

employee benefits update

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IRS simplifies timing of taxes on ADP corrections

If your plan provides for elective contributions, you're probably familiar with the actual deferral percentage (ADP) test. This test limits the amount that certain plan benefits provided to highly compensated employees (HCEs) may exceed benefits provided to nonhighly compensated employees (NHCEs).

A failing ADP test is something that many plans have to face at some point in time. While this

sounds intimidating, the fix is actually pretty easy under new IRS requirements. So what should you do and what are the tax ramifications? Let's take a look at the law and a few examples.

What to do

The most common way to make an ADP correction is to simply return the excess deferrals and associated earnings to the affected HCEs.

Your plan administrator will issue a correction

letter to all affected HCEs informing them of the failure and the plan's intention to make a corrective distribution. In addition, the letter should describe the refund process and any tax liability issues that the participant may face.

Along with the letter, you'll need to document the distribution. You can do so by issuing an IRS Form 1099-R to the affected participants. This form will show the total amount of the distribution and the taxable amount, and indicate the year of taxation.

New tax rule

For plan years beginning after Dec. 31, 2007, ADP correction distributions are now generally taxable to the participant in the year you *distribute* them. Before the change, the year of taxability depended on the distribution's timing. Excess contributions were taxable in the year of *deferral* if



paid out within two and a half months of the plan year's close.

This change can have a major impact on participants. For example, in the past a participant may already have filed his or her personal income tax returns before the ADP testing was completed. In that case, the corrective distribution (a taxable event) could have been made after the participant filed his or her return. Consider these examples:

Example 1. The Acme, Inc. 401(k) plan is a calendar year plan that failed the ADP test for 2008. On March 1, 2009, the plan made a corrective distribution to John in the amount of \$2,000 plus \$20 of associated earnings. The entire \$2,020 distribution will be taxable in 2009, the year of distribution. The plan must issue a 2009 IRS Form 1099-R to John showing \$2,020 for both the amount of the distribution and the taxable amount.

That takes care of the plan's side of things, but what about John, the participant? Under the old regulations, the distribution would have been taxable in 2008 because that's when the amount was actually deferred and the plan paid out the corrective distribution within two and a half months of the calendar year end. What if John had already filed his 2008 tax return before

receiving the ADP corrective distribution? Because the distribution was taxable for 2008, he would have had to amend his 2008 return to include the distribution as income. But, under the new regulations, no amending is necessary because the excess distribution is considered taxable in the year of distribution, or 2009. John would include the \$2,020 of income on his 2009 income tax return.

ADP correction distributions are now generally taxable to the participant in the year you distribute them.

Example 2. Assume the same as in example 1, but John made Roth deferrals into the plan. In this case, the \$2,000 in deferrals was included in Jeff's 2008 income in 2008, which was the year of deferrals. The plan should issue a 2009 IRS Form 1099-R and show \$2,020 for the amount of the distribution, but only \$20 will be reported as taxable income.

Example 3. Assume the same as in example 1, except there was actually an associated loss of \$200 instead of any earnings. In this case, the plan would distribute \$1,800 to the participant and issue a 2009 IRS Form 1099-R showing \$1,800 for both the amount of the distribution and the taxable amount. If the deferrals were Roth deferrals, the plan would again distribute the net corrective distribution of \$1,800 and the 2009 IRS Form 1099-R showing \$1,800 in distributions and no taxable income.

Opting out of withholding

The withholding on actual deferral percentage (ADP) distributions to affected participants is another aspect you'll need to consider. Under the Internal Revenue Code, ADP distributions are generally subject to a 10% withholding. But participants may elect out of the withholding.

Currently the 2009 IRS Form 1099-R instructions are vague about the 10% withholding requirement under the new distribution rules as outlined in the main article. While it could be said that the 10% withholding no longer applies, it may be best to simply withhold at the 10% rate until the IRS issues clearer guidance.

Simplified rule for everyone

By removing the requirement that returns made within the first two and a half months after the close of the plan year be taxable to the participant in the prior year, the new regulations have simplified the reporting requirements. This makes easier the lives of many HCEs. The new rule ends the risk of your employees having to file an amended tax return if corrective ADP distributions are made. ☺



Upcoming compliance deadlines:

- 9/15** Extended deadline for corporate tax returns
- 9/15** Extended deadline for partnership tax returns
- 9/30** Deadline for summary annual report for Form 5500 (due July 31)

Is your plan ready for automatic enrollment?

IRS ISSUES FINAL REGULATIONS

Final IRS regulations now in effect encourage greater retirement plan participation through two types of automatic enrollment arrangements: qualified automatic contribution arrangements (QACAs) and eligible automatic contribution arrangements (EACAs). The regulations, which implement provisions of the Pension Protection Act of 2006 (PPA), were issued in February 2009.

Understanding QACAs

Here are the highlights of QACAs:

Nondiscrimination testing. QACAs allow 401(k) plans to pass the average deferral percentage (ADP) and average contribution percentage (ACP) nondiscrimination testing. The ADP and ACP tests limit the amounts that are deferred to highly compensated employees. Deemed by the IRS to pass, QACAs don't have to limit the highly compensated deferrals. But the rules do require certain vesting requirements, notices to employees and funding amounts.

Deferral rates. Under a QACA, each eligible employee enters the plan with an initial minimum deferral rate of 3% of compensation for the first plan year. After this, the minimum percentage must increase to 4%, 5% and 6% by the end of the following three plan years. For any year, the amount cannot exceed 10%.

Safe harbor elements. Employers must provide a special safe harbor notice to participants within



a reasonable period before each plan year. This generally means at least 30 days, but no more than 90 days, before the start of each plan year. Newly eligible employees must receive the notice no earlier than 90 days before and no later than the date of eligibility.

Under a QACA, the employer makes a mandatory safe harbor contribution. However, unlike other safe harbor 401(k) plans that offer immediate vesting, employees don't vest in the matching contributions under the automatic safe harbor until completing two years of service.

Plans must provide for either employer safe harbor matching contributions or employer safe harbor nonelective (profit sharing) contributions. You must provide the match to all employees who defer and give the profit sharing nonelective contribution to all eligible employees, even if not deferring.

Matching contributions. An employer must match 100% of elective contributions up to 1% of compensation, plus 50% of elective contributions between 1% and 6% of compensation. (This equates to a matching contribution equal to 3½% of compensation.) A plan can't match contributions in excess of 6% of compensation or increase the rate of matching contributions as an employee's elective contributions increase. In the latter case, a plan may use various formulas for matching contributions if the alternative design is at least as generous for each rate of contributions as the basic method. Finally, you can't provide matching contributions at a higher rate for highly compensated employees.

Instead of matching contributions, a QACA can provide for an employer nonelective contribution of at least 3% of compensation for all eligible non-highly compensated employees.

Nonelective and matching contributions under a QACA aren't eligible for hardship withdrawals. Additionally, plans must limit the distribution of safe harbor matching and nonelective contributions in the same manner as employee elective

contributions (for example, not available for withdrawal until the age of 59½).

Administering EACAs

Here are the highlights of EACAs:

Nondiscrimination testing. EACAs allow employers to enroll employees into the plan without approval, but they require ADP/ACP testing. You can extend the EACA ADP/ACP testing for a six-month period instead of the now typical 3½ months after the end of the plan year.

Plan timing. You only can start an EACA in the middle of the plan year to cover new hires. Employers must provide a notice to each employee eligible to participate within a reasonable period before each plan year. Employees may choose to stop participation within a specific timeframe without a penalty.

Contributions. A plan may provide for separate EACAs for different employee groups. Examples include groups tested separately under multiple employer rules and qualified separate lines of businesses. But the EACA default election must be a uniform percentage of compensation. Your plan document must specify which employees are covered under the EACA and whether an employee who makes an affirmative election remains covered under the EACA.

The plan must forfeit employer EACA contributions, such as matching contributions, if it returns deferral contributions to employees. The employee must include this amount in his or her gross income for the year.

Providing a better retirement for your employees

Under either arrangement, participants may opt out once they're enrolled. The final regulations for automatic arrangements are effective for plan years beginning after Jan. 1, 2008, for QACAs and Jan. 1, 2010, for EACAs. Contact your plan sponsor to learn more so you can provide a more secure retirement for your employees. ☺

What you need to know about changes to COBRA coverage

The American Recovery and Reinvestment Act of 2009 (ARRA) makes substantial changes to COBRA coverage, including the addition of a government subsidy for medical premiums. Signed into law earlier this year, ARRA affects employers with 20 or more employees who maintain group health plans.

What ARRA does

ARRA provides a government subsidy for COBRA medical premiums to employees who are involuntarily terminated through the end of this year.

The employer must first provide this payment and then will be reimbursed by the government. These adjustments are credited through various payroll filings. The law also has special notice requirements.



ARRA provides a government subsidy for COBRA medical premiums to employees who are involuntarily terminated through the end of this year.

The U.S. government will provide a 65% subsidy toward any coverage to which COBRA is applicable, including medical, dental and vision. But it excludes health Flexible Spending Accounts through cafeteria plans.

The subsidy isn't retroactive to when COBRA coverage was, or could have been, elected by the assistance eligible individuals (AEIs). Instead, it will continue for up to nine months for the periods of coverage beginning on or after Feb. 17, 2009, through Dec. 31, 2009.

Who is eligible

AEIs are former employees, eligible for COBRA, who qualify for the government subsidy. This includes a former employee if his or her involuntary termination takes place between Sept. 1, 2008, and Dec. 31, 2009.

If you terminate an employee for acts of gross misconduct, that person isn't eligible for COBRA coverage under ARRA.

When eligibility is lost

The subsidy terminates at the earlier of:

- › Nine months,
- › Medicare eligibility,
- › Eligibility for other group health plan coverage, including a spouse's plan, or
- › The end of the maximum COBRA coverage period required by law.

An AEI who fails to notify the employer of eligibility for Medicare or other group coverage is subject to a penalty tax equal to 110% of the premium reduction received for the disqualifying months.

High-income individuals may lose a portion of the new subsidy. The subsidy begins to phase out for taxpayers with modified adjusted gross income of more than \$125,000 (\$250,000 if married filing jointly). The subsidy is capped for taxpayers with modified adjusted gross income of \$145,000 (\$290,000 if married filing jointly). In these cases, the taxpayer would simply pay the full COBRA premium charged.

A helping hand

ARRA is meant to help taxpayers who've lost their jobs continue to receive affordable health coverage when electing COBRA. The employer gets a government reimbursement, so it becomes a win/win situation. To make sure your employees understand the eligibility requirements and your plan receives its reimbursement, contact your plan sponsor. ☎

3 retirement benefits options for small businesses

For small business owners, a 401(k) plan may be impractical. Yet helping employees save for their retirement is a perk for many businesses. So what can you do? Three possibilities exist, and two of them allow employees to save quite a bit more than they can with a traditional IRA. Remember, contributions to a traditional IRA are limited to \$5,000 for 2009 or \$6,000 if the employee is 50 or older. Here are the three options:

1. The SEP plan. This allows an employer to contribute more money to an employee's IRA account than otherwise allowed under the standard IRA rules. For 2009, the employer can contribute and deduct up to 25% of an employee's compensation up to \$245,000, or \$49,000, whichever is less. IRS rules exclude SEP contributions from pay and you won't include the contribution amount on the participant's IRS Form W-2. Strict eligibility rules apply.

2. The SIMPLE IRA. This option is generally available to employers with no more than 100 employees who earned compensation of \$5,000 or more. The maximum employee contribution for 2009 is \$11,500, or \$14,000 if the employee is 50 or older. Employers must make either a standard matching or nonelective contribution each year to maintain a SIMPLE IRA. Again, strict eligibility rules apply.

3. The payroll deduction IRA. This involves the employer merely setting up the program with a financial institution and encouraging its employees to make contributions. These IRAs are no different from "outside" IRAs except that the employer can withhold the money and submit it directly from payroll into the IRA. In addition to clearing the psychological hurdle of actually writing a check to an IRA, this allows for smaller contributions by the employee.

As you can see, the main difference between these alternatives is the contribution limits. Check with your plan sponsor to see if one of these three plans is a good fit for your business.

