THE EMPLOYEE BENEFIT
Forum
current issues in retirement benefit planning

qualified PLANS LLC

Change of Mind

SITUATION: An employee who recently left our company filled out a distribution request form directing that his regular 401(k) balance be rolled over to a traditional IRA. Now, he's changed his mind and would like his account balance to be rolled over to a Roth IRA instead.

QUESTION: What should we do?

ANSWER: If the rollover hasn't been completed, have the former employee fill out a new distribution request specifying that he wants his balance transferred to a Roth IRA. Then, your plan can complete the rollover. If the rollover has already been completed, the former employee will have to convert his traditional IRA to a Roth IRA himself.

DISCUSSION: Since 2008, plan participants have been allowed to roll over their account balances to either a traditional IRA or a Roth IRA. An employee who makes a qualified rollover contribution to a Roth IRA must include any previously untaxed amount of the contribution in his or her gross income for the year the rollover is made. There is no 20% income-tax withholding requirement with a direct trustee-to-trustee transfer, even for the amount includable in gross income. However, voluntary withholding is permitted.

Currently, rollovers from an employer-sponsored plan account or a traditional IRA to a Roth IRA may be made only if the account owner's adjusted gross income, not including the rollover amount, doesn't exceed $100,000, and he or she files a joint return if married. Your plan is not responsible for ensuring that the participant is eligible to make the rollover. Beginning in 2010, the income and separate-filer restrictions are lifted.

Your plan will have to complete a Form 1099-R reflecting the rollover to the Roth IRA and furnish a copy to the former employee by February 1, 2010. A copy must be filed with the IRS by March 1, 2010, or if filing electronically, by March 31, 2010.

To help avoid similar requests from former employees, you may want to review your distribution educational materials to make sure they adequately explain the differences between traditional and Roth rollover IRAs and the advantages of each. Also check to make sure your distribution request forms clearly indicate all available distribution choices.

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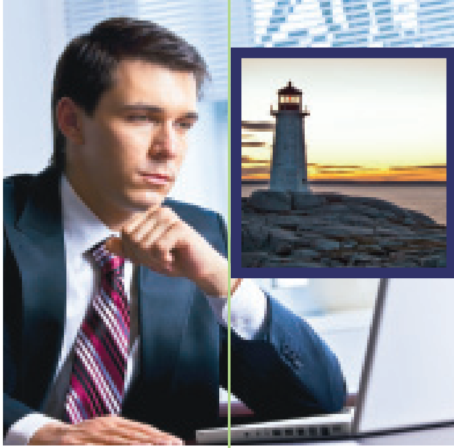


Safe Harbor Update

The IRS recently issued proposed regulations that permit safe harbor 401(k) plans that require the plan sponsor to make qualified 3%-of-compensation nonelective contributions on behalf of nonhighly compensated employees to suspend or reduce contributions. Previously, sponsors that wished to suspend or reduce these contributions after the start of the plan year had to terminate the plan or make the change effective for the next plan year.

Under the proposed regulations, the sponsor must experience a *substantial business hardship*. The factors taken into account in determining substantial business hardship include (but are not limited to) whether or not: (1) the employer is operating at an economic loss, (2) the industry concerned is experiencing substantial unemployment, (3) the sales and profits of the industry are depressed or declining, and (4) it is reasonable to expect that the plan will be continued after the planned reduction or suspension. Other requirements parallel the existing regulations for suspending or reducing employer matching contributions.

Will Your Plan Pass?

Employers that have discontinued or reduced their 401(k) employer matching contributions may be in for a surprise. Without a match incentive, some nonhighly compensated employees may reduce their deferrals or stop contributing. The result? Plans that normally pass the actual deferral percentage (ADP) nondiscrimination test may fail.

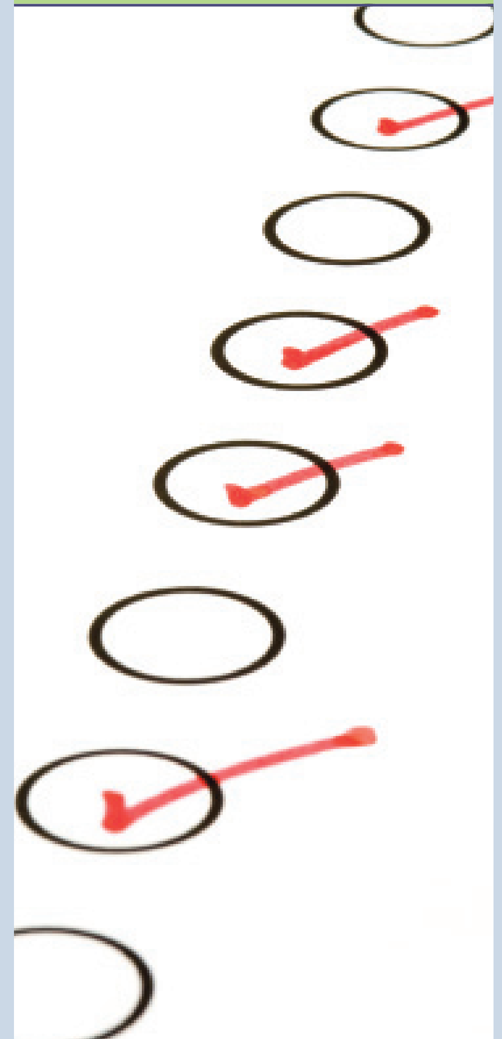
The ADP test compares the average rate at which highly compensated employees defer salary with the average deferral rate for nonhighly compensated employees. The difference between the two must be within defined limits. If it isn't, the excess contributions made by the highly compensated employees, and earnings on those contributions, must be corrected using one of three primary options.

Correcting Excess Contributions

The first option is to refund the excess contributions. While refunds can be made anytime within 12 months of the close of the plan year, a 10% excise tax applies to excess contributions not returned within 2½ months (six months for eligible automatic contribution arrangements). Another is to recharacterize the excess contributions as after-tax contributions, if plan provisions allow. Recharacterizations must occur no later than 2½ months after plan year-end. For either option, the amounts will be taxable to the employees. The third option is to make additional qualified nonelective contributions (or qualified matching contributions) to nonhighly compensated employees.

Avoiding Test Failure

Some sponsors may be able to avoid test failure by limiting the percentage of compensation highly compensated employees can defer. To do so, you would have to amend your plan before the end of the plan year. Such an amendment could help you satisfy nondiscrimination testing in future years as well.



FAQs About Required Notices

As we move into the final months of the year, employers should be aware of various notices they may have to provide to their 401(k) plan participants before year-end. Below we answer some questions about the notices most likely to be required.

When does the safe harbor plan notice have to be distributed? If your 401(k) plan has a safe harbor design, you must provide eligible employees with a written notice at least 30 days and not more than 90 days before the beginning of every new plan year. The notice must describe your plan's safe harbor provisions and the employees' rights and obligations under the plan. For employees who become eligible to join the plan after the start of the year, notice must be provided not more than 90 days before but no later than the date the employee becomes eligible.

The safe harbor notice can be a standalone notice or combined with the automatic enrollment notice and/or with the qualified default investment alternative notice. For employers that want to combine notices, the IRS has a sample notice available on its website (*www.irs.gov/pub/irs-tege/sample_notice.pdf*).

When do we need to give participants notice of our plan's automatic enrollment feature? You must provide employees with an automatic enrollment notice when they are hired, just before they become eligible to participate in your plan, and annually at least 30 days before the beginning of the plan year. The notice must explain the employee's right to decline automatic enrollment, to make changes to the election amount, and to opt out of the plan altogether. For example, the sample notice mentioned above meets the automatic enrollment notice requirements by explaining: (1) to whom a plan's automatic enrollment features apply, (2) what amounts will be deducted from an employee's compensation and contributed to the plan, (3) what other amounts the employer will contribute to the employee's plan account, (4) when the plan account will be vested, and (5) how the employee can change his or her contributions.

What if our plan uses a qualified default investment alternative (QDIA)? Plans that use a qualified default investment alternative (QDIA) for investments made on behalf of employees and plan beneficiaries who fail to direct the investment of their 401(k) plan account balances must provide a QDIA notice. The notice must reach employees and beneficiaries at least 30 days before (1) they are eligible to participate in the plan or (2) the first investment in a QDIA is made on their behalf *or* on or before the date of eligibility if they have the opportunity to withdraw investments from the QDIA within 90 days of the first deposit. They also must receive an annual QDIA notice within a reasonable period of at least 30 days before the beginning of each plan year.

The QDIA notice must explain the employee's rights under the plan to designate how his or her contributions will be invested and, if he or she doesn't make any investment election, how the assets will be invested. The notice also must describe the QDIA, including the investment objectives, risk and return characteristics, and any fees and expenses involved. And it must explain the employee's right to transfer assets invested in the QDIA to other plan investment alternatives, as well as where to obtain information about other plan investments. Employees must be given a reasonable period after receiving the notice and before the beginning of the plan year to make investment choices.

The notice may not be provided in a summary plan description or a summary of material modifications. However, employers can provide the required description of the QDIA in a separate, simultaneously furnished document, such as the default investment's prospectus.

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.

RECENT DEVELOPMENTS
In Benefit Plans

How Workers Expect To Fund Retirement. According to the *2009 Retirement Confidence Survey*, 42% of workers expect an employer-sponsored retirement savings plan, such as a 401(k) plan, to be a major source of retirement income. Thirty-two percent of respondents said that Social Security would be a major source of retirement income, while 28% said that an employer-provided pension would be a major source. Workers who have not saved for retirement were more likely to say they would be relying on Social Security and employment during retirement than those workers who have saved and expect to receive retirement income from workplace savings, pensions, and IRAs.

Account Balances and Rollovers. A recent report from the Employee Benefit Research Institute found that the higher an employee's account balance, the more likely the employee will roll over the entire distribution received when he or she leaves employment. For example, only 19.5% of employees with account balances of $500 to $999 roll over their accounts, versus 46.5% of those with balances of $10,000 to $19,999 and 72.4% of employees with balances of $50,000 or more. Many of the people with lower balances may be younger participants who could benefit greatly from rolling over their distributions. Employers should consider educating *all* of their participants about the benefits of rolling over retirement plan distributions to an IRA or another employer's plan.

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