THE EMPLOYEE BENEFIT

Forum

current issues in retirement benefit planning

"Banking" Vacation Time for Retirement

SITUATION: Our company has a paid time off (PTO) plan. At the end of the year, employees forfeit any vacation days they have not used. We are short-staffed and have several employees who generally do not use all of their allotted vacation time.

QUESTION: Can we amend our 401(k) profit sharing plan to allow us to contribute the dollar equivalent of the unused vacation days to these employees' accounts?

ANSWER: Yes. Contributions of the dollar equivalent of unused paid time off are permissible. The contributions will not jeopardize a plan's tax-qualified status as long as the plan meets all relevant tax law requirements.

DISCUSSION: A recent IRS revenue ruling* gives two examples. In the first, a company's PTO plan provides that employees forfeit any paid time off they haven't used by the end of the year. At that time, the company allocates the dollar equivalent of the forfeited time to the employee's plan account to the extent applicable tax law limitations are not exceeded.

At the close of business on December 31, 2009, an employee has unused paid time off equal to $500 (number of unused PTO hours multiplied by pay rate). After applying the tax law's limitation on annual additions, the company can contribute only $400 to the employee's account. The company makes the contribution in February 2010 and pays the employee the remaining $100. The employee includes the $100 in his gross income for 2010, the year he receives the payment.

Since the employee wasn't given the option of receiving the $500 in cash, the plan contribution is a nonelective employer contribution instead of an elective deferral. The contribution is considered made in 2009, the year it is allocated to the employee's account.

What happens if employees have a choice of receiving a cash payment for their unused paid time off or having the dollar equivalent contributed to the employer's 401(k) plan? The second IRS example illustrates this scenario.

In the situation described, the employee defers only a portion to the 401(k) plan and receives the rest in cash. The plan contribution is considered an employee elective deferral and is subject to both the annual additions and deferral limitations. The amount not contributed is taxed to the employee in the year paid.

The ruling does not provide a nondiscrimination safe harbor. Plans offering contributions of unused paid time off need to test to ensure they do not discriminate in favor of highly compensated employees.

* Rev. Rul. 2009-31 (9/4/2009)

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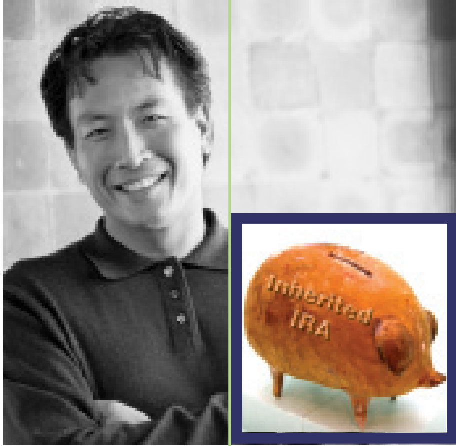

Nonspouse Beneficiary Rollover Reminder

Qualified plan sponsors should be aware that, for plan years beginning after December 31, 2009, plans *must* offer nonspouse designated beneficiaries the option to directly roll over an eligible rollover distribution. The rollover has to be made to an inherited IRA established for the purpose of receiving the benefits on behalf of the designated beneficiary. A nonspouse beneficiary cannot roll over the account assets to his or her own IRA.

Also starting in 2010, nonspouse rollovers are considered eligible rollover distributions. They are generally subject to the same rules as other eligible rollover distributions. Consequently, plan sponsors will have to provide nonspouse beneficiaries with a Section 402(f) notice. This notice informs plan participants and beneficiaries of their choices for receiving the distribution and the tax effects of each choice. In addition, any funds paid to the nonspouse beneficiary instead of being directly rolled over to an inherited IRA will be subject to mandatory 20% federal income-tax withholding.

More Roth Rollovers Ahead?

Beginning in 2010, more retirement plan participants will be able to roll over eligible distributions to Roth IRAs. With the start of the new year, the tax law's income and filing status restrictions on these rollovers are rescinded. (Before 2010, Roth IRA rollovers, other than from a designated Roth account, are available only to participants with modified adjusted gross income of $100,000 or less. If married, the participant must file a joint return.)

Tax Consequences

Participants may like the idea of rolling their retirement savings into a Roth IRA because it can serve as a source of tax-free income during retirement. But there's a price to be paid. Unlike rollovers to traditional IRAs, Roth IRA rollovers generally are taxable.* On the plus side: The 10% early withdrawal penalty won't apply.**

If a rollover is accomplished by way of a direct trustee-to-trustee transfer, 20% federal income-tax withholding is not mandatory. Withholding is required for distributions paid to participants.

Another Option

A participant who isn't sure about rolling over a distribution to a Roth IRA may want to opt for a tax-free rollover to a traditional IRA. If desired, the participant could later convert the traditional IRA to a Roth IRA. Taxes would be payable on the conversion.

* Exception: Distributions from designated Roth accounts may be rolled over to Roth IRAs tax free.
** The 10% penalty could apply to an early withdrawal from the Roth IRA within a specified five-year period after the rollover.

Talking to Preretirees

In 1999, 17.2 million American workers were age 55 or older. By mid-2009, this number had increased to 27.1 million. With this aging of the U.S. work force, it's important for employers to take care that their retirement education programs meet the needs of preretirees as well as those of younger employees. Below we answer some questions about providing preretirees with the information they need to make the transition from work to retirement.

How are the communication needs of older employees different? Most retirement education materials focus on encouraging employees to enroll in the company's plan and contribute as much as they can to their plan accounts. Increasing the number of younger and lower paid plan participants to help the plan meet nondiscrimination testing requirements is often one goal of these materials. Communications concentrate on plan basics: how the plan works; the advantages of pretax contributions, tax-deferred compounding, starting early, and contributing regularly; and how to invest plan contributions to reach retirement goals. Investment education stresses "growing your account." This is important information for most plan participants. But, as employees move closer to retirement age, they need additional information about their plan distribution options and how to invest their accounts to preserve their assets.

With all the statistics on the "baby boomers" not having saved enough for retirement, don't older employees need to be encouraged to contribute, too? Yes, they do. But you may want to customize some "contribute more" messages to appeal specifically to preretirees. If your plan allows catch-up contributions, send annual reminders to workers age 50 and older. Many of these employees are in their highest earning years. Consider participant newsletter articles or other communications that remind participants that they can really focus on retirement "now that the kids are through college" or "now that your home mortgage is paid off." Online tools that help older workers project their retirement budgets and calculate the gap between current retirement savings and the amount of savings needed at retirement may be particularly helpful.

What kinds of distribution information do these employees need? Before they are actually ready to retire, employees need to be aware of the types of retirement distributions available from your plan and how each option works. One survey* of participants age 50 to 64 found that, when asked whether they could withdraw their account balances as a life annuity rather than a lump-sum distribution, fewer than half answered correctly. An employee's distribution options can have an impact on retirement planning. Older participants also need to know that they generally must begin taking annual required minimum distributions from their plan accounts after they turn age 70½.

What about investment education? Targeted communications can help older employees understand the need to review their asset allocations periodically as they move closer to retirement and, in many cases, gradually shift some of their growth investments into more conservative investments that can help them preserve their savings. The impact inflation can have on retirement expenses and the resulting need to keep some growth investments to stay ahead of inflation is another important topic for both preretirees *and* retirees.

How about communicating with retirees who stay in the plan? Along with providing statements, you should communicate to retirees the importance of keeping the plan informed of changes in their lives, such as residential or e-mail address changes and family changes that may require them to update their beneficiary designation(s).

* *U.S. Survey of Older Employees' Attitudes Toward Lump Sum and Annuity Distributions from Retirement Plans,* May 2007, Watson Wyatt

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RECENT DEVELOPMENTS In Benefit Plans

New Section 402(f) Model Notices. The IRS has issued two updated safe harbor explanations that plan sponsors can give to participants who are eligible to receive "eligible rollover distributions" in order to satisfy the Section 402(f) notice requirements. One applies to distributions from "regular" plan accounts (i.e., non-Roth) and the other applies to distributions from designated Roth accounts. The new notices reflect changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Pension Protection Act of 2006. A plan may customize the notices by omitting any information that does not apply to that plan.

No 2010 COLAs. Because the cost-of-living index for the quarter ended September 30, 2009, was lower than the index for the same period in 2008, these retirement plan contribution and benefit limitations are unchanged for 2010:

- Maximum annual additions to defined contribution plan account, $49,000
- Maximum annual benefit from defined benefit pension plans, $195,000
- Maximum annual compensation used to determine qualified plan benefits or contributions, $245,000
- 401(k), 403(b), and 457 plan deferrals and catch-up contributions, $16,500/$5,500
- SIMPLE deferrals and catch-up contributions, $11,500/$2,500
- The maximum annual contribution that can be made to an IRA, $5,000/$6,000 for individuals age 50 or older
- Dollar limit used in the definition of "highly compensated employee," $110,000
- Compensation limit for determining whether officers are key employees for top-heavy plan purposes, $160,000

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