributions, the following overview of IRS regulations regarding taxation, rollover, and reporting of Roth 401(k) distributions should be useful.

“Qualified” Distributions

The tax treatment of Roth distributions depends on whether the distribution is “qualified.” With a qualified distribution, none of the Roth deferral contributions and earnings are included in an employee’s income for federal tax purposes. Generally, a distribution is qualified if it is made (1) after the employee reaches age 59½ or on account of the employee’s disability or death and (2) after a five-tax-year period has elapsed. If a distribution is not qualified, the portion of the distribution allocable to account earnings is subject to income tax and possibly to a 10% early withdrawal penalty.

The five-tax-year period necessary for a Roth distribution to be considered qualified begins on the first day of the employee’s tax year in which the employee first makes a designated Roth deferral contribution to the employer’s plan and ends when five consecutive tax years have been completed.

An exception applies to reemployed veterans. For these employees, the five-tax-year period starts on the first day of the tax year for which the contributions are being made. In addition, the regulations clarify that a contribution that is returned to prevent an average deferral percentage (ADP) test failure or is a “permissible withdrawal” from an automatic contribution arrangement (after 2007) does not begin the five-year period.

Rollovers of Designated Roth Accounts

A rollover of an “eligible rollover distribution” from a designated Roth account can be made to either a designated Roth account within another employer’s plan or a Roth IRA. However, rollovers of otherwise nontaxable

amounts — either the full amount of a qualified distribution or the after-tax contribution portion of a nonqualified distribution — to another designated Roth account must be directly transferred between the two designated Roth accounts. According to the regulations, if an eligible rollover distribution is instead paid to the employee, the employee can still roll over the entire amount (or any portion of it) to a Roth IRA within 60 days.

If an employee receives a nonqualified distribution and rolls over less than the entire amount, the part that is rolled over is deemed to consist first of the portion of the distribution attributable to income (account earnings). It is possible for an employee to roll over the taxable portion of a distribution from a designated Roth account into a designated Roth account under another plan within 60 days. However, the recipient plan would have additional reporting requirements.

Applying the Five-year Rule to Rollover Accounts

The type of rollover determines the starting date of the five-year period of participation for the account receiving the rollover. For example:

- ▶ **With a direct rollover to another employer’s plan**, the starting date of the five-year period generally carries over to the new plan account. When the direct rollover is made to an alternate payee’s or spouse beneficiary’s designated Roth account, the employee’s starting date carries over unless the receiving account had an earlier starting date.
- ▶ **With an indirect rollover of taxable amounts to a designated account under another plan**, the employee’s period of participation under the distributing plan generally does not carry over. Instead, for any employee who has not previously made Roth contributions to the receiving plan, a new five-year participation period for that plan begins in the taxable year the rollover is completed.
- ▶ **With a rollover to a Roth IRA**, the starting date depends on whether the employee has an existing Roth IRA. If the employee does not, the five-year participation period begins with the year the rollover is completed. If the employee already has a Roth IRA, the five-year participation period for the amounts attributable to the rollover contribution has the same start date as the period for the previously established Roth IRA. ▼

Default . . . Continued from page 1

- ▶ **Short-term capital preservation products**, such as stable value products, but only for the first 120 days of participation in the plan

Current Default Investments

According to the DOL, the regulation is effective December 24, 2007. Default investments made in stable value products prior to the effective date are “grandfathered” for purposes of liability protection. If you have any questions about the new regulations or whether your current default investment meets the QDIA requirements, please contact us. ▼

New Regulations for 403(b) Plans

Employers that sponsor 403(b) tax-deferred retirement arrangements will likely have to make several changes to their plans as a result of new IRS regulations issued recently. Below are some highlights of the regulations and actions 403(b) plan sponsors may need to take.

Only public schools, including colleges and universities, and nonprofit organizations that are exempt from tax under Code Section 501(c)(3) can offer these plans. The new regulations eliminate many of the operational differences between 403(b) plans and 401(k) and 457(b) plans.

A Written Plan Is Required

One change that will affect many 403(b) plan sponsors is a requirement to have a written plan document that includes all of the plan's material provisions (regarding eligibility, benefits, contribution limits, distributions, etc.). The plan document also must describe how the plan is funded and include the allocation of responsibilities between the employer, the service providers, and participants. Other documents (annuity contracts, for example) may be incorporated into the plan document by reference. Employers that do not currently have a written 403(b) plan document will need to adopt one, generally by January 1, 2009.

Nondiscrimination Rules

Under the new rules, employer contributions (contributions other than a participant's elective deferrals) and after-tax employee contributions must satisfy certain requirements similar to the nondiscrimination rules for tax-qualified plans. Employers that make discretionary plan contributions should check now to see if their plan would pass nondiscrimination testing under the new rules. That way, there will be enough time to amend the plan if it doesn't. These new rules generally do not apply to governmental plans or 403(b) contracts purchased by churches.

The "universal availability" rule continues to apply to employee elective deferrals. With some exceptions, this rule provides that, if one employee is offered the opportunity to make elective deferrals to the plan, that opportunity must be available to all employees. The final regulations narrowed the exceptions allowed, reducing the categories of those who can be excluded. Employers will want to review their excluded employees to make sure the new exclusion rules aren't violated.

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Exchanges, Transfers, and Distributions

Under existing rules, participants in 403(b) plans generally had the ability to transfer assets out of their plan accounts on a tax-free basis to another investment provider. The new regulations eliminate these so-called "90-24" nontaxable transfers by employees (after September 24, 2007) without the employer's specific consent. Now, such transfers are allowed only if the employer and the vendor have a written agreement that plan and employee information will be shared. The purpose of this requirement is to ensure that eligibility and distribution rules are properly applied.

The new rules for 403(b) distributions are similar to the 401(k) distribution rules. The 403(b) regulations also require 20% federal income-tax withholding on any eligible rollover distribution that is not directly rolled over to another 403(b) plan or to a rollover IRA. In addition, 403(b) plans must provide any employee receiving a distribution with a "402(f)" notice explaining the tax options for the distribution.

Other Provisions

The regulations also address the application of the tax law's contribution limits and clarify that designated Roth contributions are considered elective deferrals for purposes of the limits. The regs confirm that, if an employee is eligible to make both an age-50 catch-up contribution and a 15-years-of-service catch-up contribution, the 15-years-of-service catch-up applies first. And they provide rules for determining when tax-exempt entities are treated as a single employer for purposes of certain plan limits and plan administrative requirements.

The regulations generally become effective in 2009, although some exceptions are provided.

Of course, these are only some of the many provisions included in the comprehensive new 403(b) regulations. If you would like to discuss how they will affect the administration of your 403(b) plan, please contact us. ▼

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.

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► Benefit Notes

2008 COLAs

The annual inflation adjustments for plan limitations are in. For 2008, limits on 401(k), SARSEP, 403(b), and 457 plan deferrals remain at \$15,500 (maximum catch-up contribution, \$5,000). SIMPLE deferrals are \$10,500 (maximum catch-up contribution, \$2,500), the same as in 2007. Other limitations have increased:

- ▶ Maximum annual additions to a defined contribution plan account from \$45,000 to \$46,000
- ▶ Maximum annual benefit from deferred benefit pension plans from \$180,000 to \$185,000
- ▶ Maximum annual compensation used to determine benefits or contributions from \$225,000 to \$230,000
- ▶ Compensation limit for determining "highly compensated employee" from \$100,000 to \$105,000
- ▶ Compensation limit for determining whether officers are "key employees" for top-heavy plan purposes from \$145,000 to \$150,000
- ▶ Social Security Taxable Wage Base from \$97,500 to \$102,000

Fiduciary Bonding Reminder

Generally, plan fiduciaries — including the sponsoring employer, plan trustee, investment manager, and plan administrator — and any other person who handles a retirement plan's assets have to be bonded. For most plans, the face amount of the bond must be 10% of the plan assets handled (minimum \$1,000) up to a \$500,000 maximum. However, for plans holding employer securities, the maximum is generally increased to \$1,000,000 starting with the 2008 plan year. A plan that holds employer securities only in mutual funds and other broadly diversified funds is not considered to hold employer securities for purposes of the higher bonding limit. ▼

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