

# retirement

## plan news

SEPTEMBER/OCTOBER 2005

### Safe Harbor 401(k) Plan for 2006

It's that time again: time to consider whether a safe harbor 401(k) plan design is right for you.

Traditional 401(k) plans are subject to discrimination tests that apply to employee deferrals (the actual deferral percentage or ADP test) and, in most cases, matching contributions (the actual contribution percentage or ACP test). Safe harbor designs allow plans to skip these discrimination tests.

**The Benefits.** In addition to avoiding the complex tax laws associated with discrimination testing, safe harbor plans allow highly compensated employees (HCEs) to defer the maximum amount of compensation permitted by law. In 2006, the maximum elective deferral to a 401(k) plan will be \$15,000. In addition, participants who are age 50 or older in 2006 may make catch-up contributions of \$5,000 (if plan documents allow).

**The Requirements.** There are two contribution formulas that satisfy the safe harbor requirements: a nonelective contribution of 3% or more and a matching formula. There are some additional requirements to keep in mind. All contributions satisfying the safe harbor are immediately 100% vested and may not be subject to allocation conditions (such as requiring that participants be employed on the last day of, or work a minimum of 1,000 hours during, the plan year). In addition, a safe harbor notice must be

given to all eligible employees between 30 and 90 days before the beginning of the new plan year.

**Nonelective Contributions.** If an employer elects to satisfy safe harbor requirements by making a nonelective contribution (NEC), that contribution must be 3% (or more) of compensation, commonly known as the 3% NEC. Generally, the 3% NEC must be provided to all employees who are eligible to make elective deferrals to the plan.

The NEC may be either *guaranteed* or *flexible*. An employer that provides a guaranteed 3% NEC must make that contribution regardless of subsequent financial developments during the plan year. The flexible NEC permits the employer to decide each year whether to provide the NEC.

With a flexible NEC, the employer must provide participants with a second notice (no later than the first day of the twelfth month of the plan year) indicating that



safe harbor status has been elected and that the NEC is being given. If the NEC is made, discrimination testing of elective deferrals is not required. If the NEC is not made, the second notice is not sent and elective deferral contributions must be tested.

(Continued on page 2)

#### CONTENTS

**Safe Harbor 401(k) Plan for 2006**

**Provide Plan Documents in a Timely Manner**

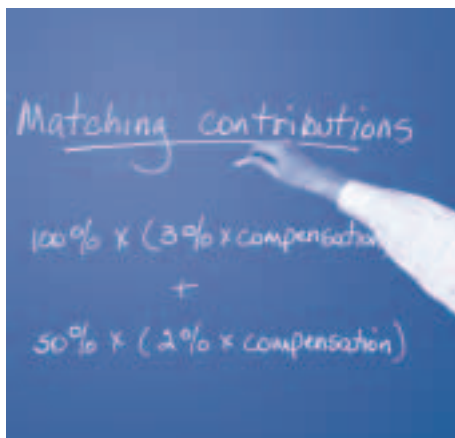
**Using Severance Compensation for a Qualified Plan**

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## Safe Harbor 401(k) Plan for 2006 *(Continued from page 1)*



**Matching Contributions.** If a matching contribution is used to satisfy the safe harbor, the employer may elect either a *basic* or *enhanced* match. The basic safe harbor matching contribution is defined as a 100% match on the first 3% of compensation deferred and a 50% match on deferrals between 3% and 5%.

An enhanced matching contribution must be *at least* as much as the basic match. It may not increase as the percentage of deferrals goes up. And the rate of match for the HCE group may not exceed the rate of match for the nonhighly compensated employee (NHCE) group.

**Additional Matching Contributions.** Within limits, a safe harbor plan may make additional, non-safe-harbor matching contributions. What are the limits? An allocation of discretionary matching contributions may not exceed 4% of compensation. Matching contributions may not be made on deferrals that exceed 6% of compensation. And the rate of match for any HCE may not be more than that of any NHCE.

**Allocation Restrictions.** The final 401(k) and 401(m) regulations, effective for

plan years beginning after December 31, 2005, add an additional requirement. There cannot be any restrictions — such as the last-day rule or 1,000-hour requirement — on any matching contributions in a safe harbor plan (unless *all* NHCEs satisfy the restrictions). For a plan to be exempt from discrimination testing, all matching contributions must be allocated in a nondiscriminatory manner.

**The Bottom Line.** Safe harbor plan designs may be a good option in many cases. However, employers should consider the cost (100% vesting and the elimination of allocation restrictions) as well as the advantage (maximizing HCE deferrals). Expectations, finances, and demographics should also be carefully weighed before committing to a safe harbor plan. ❖

## Provide Plan Documents in a Timely Manner

ERISA Section 104(b)(4) requires employers to disclose certain plan documents to plan participants and their beneficiaries (including Form 5500 and any document under which the plan is established or operated). Photocopies of documents must be provided at a reasonable cost upon written request. If an employer does not comply in a timely manner (generally within 30 days of request), penalties may be imposed.

**A Recent Case.** The sponsor of a defined benefit plan was assessed \$35,050 in fines and paid \$19,000 in attorney's fees for not providing the beneficiary of a deceased participant with copies of plan documents on a timely basis (*Lowe v. McGraw Hill*).

The defined benefit plan's normal form of benefit for married participants is a qualified joint and survivor annuity. The deceased participant in this case elected a single life annuity (which required the spouse to sign a witnessed waiver). Payments ceased with the participant's death. When questioned by the

participant's spouse about the termination of benefits, the plan ultimately produced an election form that *did* have the spouse's signature. However, it had not been properly witnessed by either the plan administrator or a notary.

When explaining its failure to timely provide the documentation, the plan sponsor argued that the paperwork could not be located due to a plan merger and poor recordkeeping by the former employer. The court fined the sponsor \$50 per day for the 701 days it took to produce the form. The fine could have been \$110 per day. The plan administrator agreed to reinstate the joint and survivor payments. ❖

# Using Severance Compensation for a Qualified Plan

The U.S. Treasury Department and the IRS have released long-awaited guidance on the treatment of post-severance compensation for qualified plan purposes. The regulations specifically address the inclusion of post-severance compensation in regards to elective deferrals and employer contributions. This guidance is effective immediately and may be followed until the final regulations are issued.

If a participant receives severance pay after he or she leaves an employer, it may be considered as compensation (within limits) for retirement plan purposes providing certain conditions are met. To be eligible, post-severance compensation:

- Must be paid to the participant within 2½ months of termination, and
- Must be payment for bona fide sick, vacation, or other leave the participant would have been entitled to use if employment had continued.

If eligible, the compensation may be used to make elective plan deferrals and be included as compensation in calculating certain employer contributions, including profit sharing, safe harbor, and top-heavy contributions.

Here are some examples that illustrate the new rule.

## **Example 1:**

An employee terminates employment on June 10, 2005. She is entitled to three weeks of unused vacation time and is paid for that time within a 2½-month period of June 10, 2005. She may use three weeks of severance compensation to make elective deferrals and is entitled to have it included as plan compensation for employer contribution purposes.

The 2½-month limit is absolute. Had the company provided a 6-month severance package, only the pay covering bona fide sick, vacation, or other paid leave during the first 2½ months after separation would have been includible for qualified plan purposes. Payments made after the 2½-month period, regardless of the date, are ineligible. In addition, a lump-sum settlement in which an employee waives potential claims against the employer is also ineligible.



## **Example 2:**

An employee terminates employment on October 15, 2005. He is granted a lump-sum severance payment equal to 12 months of compensation, including four weeks of unused vacation time. The plan is a safe harbor 401(k) plan with a guaranteed 3% nonelective contribution. In this case, only the compensation for his four weeks of accrued vacation time may be used for qualified plan purposes. The employer also must make a safe harbor nonelective contribution for this employee, but only using compensation through November 15, 2005 (the four weeks of bona fide unused vacation time).

## **Example 3:**

An employee has accumulated four months of sick leave over her 20-year career. She is entitled to compensation for the unused time when she leaves the job on July 1, 2005. The employer has agreed to pay her for the sick leave over four months beginning July 1, 2005. The retirement plan is a 401(k) plan that provides elective deferrals and matching and nonelective contributions. Only bona fide sick leave compensation paid through September 15, 2005, the first 2½ months after severance, may be included as eligible compensation for purposes of elective deferrals, matching contributions, and the employer's nonelective contribution.

**This Guidance Is a Relief.** For many years, there was no regulatory method of permitting severance pay to be used for contributions. It is better to have clear IRS guidance than to risk being on thin ice with a decision that is “arguably the best.” ❖

# recent developments

■ **Hardship Changes.** Acceptable safe harbor reasons for plan hardship withdrawals are expanded in the final 401(k) regulations to include funeral expenses and costs to repair damage to an employee's principal residence that would qualify for the casualty deduction (such as damage resulting from a hurricane or flood). The expanded definitions are for plan years beginning after December 31, 2005. However, earlier adoption is permitted if the employer applies *all* provisions of the final 401(k) regulations.

■ **Grace Period.** Contributions that remain in a health flexible spending account (FSA) or dependent care assistance plan (DCAP) at the end of a plan year generally must be forfeited

and may not be used to pay claims that occur in the following plan year. To soften the "use-it-or-lose-it" aspect, the IRS now allows plans to pay claims that occur in the first 2½ months of the new plan year with unused funds from the prior plan year. According to IRS Notice 2005-42, an employer may adopt this grace period for an FSA or DCAP for any plan year (including the current one) by amending the cafeteria plan document before the end of the affected plan year.

■ **IRS Provides IRA Resource Guide.** The IRS has issued a multimedia CD-ROM featuring information on retirement planning (Publication 4395). The IRS previously issued a disk outlining its correction programs

for retirement plans (Publication 4050). This second CD-ROM covers IRAs, SEPs, and SIMPLE IRAs. It is geared to three different target audiences: (1) individuals, (2) small businesses, and (3) tax and benefit professionals. The CD contains IRS Publications 590 (on IRAs) and 575 (on distributions) and links to more retirement plan information from government agencies. Topics are provided by the IRS, the SEC, and the Federal Deposit Insurance Corporation. There is no charge to order the disk. To request a copy of Publication 4395 on CD-ROM, call the IRS Forms Distribution Center at 1-800-829-3676, select option 2, and a person will take your order. ❖

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