



employee benefits update

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“Cross-tested” plans offer advantages to plan sponsors

When funding profit sharing contributions, one type of plan has proven to be very effective. Known as “cross-tested” plans, they provide a unique profit sharing contribution into retirement plans. Cross-tested plans — a hybrid combination of defined contribution and defined benefit concepts — allow employers to fund a specific targeted group of employees while also meeting the needs of other employees. These plans must pass strict nondiscrimination tests designed to ensure the plan doesn’t discriminate in favor of highly compensated employees (HCEs). Combined with a 401(k) plan, cross-tested plans can provide an even greater benefit to target employees.



Making the classification

You can design a cross-tested plan to set up specific classes of employees and to categorize these classes. You then give each class various levels of contributions. This is also considered a “tiered” allocation. You can base the groupings on job classifications (management vs. staff), compensation, service or other similar classifications. For example, you can group key owners or HCEs and give them a targeted contribution that may exceed those of the other classes. This is often appealing to business owners.

For example, let’s say a company has three owner/ shareholders, five management staff leaders, 20 staff

employees, and 25 delivery workers. A cross-tested plan could place each of these levels into a grouping or class. The company may choose to give the maximum contribution (\$49,000 for 2009) to the three owner/ shareholders, a \$10,000 contribution to the five management employees, and a 5% contribution to the staff and delivery workers. These design types appeal to companies looking for ways to reward key employees.

Following the rules

To make the classifications, you must pass specific tests. First, all qualified plans must provide contributions or benefits that don’t discriminate in favor of HCEs. These aren’t just people who are paid a lot, but meet a specific IRS definition, such as earning more than a certain dollar limit or maintaining a certain level of ownership in the company.

One important test that must be passed is the Section 401(a)(4) test. Usually, defined contribution plans satisfy Sec. 401(a)(4) by showing that contributions are nondiscriminating, meaning they don’t favor key employees or other highly compensated personnel. When a defined contribution plan satisfies Sec. 401(a)(4) by benefits or a defined benefit plan satisfies Sec. 401(a)(4) by contributions, the plan is said to be cross-tested.

You can group key owners or highly compensated employees and give them a targeted contribution that may exceed those of the other classes.

Sec. 401(a)(4) regulations also require that sponsors make available optional forms of plan benefits, ancillary benefits, rights and features to participants on a non-discriminatory basis. Also, the employer can’t amend the plan in a manner that is discriminatory, nor cause discrimination during plan termination.

Testing for compliance

Cross-tested plans must meet several other testing requirements, including:

Rate-group testing. This is performed by showing that either plan allocations or plan benefits are nondiscriminatory by analyzing each rate group separately. You can determine allocation rates by dividing the amount of the allocation by the employee's compensation. The plan will determine equivalent benefits using the plan year compensation, annuity rates, normal retirement ages and the contribution. You can then use the allocation rates to determine various rate groups.

Gateway contribution test. Cross-tested plans must also meet the so-called "gateway requirement." Under this test, the lowest permissible allocation rate for any non-HCE who benefits under the plan is the lesser of 5% of IRS Sec. 415 compensation or $\frac{1}{3}$ of the highest allocation rate for any HCE who benefits under the plan.

Other testing includes nondiscrimination testing for the elective deferral feature of the 401(k) plan and the

matching contributions feature of that plan, annual additions testing and deductibility testing.

Considering the option

Your cross-tested plan may require employees to meet a certain number of hours before receiving a contribution. You can also require employees to be employed on the last day of the plan year to receive a contribution.

When the plan is a safe harbor 401(k) plan, you can use a portion of the cross-testing contribution to satisfy both the safe harbor contribution and the cross testing. However, you can't impose an hours or last day requirement on the safe harbor contribution.

Offering the option

Cross-tested plans provide a solution for companies who wish to provide maximum benefit to target employees. Generally, these plans can be more expensive because of documentation requirements. But the funding benefit is greater for the target employees and the employer. Contact your plan administrator or benefits specialist to find out if a cross-tested plan is right for your company. 📞

Terminating 403(b) plans

NEW IRS REGS ARE A WELCOME CHANGE

For many years, nonprofits could maintain only Section 403(b) plans; there was no other choice. These plans are a tax-deferred retirement plan — similar to a 401(k) plan — available for nonprofit organizations, such as public schools, churches and certain health care industries. Both employer and employee contributions grow tax deferred until the participant makes a withdrawal. But what if a nonprofit wants to terminate its 403(b) plan? The IRS released new regulations last year governing 403(b) plans and their terminations. Here's what you need to know.

The old process

The new final 403(b) plan regulations are a welcome change for employers. Previously, these plans had restrictions that hindered an employer's ability to terminate the plan and eliminate administrative costs.





Prior to the new ruling, employers had to wait until a distributable event occurred before terminating their 403(b) plan. Distributable events included termination of employment, hardship withdrawals and death. This meant that the employer had to maintain the plan until the employee terminated employment, the company went out of business or another distributable event occurred. The employer also had to adhere to the reporting and disclosure requirements under the plan.

The new termination rules

Starting with plan years beginning Jan. 1, 2009, sponsors may now terminate 403(b) plans. On termination, participants will be deemed as having a distributable event and can roll their accounts into an IRA or other qualified plan that allows for rollover contributions from 403(b) plans.

But certain restrictions do apply:

Contribution restrictions. An employer may not start a new 403(b) plan and make contributions during the 12 months following distribution of all assets from the terminated plan.

2% rule. Sponsors can start a new alternative 403(b) plan if less than 2% of the employees who were eligible under the terminated plan are eligible under the new plan. The window for this allowance is the 12-month period *before* plan termination and ending 12 months *after* distribution of the terminated plan's assets.

Notice. The plan sponsor must provide required documentation (including a notice to plan participants) and

must distribute all benefits under the plan to participants and beneficiaries.

Form 5500. If the terminated plan was required to file Form 5500, you'll need to file the form until all plan assets have been distributed.

Other considerations

You can establish a new 401(k) plan. You must completely terminate your 403(b) plan if you choose to start a new 401(k) — you can't merge 403(b) assets into the 401(k).

Instead of plan termination, you may freeze your 403(b) plan. This essentially suspends future plan contributions. You'll still need a plan document and must meet disclosure and Form 5500 requirements, and participants can withdraw their funds only for a distributable event.

Helpful rules for all

It's essential that you include an employee benefits professional in your compliance and 403(b) plan termination process. You'll also need to file Form 1099-R to provide proper tax reporting to the IRS for the distribution. 🕒

Where's your plan document?

In general, if you have a 403(b) plan, the new IRS regulations require you to have a plan document. This document controls participant options for choosing an annuity platform. It can also enhance the distribution provisions and limit life insurance options in the plan. Before you can terminate your 403(b) plan, you must update the plan document to allow for termination.

All your contracts and custodial accounts must comply with your plan document. For example, be sure your plan document lists the vendors holding the accounts, or have a custodial agreement between the plan and the vendor.

Prototype documents and individually designed documents are available that adhere to the new requirements. Plans have until Dec. 31, 2009, to comply. Check with your plan administrator if you have any questions about whether your 403(b) plan has met the new regulations.

Is the time right for an interim valuation?

Balance forward plans are defined contribution plans in which participant accounts are generally valued on an annual basis. Because of the stock market decline last year, a number of plan administrators are considering having interim valuations done on their balance forward plans. The decision to perform or not perform an interim valuation is fraught with concerns for plan fiduciaries.

Should you have one?

Before considering whether to have an interim valuation done, review your plan document to determine if it allows for interim valuations beyond the scope of the plan terms. Many plans allow interim valuations to be performed.

Performing interim valuations has caused some concern among fiduciaries, specifically with regard to participants who have previously terminated and requested a distribution of their account balance. Plan losses resulting from the stock market decline are distributed to all participants — even those who have terminated. Those participants who have terminated are left unpleasantly surprised when they discover that their distribution amounts are less than what they were expecting.

But remember, a plan's valuation date is a right or feature, not a protected benefit. Therefore, participants aren't guaranteed a particular valuation date. In addition, according to ERISA, the fiduciary must operate the plan in the best interest of *all* participants and beneficiaries.

Can you amend your plan?

If your plan doesn't allow for interim valuations, you can amend your plan to permit them. But be careful in situations where a participant terminated employment before you amended the plan to allow for interim valuations. The participant may raise "anticutback" issues. IRS rules provide that a participant's accrued benefit may not be decreased by a plan amendment.

Amending the plan to allow for more frequent valuations — such as quarterly — may be an option worth considering. One of the main advantages is that it would avoid anticutback issues.

Your plan should have a policy for when interim valuations will occur in the plan's investment policy statement. This policy should state that the plan will have an interim valuation if the market fluctuated more than a specific percentage. Or it could allow for distribution of accounts which are more than a set percentage of the plan assets. The purpose of an interim valuation is to protect the remaining participants in a down market and to protect the distributing participants in an up market.



What should you tell participants?

After completing a valuation, it can potentially be several weeks before participants receive their account statements. By the time they receive their statements, it's likely that their account balances will have changed. For this reason, use caution when communicating with participants about their account balances. Excellent communication with participants will eliminate unpleasant surprises, especially for those participants who have terminated employment and are expecting a distribution.

Valuations that work

Performing an interim valuation of your plan's assets can be useful. Make sure your plan document has an investment policy stating when interim valuations will occur and apply these rules on a consistent basis. ⌚

DOL proposes investment disclosure regulation

Fee disclosure has been a much discussed employee benefit topic in the past several years. The Department of Labor (DOL) has issued three sets of proposed regulations on fee disclosure during the past year and a half alone. The latest involves investment-related fee disclosures to participants.

DOL proposals

The DOL has been busy putting together legislation regarding fee disclosures. In November 2007, the DOL issued final regulations relating to the information that plans must disclose on their annual Form 5500. Filing electronically is mandatory, but has been postponed until the 2009 filing year. For large plans, the Schedule C included in the Form 5500 filing will be required to disclose both direct and indirect compensation paid as well as whether any providers failed to supply the information needed for disclosure.

It then issued proposed disclosure regulations in December 2007 on fees and expenses charged by service providers to plan fiduciaries. This includes



revenue sharing, commissions, sales loads, deferred sales charges, TPA fees, wrap fees, 12b-1 fees, bonus payments and awards or gifts, and redemption or exchange fees.

Most recently, in July 2008, the DOL issued proposed regulations on disclosure to plan participants relating to investment-related information and fees.

Investment disclosure information

The DOL proposal will require sponsors to disclose four categories of information to participants and beneficiaries:

- 1. General plan information.** You must provide this information on or before a participant becomes eligible to participate in the plan and then annually after that. The disclosure must include a listing of the plan's investment options, an explanation of how participants or beneficiaries can give investment instructions and a description of any limitations on investment instructions. After a participant invests in a specific option, provide him or her with a description of voting rights and other rights associated with that investment option. Notify participants within 30 days of any material changes to the plan. Material changes can be, but aren't limited to, changing investment options or investment managers.
- 2. General administration expenses.** Keep in mind that administration fees are separate from investment-related fees and expenses. Administrative expenses are charged to individual participant accounts and include legal, recordkeeping and accounting fees. You must disclose these fees on or before the date a participant becomes eligible for the plan and then annually thereafter. In addition, participants must receive quarterly statements of dollar amounts charged to the participant's account for the preceding quarter and a general description of the services.
- 3. Individual administrative expenses.** Plan sponsors have to disclose individually assessed fees for participant loans, qualified domestic relations orders (QDROs), hardship distributions or investment advice at least every quarter for the preceding quarter. The notice

must detail the fees charged and include a description of each service.

4. Investment-related information and expenses.

Under the proposed regulation, you'll need to disclose general information about the plan's investment option, historical performance, and fees and expenses to plan participants in a comparative chart or similar format. The performance history will need to include one-year, five-year and 10-year investment results, when applicable, for each investment option.

Investment disclosure timing

The DOL proposal requires a plan fiduciary to initially communicate the four categories of information listed above to plan participants on or before the first day

they become eligible to participate in a plan. After a participant is enrolled in the plan, the fiduciary is required to make the required disclosures at least annually, and in some cases quarterly.

You can provide these notices in materials that all plan participants receive or send them along with benefit statements. Or you can incorporate the annual notices in the summary plan description.

Proposal watch

With the amount of focus the DOL has given disclosures during the past couple of years, these proposed regulations should come as no surprise. Consult with your benefits specialist or plan administrator if you have any questions about making the proper disclosures. ☎

Get ready: 401(k) plan audits

When your 401(k) plan reaches a certain size, the IRS requires that an independent CPA perform an audit. Generally, plans file this audit with their annual Form 5500 by July 31. (It can be extended to Oct. 15.) Let's take a look at what you need to know before this filing date.

When your plan's participant count reaches 120 at the beginning of the plan year, your plan must have an audit for that year. If it's the plan's first year, the threshold is 100. If the count drops below 100, an audit isn't required. However, the plan sponsor has the option of still auditing the plan when the counts are between 80 and 100 if the plan was audited in the prior year.

Make sure you choose a qualified auditor. Consider the firm's experience, peer reviews and staff qualifications. Obtain several opinions to show due diligence in the selection of the auditor.

An audit can be either full or limited in scope. Full scope audits include more detailed review of the administrator's records, such as payroll, deposits and plan investments. In a limited scope audit, the plan must provide certifications from the plan trustee or administrator that the information provided as to ordinary business records is complete and accurate.

The audit will have to meet various risk assessment standards. Using these standards, your auditor will ask new questions and request more detailed information than in previous audits. For example, previously it was sufficient to determine if an employee was simply employed at the company; now more detailed review of payroll records may be necessary. Auditors are now expected to pay closer attention to the likelihood of fraud in the area of loans, hardship withdrawals and other distributions. It's your responsibility to comply with all requests for information under these standards.

So what should you do to assist your auditor? Make sure your plan is current on all the plan tax filings. These include Form 5500 and Form 1099-R. The plan sponsor must take full responsibility related to the timely filing of these returns. Review and update your bond policies covering employee theft or embezzlement under ERISA. And make sure to deposit 401(k) deferrals into the trust in a timely manner.

After you've reviewed your responsibilities, check with your plan administrator or legal counsel to see whether you've complied with your audit requirement.