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**RETIREMENT PLANNING
OPTIONS AND UPDATE
PANEL #2
ACCUMULATION OF WEALTH**

by

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RETIREMENT PLANNING OPTIONS AND UPDATE PANEL #2 ACCUMULATION OF WEALTH

I. TAX QUALIFIED RETIREMENT PLANS.

A. Introduction.

1. For professionals and other small business owners, qualified retirement plans have been vastly improved by EGTRRA and other recent changes in law. Qualified plans can be structured to provide large benefits for professionals and other key employees at a minimal cost for benefits for rank and file employees.
2. Whether the key employee is motivated by a desire to provide for his retirement or solely to shelter income from taxes, the same result is attained — he retains more of what he earns by diverting a substantial portion of his earnings into a tax-sheltered retirement plan.
3. Qualified retirement plans serve two major functions — they provide employee benefits and they act as tax shelters. As a general rule, the tax shelter aspect is emphasized in smaller plans and employee benefits are emphasized in larger plans. Both features are present in all plans, however, and should be recognized when designing a plan and when reviewing a plan with a client. Even in a plan designed primarily as a tax shelter for a key employee, the funding of benefits for rank and file employees should not be viewed in an entirely negative light. Participation in a pension plan should always be presented to employees in a positive manner and can be used to encourage employee loyalty and longevity and to thereby reduce employee dissatisfaction and turnover. Thus, participation by non-key employees engenders a more cohesive staff and can reduce employee training and turnover costs. Remember: proper and positive communication to employees is the key to employee appreciation of pension and other fringe benefits.

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4. Retirement Plan Assets at 12/31/2005.
 - a. IRAs: \$ 3.7 Trillion
 - b. Defined Contribution Plans: \$ 3.7 Trillion
 - c. Defined Benefit Plans: \$ 1.9 Trillion
 - d. Government Employee Plans: \$ 3.8 Trillion
 - e. Annuities: \$ 1.4 Trillion
 - Total: \$14.5 Trillion

Retirement plan assets account for more than one-third of all U.S. household assets. (Investment Company Institute, July, 2006).

5. Importance of Employer Sponsored Plans.
 - a. 10% of individuals eligible to contribute to an IRA do contribute to an IRA.
 - b. 75% of individuals eligible to contribute to a 401(k) plan do contribute to a 401(k) plan.

B. Tax advantages of qualified plans:

1. Employer contributions are deductible in the year made. Contributions are deductible if made prior to the due date for the corporate tax return, including extensions. IRC §404(a).
2. Participants are taxed only when they receive payments from the trust. IRC §402(a).
3. The retirement trust is tax-exempt and the trust funds accumulate income tax free. IRC §501(a).
4. Income tax brackets are generally lower at the time benefits are received following the participant's retirement or death. Additionally, Social Security taxes are paid neither on employer contributions to tax-qualified retirement plans nor on distributions to participants from such plans.
5. Qualified plans provide a means of forced savings and protection of assets from creditors claims. A 1993 survey showed that 43% of doctors saved less than \$3,000.00 outside of their retirement plans in 1992. The median for all surveyed M.D.s was \$7,500.00. The moral is that it is very difficult for anyone to save money outside of a retirement plan.

a. Example:

For example, compare the tax effects of a \$10,000.00 contribution to a tax-qualified plan and a \$10,000.00 compensation bonus. The \$10,000.00 contribution to the plan is deductible to the employer pursuant to IRC §404(a). The employee is not taxed until the funds are distributed from the plan. The \$10,000.00 contribution is held in a tax-exempt trust (assume a 10% annual return) and at the end of the year, \$11,000.00 would be saved. If a \$10,000.00 bonus was paid, the bonus would be deductible to the employer pursuant to IRC §§162, 212. The employee would be taxed on the bonus and assuming a 40% tax rate (federal, state and local taxes and Social Security/ Medicare), the employee would net \$6,000.00. Of the \$6,000.00, assume the employee saves half (\$3,000.00) and invests it in a funding vehicle with a 10% annual return. Since the 10% return is not in a tax exempt trust, it is subject to tax (assuming 20% tax rate). Therefore, of the \$300.00 investment gain, the employee would net \$240.00 (\$300.00 less 20%), and at the end of the year, of the \$10,000.00, the employee would have savings of only \$3,240.00.

<u>Compensation</u>		<u>Retirement Plan Contribution</u>
\$ 10,000		\$ 10,000
- 4,000	Taxes	- 0
<u>\$ 6,000</u>		<u>\$ 10,000</u>
- 3,000	Spend	- 0
<u>\$ 3,000</u>	Save	<u>\$ 10,000</u>
x .1	Invest	x .1
<u>\$ 300</u>		<u>\$ 1,000</u>
- 60	Taxes	- 0
<u>\$ 240</u>		<u>\$ 1,000</u>
<u>+ 3,000</u>		<u>+ 10,000</u>
<u>\$ 3,240</u>		<u>\$ 11,000</u>

6. *Comparison to non-qualified deferred compensation plan.* A nonqualified deferred compensation plan is an unfunded, unsecured promise to pay benefits at a future date.

- a. Contributions to a non-qualified plan are only deductible in the year that the employee picks up the benefit in income.
- b. There is no tax-free or tax-deferred growth.
- c. Although non-qualified plans may be informally funded, the employee/beneficiary is, at best, an unsecured general creditor of the employer and the benefits are subject to claims by the employer's creditors.

C. Types of Retirement Plan Documents.

1. *Prototype Plan Documents*

- a. Prototype documents are pre-approved by the IRS and consist of two separate documents: the prototype document and the adoption agreement.
 - i. The prototype document is a document that cannot be changed or modified by the adopting employer. It contains the required "boilerplate" provisions for the plan.
 - ii. The adoption agreement contains various options that can be selected to adapt the documents to the preferences of the individual adopting employer.
- b. There are two types of adoption agreements: Standardized and Non-Standardized.
- c. *A Standardized Adoption Agreement* contains strict limitations on the election options for the adopting employer. In most circumstances, however, the IRS Approval Letter issued for the Prototype Plan can be considered to apply to the employer adopting the plan without the need for the employer to request an individual IRS determination letter for the employer's adoption of the plan.

Standardized Adoption Agreements cannot:

- i. Require employment on the last day of a plan year to receive a contribution (last day requirement);
 - ii. Require 1,000 Hours of Service in a plan year to receive a contribution (1,000 hour requirement);
 - iii. Exclude categories of employees from plan participation other than statutory exclusions permitted by the IRC.
- d. *A Non-Standardized Adoption Agreement* can contain many more optional provisions for the adopting employer. An employer may choose to exclude certain specified categories of employees (e.g., custodian employees) from coverage under the plan. The plan can also contain last day and 1,000 hour requirements for participants to receive contributions to the plan for a given plan year.
 - i. The prototype approval letter does not necessarily apply to the adoption of the plan by the individual employer.

- ii. The employer may file an IRS Form 5307 to request an individual determination letter for the employer's adoption of the Non-Standardized Adoption Agreement.
- e. Any additions to or deletions from the prototype plan or the adoption agreement can cause the plan to lose its prototype status and cause the IRS approval letter for the prototype to be not applicable to the plan. If changes are made to the plan it is treated as an individually designed plan without a determination letter (unless one is applied for on a Form 5300 by the adopting employer).

2. *Volume Submitter Plan Documents.*

- a. Along with the prototype plans, volume submitter plans are referred to as "pre-approved plans".
- b. A volume submitter plan looks like an individually designed plan. The provisions of the plan have, however, been pre-approved by the IRS.
- c. The adopting employer can make modifications to the language of the volume submitter plan. Such modifications are pointed out to the IRS as variances when the employer files for an individual determination letter on IRS Form 5307.
- d. If an employer is a "word-for-word" adopter of the plan (i.e., no changes have been made to the approved plan document), the IRS volume submitter determination letter may be relied upon by the adopting employer.

3. *Individually Designed Plan Documents.*

- a. Many complicated documents are individually designed plans. Large defined benefit plans, cash balance plans, collectively bargained plans and ESOPs are often individually designed plans.
- b. Individually designed plans are not pre-approved by the IRS. Such plans should always be filed with the IRS with a Form 5300 determination letter request.

D. EGTRRA Document Updates/Remedial Amendment Period. Rev. Proc. 2005-66.

1. Six-Year Cycle for Pre-Approved Plans.

- a. The IRS has established a six-year cycle for the updating of the pre-approved plans (i.e., prototype and volume submitter plans). The six-year cycle begins in 2005 for Defined Contribution (DC) Plans and in 2007 for Defined Benefit (DB) Plans. Rev. Proc. 2005-66.

b. Six-Year Cycle for Pre-Approved DC Plans.

<u>Year</u>	<u>Step</u>	
2005	Step One.	All pre-approved DC Plans must be updated (based on the law in effect at time of update) and submitted to IRS for approval by January 31, 2006.
2006-2007	Step Two.	IRS processes applications for pre-approved plans.
2009-1/31/2011	Step Three.	Employers restate DC plans by adopting pre-approved plans.
2011	Step One begins again	

c. The last day of the EGTRAA Remedial Amendment cycle for employers to adopt pre-approved defined contribution plans is January 31, 2011.

d. The six-year cycle for pre-approved Defined Benefit (DB) Plans will commence in 2007 with the submission of prototype and volume submitter lead documents to IRS. Employers will adopt the restated DB documents beginning in 2011. The last day of the EGTRAA RAP cycle for defined benefit plans is January 31, 2013.

e. Good faith interim amendments (e.g., the amendments for compliance with the IRC Section 401(a)(9) final regulations on minimum required distributions) may be required based on new laws or updated IRS guidance.

Amendments for compliance with the Pension Protection Act of 2006 must be adopted by the end of the 2009 plan year.

2. Five-Year Cycle for Individually Designed Plans.

a. The IRS established a five-year cycle for updating individually designed plans. The cycle provides that plans sponsored by employers with employer identification numbers (EINs) ending in 1 or 6 must be restated in the first year (2006) of the program and restated again in 2011. Employers with EINs ending in 2 or 7 will be restated in 2007 and again in 2012, and so on for the other EINs. Rev. Proc. 2005-66.

b. Each year's deadline is actually January 31 of the following year. Therefore, plans that must be submitted in 2006 will actually have

a remedial amendment period beginning on February 1, 2006 and ending on January 31, 2007.

- c. As with the pre-approved plans, individually designed plans may need to adopt needed amendments in interim years for compliance with changes in laws or IRS guidance.
- d. Five-Year Cycle for Individually Designed Plans.

<u>Last Digit of EIN of Sponsoring Employer</u>	<u>Cycle</u>	<u>Year to be Restated</u>
1 or 6	A	2/1/06 – 1/31/07
2 or 7	B	2/1/07 – 1/31/08
3 or 8	C	2/1/08 – 1/31/09
4 or 9	D	2/1/09 – 1/31/10
5 or 0	E	2/1/10 – 1/31/11

- e. Special Rules for Five Year Cycle/Individually Designed Plans
 - i. Multiemployer (Collectively Bargained) Plans are updated under Cycle D.
 - ii. Multiple Employer Plans are updated under Cycle B.
 - iii. Governmental Plans (including governmental multiple employer plans) are updated under Cycle C.
 - iv. Controlled Group maintaining more than one plan:
 - (a) Can make election to file all plans under parent's EIN; or
 - (b) All members of controlled group can elect to file under Cycle A.
- f. Switch From Individually Designed Plan to Pre-Approved Plan. Form 8905.

The IRS issued FAQs relating to the use of Form 8905, *Certification of Intent to Adopt a Pre-Approved Plan*. Sections 17.01 and 17.04 of Rev. Proc. 2005-66 provide that an employer's plan is treated as a pre-approved plan and is eligible for the six-year remedial amendment cycle if an employer and a Master and Prototype (M&P) sponsor or a Volume Submitter (VS) practitioner who maintains the pre-approved plan execute Form 8905 before the end of the employer's five-year remedial amendment cycle. Thus, this Form is used to shift from the five-year remedial amendment cycle used for individually designed

plans to the six-year remedial amendment cycle applicable to pre-approved plans.

1. May Form 8905 be signed with an electronic signature?

Yes, but only the M&P sponsor or VS practitioner may use an electronic signature. The employer must manually sign and date the form. The employer cannot use stamped or scanned signatures or dates.

2. Who is responsible for keeping the signed original of Form 8905?

The employer is responsible for retaining the Form 8905 certification as signed and dated by the employer and the M&P sponsor or VS practitioner. The original should be filed with the appropriate application (Form 5300, 5307, 5310) to the Service if such an application is filed.

3. When should a plan M&P sponsor, VS practitioner or employer file a Form 8905 with the Service?

Form 8905 should only be filed as part of an application on Form 5300, 5307 or 5310. Only at that time should Form 8905 be attached to the application. If no Form 5300, 5307, or 5310 filing is made, the employer should keep the original certification in its records, but should not file Form 8905.

4. Should the Form 8905 ever be filed separately?

No. Form 8905 should not be filed with the Service except as part of a filing with the Form 5300, 5307 or 5310 applications discussed under FAQ 3 above.

5. Can Form 8905 be used if the five-year remedial amendment cycle applicable to a particular employer ends before the deadline for the M&P sponsor or VS practitioner to submit an application for approval of its pre-approved plan?

Yes. The Instructions to Form 8905, Part III, Line 4, state that the M&P sponsor or VS practitioner should enter the application deadline for an opinion or advisory letter application next to its signature (e.g., this would apply for Cycle A employers whose five-year remedial amendment cycle ends before pre-approved defined benefit plans are

submitted during the 12-month period from February 1, 2007 to January 31, 2008).

6. How can an employer adopting an interim plan (e.g., a new, timely filed, pre-approved plan that has yet to be issued an opinion or advisory letter) get the six-year remedial amendment cycle?

The employer should either sign Form 8905 before the end of the employer's five-year cycle, or adopt the interim pre-approved plan, in order to get the six-year remedial amendment cycle. This follows the rules for "new adopters" in section 17.03 of Rev. Proc. 2005-66. Alternatively, pursuant to section 17.04 of Rev. Proc. 2005-66, if the employer's five-year remedial amendment cycle ends with or after the six-year remedial amendment cycle, the employer must adopt a "current pre-approved plan" (e.g., a plan that has been issued an opinion or advisory letter) in order to get the six-year remedial amendment cycle).

E. Involuntary Cash-Out Rule/Mandatory Distributions.

1. A mandatory distribution is a distribution made to a participant without the participant's consent before he or she reaches the later of age 62 or normal retirement age. A plan may provide for a mandatory distribution of a participant's benefit only if the present value of the vested total accrued benefit does not exceed the \$5,000 cash-out limit. IRC §§411(a)(11), 417(e). EGTRRA amended IRC §401(a)(31)(B) to provide that mandatory distributions of more than \$1,000 from a qualified retirement plan to a plan participant (but not to a surviving spouse or alternate payee) must automatically be rolled over into an IRA unless the participant elects to have the distribution rolled over to another retirement plan or to take it in cash. The automatic rollover rules are effective March 28, 2005.
2. IRS Notice 2005-5 notes that the automatic rollover rules apply only to mandatory distributions. The rules do not apply to eligible rollover distributions made to a surviving spouse or a former spouse who is an alternate payee, nor do they apply to involuntary cash-outs made to a participant who has reached the later of age 62 or normal retirement age under the plan.
3. Under EGTRRA, the plan administrator must notify the participant in writing that the distribution may automatically be rolled over into an IRA. The IRS guidance clarifies that this information must be included in the section 402(f) tax notice that is provided to participants within 30 to 90 days of a distribution. If a participant receiving a mandatory distribution fails to elect a direct rollover or a cash payment, the plan administrator

may execute the necessary documents to establish an individual retirement plan on the participant's behalf and select a financial institution.

Department of Labor final regulations establish a safe harbor for automatic rollovers. Information about the automatic rollover procedures must be provided in the distributing plan's summary plan description (SPD) or in a summary of material modifications (SMM). Such information must describe the investment product, indicate how fees and expenses will be allocated among the IRA, the distributing plan and the plan sponsor; and identify a plan contact. These disclosures must be made before the plan's first automatic rollover.

4. Compliance Alternatives.

There are three alternatives to complying with the automatic rollover rules:

- a. Continuing to provide mandatory distributions and implementing the automatic rollover rules;
- b. Lowering the mandatory distribution limit from \$5,000 to \$1,000; or
- c. Eliminating mandatory distributions altogether.

5. Plans subject to the direct rollover rules have until December 31, 2005 to establish administrative procedures for automatic rollovers and to process automatic rollovers for 2005. This operational compliance deadline does *not* vary based on the plan year. Special effective dates apply to governmental plans, church plans, and section 403(b) plans.

Plans must revise SPDs and the section 402(f) special tax notice to include information regarding the automatic rollover requirements. Plan sponsors must adopt a good-faith plan amendment not later than the later of: (i) December 31, 2005, or (ii) if the employer's tax year and the plan year are the same, the due date of the employer's tax return (plus extensions) for the tax year ending after March 28, 2005. Notice 2005-5 contains IRS model language for the good-faith amendment.

As noted above, a plan sponsor may amend a plan to eliminate a provision that requires the plan to make mandatory single-sum distributions to participants or reduce the amount of the mandatory cash-out to \$1,000 and thereby avoid the application of the automatic rollover rules to its plan. Plans that adopt such changes may continue to provide an exception from the Qualified Joint and Surviving Annuity (QJSA) requirements for accrued benefits of \$5,000 or less.

6. Rollover IRA Investment Product Requirements.

The DOL Regulations provide that the investment product for the rollover IRA for involuntary distributions must comply with the following requirements:

- a. The IRA must be designed to preserve principal, provide a reasonable rate of return, be liquid and minimize risk.
- b. The IRA must seek to maintain, on an on-going basis, the original principal amount rolled over into the IRA.
- c. The IRA must be established with a bank, savings association, credit union, insurance company, or mutual fund provider.
- d. Fees and expenses charged shall not exceed the fees and expenses charged by the individual retirement plan provider for comparable individual retirement plans established for reasons other than automatic rollovers; and
- e. The participant for whom the automatic rollover is made must have the right to enforce the terms of the contractual agreement with regard to his or her funds.

7. Prohibited Transaction Exemptions for Certain Employees.

DOL Prohibited Transaction Exemption 2004-16 creates a class exemption for employers (such as a bank, insurance company, or mutual fund provider) that choose their own or an affiliate's investment product for the rollover IRA.

8. IRS Sample Amendment for Automatic Rollovers. IRS Notice 2005-5.

In the event of a mandatory distribution greater than \$1,000 in accordance with the provisions of section _____, if the participant does not elect to have such distribution paid directly to an eligible retirement plan specified by the participant in a direct rollover or to receive the distribution directly in accordance with section(s) _____, then the plan administrator will pay the distribution in a direct rollover to an individual retirement plan designated by the plan administrator.

9. Application of Automatic IRA Rollover Rules to Distribution From Terminated Plans.

- a. Department of Labor Field Advice Bulletin (FAB) 2004-02 is entitled: Fiduciary Duties and Missing Participants in terminated Defined Contribution Plans.
- b. The FAB provides that the circumstances giving rise to relief under the safe harbor regulations for involuntary IRA rollovers of

amounts less than \$5,000 are similar to those confronting fiduciaries of terminated defined contribution plans.

- c. Therefore, the FAB states that rollovers to IRAs of amounts from terminated plans in accordance with the provisions of the safe harbor regulations will be deemed to be in satisfaction of the fiduciary duties for the Plan.
- d. Until the DOL issues final regulations on IRA rollovers of amounts from terminated plans, however, it may be difficult to get a bank or mutual fund to accept such rollover amounts.

II. TYPES OF QUALIFIED PLANS.

A. Profit-Sharing Plan.

- 1. Profit-Sharing plans are the most flexible of all qualified plans. The employer is not obligated to make contributions to the plan, but each year it can elect to contribute any amount between 0% and 25% (15% for plan years commencing prior to 2002) of the annual compensation of the covered employees. Employer contributions may be determined each year by action of the board of directors or by a contribution formula written into the plan.
- 2. For all defined contribution plans, the maximum annual additions (which includes employer contributions, forfeitures and employee contributions) under IRC §415(c) for each year is the lesser of 100% of compensation or \$40,000 (adjusted, \$42,000 for 2005; \$44,000 for 2006). Thus, contributions and forfeitures allocated on behalf of each participant cannot exceed these limitations.
- 3. The IRS requires that contributions to a profit-sharing plan be recurring and substantial. Although an employer does not have to make contributions every year, the employer's contributions must be more than single or occasional. Treas. Reg. §1.401-1(b)(2). Rev. Rul. 80-146 provides that a plan may be considered to be terminated if no contributions have been made to the plan for five (5) consecutive plan years.
- 4. The Pension Protection Act of 2006 (PPA) requires that employer contributions made to defined contribution plans after 2006 be vested no less rapidly than under a 3-year cliff or 6-year graded vesting schedule.

Year	3-Year Cliff	6-Year Graded
1	0%	0%
2	0%	20%
3	100%	40%
4		60%
5		80%
6		100%

B. 401(k) Plan.

1. A §401(k) cash or deferred compensation plan is a type of profit-sharing plan under which employees may elect to defer a portion of their compensation to the plan. An individual can defer a maximum of \$15,000 to a §401(k) plan for 2006 (\$14,000 for 2005) under §402(g). Employees who have attained age 50 are permitted to defer additional "catch-up" contributions of \$5,000 for 2006 (\$4,000 for 2005).
2. In addition to satisfying the requirements applicable to a regular profit-sharing plan, a 401(k) plan must satisfy the Average Deferral Percentage ("ADP") Test under IRC §401(k)(3)(A) for each plan year. The ADP consists of two alternative tests which measure the deferral of income of highly-compensated employees in comparison to the deferral of all other employees.

Under the ADP limits, the ADP for the eligible highly compensated employees must be no greater than one of two limits. Under one limit, the ADP for Highly Compensated Employees ("HCEs") is limited to 125% of the ADP for the eligible non-highly compensated employees. Under the second limit, the ADP for HCEs is limited to the lesser of 200% of the ADP for the eligible non-highly compensated employees; or the ADP for the eligible non-highly compensated employees plus two percentage points.

A "highly compensated employee" ("HCE") under IRC §414(q) is an employee who is either a 5% owner (during either the current year or the prior year) of the employer or who has compensation greater than \$95,000 (adjusted, \$95,000 in 2005; \$100,000 in 2006) (during the prior year) from the employer. HCE in 2005 if compensation greater than \$90,000 in 2004. HCE in 2006 if compensation greater than \$95,000 in 2005. HCE in 2007 if compensation greater than \$100,000 in 2006.

3. 2004 Final Regulations for 401(k) Plans.

Final Treasury Regulations Sections 1.401(k)-1 through 1.401(k)-6 and Sections 1.401(m)-1 through 1.401(m)-5 were issued on December 29, 2004. The regulations will be effective for plan years beginning on or after January 1, 2006.

- a. "Targeted" QNECs and QMACs. The regulations limit the use of "targeted" qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs) thereby restricting the use of "bottom up" QNECs. In general, QNECs for any one employee that could be included in the ADP or ACP test would be the greater of 5% or twice the plan's representative contribution rate (generally, the lowest NHCE contribution rate, taking into account a sampling of NHCEs that equals at least 50% of the total eligible NHCEs).

The limit placed on the amount of the QNEC allowed under the ADP test is independent of the amount allowed under the ACP test. Therefore, a QNEC of 10% of a participant's pay may be utilized for testing purposes by using 5% of pay for the ADP test and 5% of pay for the ACP test.

- b. Disproportionate match allocated to NHCEs. The ACP test will not include matching contributions for NHCEs which exceed the greater of 100% or twice the plan's representative matching rate. Similarly, disproportionate matching contributions will not be permitted to be used as QMACs under the ADP test.
- c. Timing of QNECs under prior year tested plans. QNECs for prior year tested plans must be contributed by the end of the testing plan year.
- d. Corrective distributions. Gap period earnings on excess contributions under the ADP test and excess aggregate contributions under the ACP test would be required if the plan credited earnings during gap period (for example, in a daily valued plan).
- e. Plans with only eligible HCEs. The regulations provide that, if a plan uses the prior year testing method and the only eligible employees are HCEs for such prior plan year, the plan is deemed to pass the ACP/ADP tests.
- f. ESOPs. Current rules that require the disaggregation of ESOPs and non-ESOPs for ADP and ACP testing will be eliminated.
- g. Catch-Up Contributions. A plan with a plan-imposed deferral limitation of less than 75% of compensation will violate the universal applicability requirements for catch-up contributions. Treas. Reg. Section 1.414(v)-1(e)(ii)(B).

4. Pension Protection Act of 2006 (PPA) Simplifies Administration of 401(k) Corrective Distributions.

- a. All ADP/ACP testing refunds will now be taxable in the year distributed. Under prior law, refunds within the 2-1/2 month window were taxable in the previous year.
- b. "Gap period" earnings on refunds will not be required if paid under the 2-1/2 month rule for all 401(k) plans and the new six month rule for passively enrolled plans.
- c. The new rules are generally effective for the 2008 plan year.

5. Hardship Distributions for Non-Spouse Beneficiaries.

PPA allows hardship distributions from 401(k) and 403(b) plans with respect to any designated beneficiary, not just a spouse or dependent.

The IRS is to issue regulations under this rule within 6 months of the date of enactment of PPA (date of enactment is August 17, 2006).

6. Certain Reservists Eligible for IRA and 401(k) Distributions.

401(k) Plans and IRAs will be able to make distributions to "qualified reservists" called up to active duty for 179 days. The 10% penalty does not apply to these distributions. Reservists must be called up between September 11, 2001 and before December 31, 2007 for more than 179 days. The reservist also has a two-year window beginning on the day after active duty ends to rollover the distribution to an IRA.

C. Roth 401(k) Contributions.

1. Effective for Plan Years commencing on or after January 1, 2006, Plan Sponsors may amend 401(k) or 403(b) plans to permit plan participants to elect to treat some or all of their elective deferrals as contributed on a Roth basis. The amendment must be adopted by the last day of the plan year in the calendar year that Roth deferrals are permitted.

IRS Notice 2006-44 provides a sample plan amendment for Roth contributions for a 401(k) plan.

2. If the Plan so permits, participants will be able to elect to have all or a portion of elective deferrals on or after January 1, 2006 as being deferred into the 401(k) plan on an after-tax basis. Future distributions from the Roth 401(k) account would be distributed on a tax-free basis (similar to a Roth IRA). Thus, a participant under Age 50 could defer up to \$15,000 into the 401(k) plan on a Roth basis. Participants Age 50 or older could also have catch-up contributions treated on a Roth-type basis for total deferrals of \$20,000 in 2006 (*i.e.*, the normal 401(k) deferral limits).
3. The Roth treatment only applies to the Participant's elective deferrals. Employer matching contributions or employer non-elective contributions will continue to be treated as tax-deferred contributions and will be taxable to the participant when distributed from the Plan.
4. Unlike Roth IRA assets, Roth 401(k) accounts will continue to be subject to the minimum distribution rules under IRC Section 401(a)(9).
5. Any excess deferrals attributable to a designated Roth contribution must be distributed no later than April 15 of the year following the year of the designated Roth contribution. If the excess deferrals are not distributed by April 15, the contribution will be taxed both in the year of contribution

and the year of distribution (*i.e.*, subject to double taxation), however, earnings attributable to the excess Roth deferral are only taxed in the year of distribution.

6. Roth 401(k) Contribution Compliance.

- a. Roth contributions are taxed at the time of the contribution and only earnings, if not qualified, are subject to future income taxes.
- b. There is still one annual limit for deferrals which includes both Roth and traditional deferrals. The limit for 2006 is \$15,000 (\$20,000 for participants age 50 or older).
- c. Traditional 401(k) and Roth (401(k) deferrals are tested together in the ADP test.
- d. Both contribution types will be treated the same when applying a match formula. All matching contributions are tested together in the ACP test. There is no special tax treatment for matching contributions attributed to Roth 401(k) contributions since these are still considered employer contributions.
- e. Separate recordkeeping accounts for Roth 401(k) and Traditional 401(k) deferrals are required.
- f. The amendment to the plan document will need to specify if the participant has the option between Roth 401(k) and Traditional 401(k) contributions or a mix of both, and whether the participant has a choice as to the source from which compliance refunds should be taken.

7. Roth 401(k) Distribution Rules.

- a. Distributions are subject to the same restrictions as traditional 401(k) contributions — *i.e.*, hardship distributions from contributions only and in-service distributions only allowed after attainment of age 59½.
- b. The portion of the account attributable to Roth 401(k) contributions is always tax free upon distribution.
- c. Earnings are tax free only if the participant is either age 59½, disabled or deceased AND the first Roth 401(k) contribution was deposited five or more tax years ago. (If the plan allows Roth 401(k) rollovers, this would include the date the first Roth 401(k) contribution was made to the prior plan.) Roth 401(k) earnings can be distributed tax free as early as 2011 under these rules.

- d. The Plan Sponsor is responsible for tracking the five years and the basis on the contributions to determine the tax that may be due upon distribution, even on rollover Roth 401(k) contributions.
 - e. The five-year period is based on tax years, not the elapsed time from the first contribution.
 - f. Unlike the Roth IRA, withdrawals are taken out pro-rata between contributions and earnings. Participants cannot choose to take only contributions first for non-qualified distributions.
8. Roth IRA Alternative. Elimination of \$100,000.00 AGI limit for Roth IRA Rollover (effective in 2010).
- a. TIPRA eliminates the current \$100,000.00 adjusted gross income (AGI) ceiling for converting traditional IRAs to Roth IRAs, for tax years after 2009. A conversion is treated as a taxable distribution, but is not subject to the 10% early withdrawal penalty. Taxpayers who convert in 2010 can elect to recognize the conversion income in 2010 or average it over the next two years.
 - b. Planning Opportunity. Individuals may wish to contribute non-deductible contributions to IRAs for 2006-2010 and rollover the IRA to a Roth IRA in 2010.

D. Safe Harbor §401(k) Plan.

IRC §401(k)(12); IRS Notice 98-52; IRS Notice 2000-3.

- 1. Safe Harbor Non-Discrimination Rules. A 401(k) plan satisfies the non-discrimination rules (the ADP test) if it meets the following requirements:
 - a. a notice requirement; and
 - b. one of two contribution requirements (discussed below).
- 2. The notice requirement is met if each employee eligible to participate in the Plan is given written notice (prior to the plan year) of his rights and obligations under the plan. The notice must be given between 30 and 90 days before the beginning of the plan year.
 - a. For an employee who becomes eligible later than the 90th day before the beginning of the plan year, the notice may be given not later than the employee's date of eligibility.
 - b. With respect to a new plan, the notice can be given up to the first day of the first plan year.

- c. Please note, the IRS has stated that if the safe harbor is blown (e.g., the notice is not provided), the plan is disqualified. It does not merely revert to a 401(k) plan subject to ADP testing.
3. Basic Formula. The contribution requirement is met under the safe harbor if the employer provides a matching contribution on behalf of each Non-Highly Compensated Employee of (i) 100% of the employee's elective contributions up to 3% of compensation and (ii) 50% of the employee's elective contributions to the extent that they exceed 3% (but not 5%) of the employee's compensation. Additionally, the rate of the matching contributions with respect to any elective contribution for highly compensated employees is not greater than the rate of match with respect to non-highly compensated employees.
 - a. Alternatively, the matching contribution safe harbor may be met if the rate of the employer's matching contribution does not increase as the employee's rate of elective contributions increases and the total amount of matching contributions is at least equal to the requirements set out above (e.g., 100% of the contributions up to 3% of compensation and 50% of contributions between 3% and 5%).
 - b. Enhanced Formula. An enhanced formula provides a match that is at least equal to the amount of the match that would be made under the basic formula. A match of 100% of the first 4% deferred is an acceptable enhanced formula.
4. In lieu of a matching contribution, the employer may make a non-elective contribution of at least 3% of an employee's compensation to a defined contribution plan on behalf of each non-highly compensated employee who is eligible to participate in the plan regardless of whether the employee makes an elective contribution.
5. 100% Vesting Required. The employer matching safe harbor contributions must be non-forfeitable and subject to the restrictions on withdrawals that apply to elective deferrals.
6. Last Day of Plan Year And 1,000 Hour Requirements Not Permitted. The employer safe harbor matching or non-elective contribution for a plan year cannot be made subject to a requirement that the participant is employed in the last day of the plan year or that the participant completes 1,000 hours of service during the plan year.
7. Definition of Compensation. A safe harbor matching contribution formula or a safe harbor nonelective contribution formula must use a definition of compensation that satisfies IRC §414(s). The plan is permitted to use partial-year compensation for newly eligible employees.
8. Document Requirements. A plan must specify the formula requirement (the matching contribution or the nonelective contributions). As a general

rule, a plan may not rely on the safe harbor unless the plan document reflects such requirements before the first day of the plan year. However, the remedial amendment period rules are applied by Notice 98-52 to the plan document requirements for the safe harbors.

9. Plan Year Requirements. Plans may not rely on the safe harbors for a plan year unless the plan year is 12 months long. For a new plan, however, (other than a successor plan) the first plan year may be less than 12 months, but must be at least 3 months. A new plan for a newly established employer may be less than the 3-month minimum. A plan is a successor plan if 50% or more of the eligible employees for the first plan year were eligible under another 401(k) plan of the employer in the prior year. IRS Notice 98-1.

Treasury regulations would allow a short plan year in additional circumstances:

- When the plan terminated, if the plan termination was in connection with a merger or acquisition involving the employer, or the employer incurred a substantial business hardship comparable to a substantial business hardship described in Section 412(d);
- When the plan terminated, provided the employer made safe harbor contributions for the short year, employees were provided notice of the change, and the plan passed the ADP test; and
- Where the short plan year was preceded and followed by 12-month plan years during which the plan was a safe harbor plan.

10. Amendment of Existing Plan. Notice 2000-3 allows a non-safe harbor 401(k) plan that uses the current year testing method to be amended into a safe harbor plan as late as 30 days before the end of the plan year. The safe harbor contribution must be in the form of a 3% nonelective contribution and two notices must be given. First, eligible employees must receive notice before the beginning of the plan year advising them that the plan sponsor may choose to amend the plan into a safe harbor plan. Second, a notice of the amendment must be given to participants at least 30 days before the end of the plan year.
11. Amendment of Profit-Sharing Plan to Add Safe Harbor Provisions. Under Notice 2000-3, a profit-sharing plan can be amended to add safe harbor 401(k) features up to three months before the end of the plan year as long as the plan is not a successor plan (as defined in Notice 98-1), the cash or deferred elections begin not less than three months prior to the end of the plan year and the requirements of Notice 98-52 are otherwise satisfied for the period during which deferral elections are permitted.
12. Suspension of Safe Harbor Matching Contributions. A safe-harbor plan is permitted to prospectively suspend or reduce matching contributions and to discontinue safe harbor status. The suspension of safe harbor matching

contributions cannot take effect earlier than the later of 30 days after (i) the participant notice is given or (ii) the date the plan is amended. The plan must then satisfy the ADP test using the current year method based on contributions for the entire year. Notice 2000-3.

13. Safe Harbor Contribution May Be Provided to a Separate Plan. If the contribution is made to a separate plan, the other plan must have the same plan year as the 401(k) plan.
14. Current Year Testing Method is Deemed to Apply to Safe Harbor Plans. This will impact the plan's ability to switch to the prior year testing method for any plan year beginning after the GUST remedial amendment period. Notice 98-1 generally requires that a plan use the current year method for at least 5 years before it can switch to the prior year method after the remedial amendment period ends.
15. Safe harbor contributions may not be used as QMACs or QNCs for other arrangements that need to apply the ADP test or ACP test.
16. Safe harbor 3% nonelective contribution can count in three ways:
 - a. Replaces and satisfies the ADP/ACP test.
 - b. Satisfies the 3% minimum top-heavy contribution.
 - c. As a profit-sharing contribution that can be taken into account for nondiscrimination testing under IRC §401(a)(4) (other than the permitted disparity/integration rules of §401(l)).
17. Safe Harbor Matching Contribution Satisfies Top-Heavy Rules. The safe harbor matching contribution is deemed to satisfy the top-heavy rules. This does not mean that an accompanying profit sharing plan automatically satisfies the top-heavy rules, but the matching contribution will count towards the top-heavy minimums. EGTRRA §613 modifying IRC §416 effective for plan years commencing after December 31, 2001. Rev. Proc. 2004-13.

EXAMPLE I

Safe Harbor 401(k) Example (2006)

Compensation:	\$ 50,000	\$ 100,000	\$ 220,000
	x .04	x .04	x .04
Match:	2,000	\$ 4,000	\$ 8,800
Deferral:	15,000	\$ 15,000	\$ 15,000
Subtotal:	17,000	\$ 19,000	\$ 23,800
Catch-Up (Age 50)	5,000	\$ 5,000	\$ 5,000
Total:	\$ 22,000	\$ 24,000	\$ 28,800

EXAMPLE II

Example Of Cost Of Benefits For NHCEs Under Various Retirement Plan Options To Provide Maximum \$42,000. Contribution For HCE.

a. Highly Compensated Employee (HCE)

Compensation: \$ 220,000
 Contribution: \$ 44,000
 Percentage: 20%

b. Non-Highly Compensated Employees (NHCEs)

<u>Retirement Plan Option</u>	<u>Employer Contribution</u>
1. Profit Sharing (Non-Integrated)	20%
2. Profit Sharing (Integrated)*	16.45%
3. Safe Harbor 401(k) (2006: \$15,000) with Integrated Profit Sharing	9.63%
4. Cross Tested Profit Sharing (with optimal demographics)	4.4%

* Integrated at 5.4% of compensation > 80% of social security taxable wage base + \$1.00

$$\begin{array}{r}
 \$ 220,000 \\
 - \quad 75,361 \quad (\$94,200. \times .8 + \$1) \\
 \hline
 \$ 144,640 \times .054 = \$7,810.56 \div \$220,000 = 0.0355
 \end{array}$$

18. Safe Harbor Non-Discrimination Rules for §401(m). §401(m)(11).

There is also a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions (the ACP test).

- a. The plan must meet the safe harbor contribution and notice requirements applicable to Section 401(k) arrangements.
- b. The plan must meet the following limitations on matching contributions:
 - i. Employer matching contributions may not be made with respect to employee contributions or elective deferrals in excess of 6% of compensation;
 - ii. The rate of an employer's matching contribution may not increase as the rate of an employee's contributions or elective deferrals increases; and

iii. The matching contribution with respect to any highly compensated employee at any rate of employee contribution or elective deferral is not greater than that with respect to an employee who is not highly compensated.

c. Any after-tax employee contributions continue to be tested separately under the ACP Test.

E. 401(k) Automatic Enrollment Plans

1. Effective for plan years commencing after December 31, 2007, the 2006 Pension Protection Act (PPA) creates an optional nondiscrimination safe harbor for automatic enrollment plans. Plans satisfying the safe harbors would not have to perform the nondiscrimination tests for employee elective deferrals (ADP) or for matching contributions (ACP) and are exempt from the top-heavy rules.

2. The safe harbor requires that the automatic enrollment contribution rate be at least:

first year of participation:	3%
second year of participation:	4%
third year of participation:	5%
fourth (or greater) year of participation:	6%

The plan may specify a higher percentage up to 10%.

3. The automatic enrollment safe harbor plan must provide a minimum employer matching contribution of 100% of elective deferrals up to 1% of compensation plus 50% of elective deferrals between 1% and 6% of compensation.

4. As an alternative to the matching contribution, the employer can make a nonelective contribution of 3% of compensation on behalf of each employee eligible to participate in the automatic enrollment feature.

5. The employer matching contributions or employer elective contributions satisfying the safe harbor must be vested no less rapidly than under 2-year cliff vesting (100% vested after 2 years of service).

6. The automatic enrollment safe harbor is optional. An employer is still permitted to have an automatic enrollment 401(k) plan and test for nondiscrimination under the ADP and ACP tests.

7. Effective immediately, state payroll and withholding laws that limit automatic contributions are explicitly preempted by ERISA if a plan meets participant notification requirements providing:

a. annual notice to affected employees before the beginning of the year;

b. notice of the participant's right to elect out of plan coverage or to change deferral percentages and the time periods for making such elections.

8. Plans that notify participants how contributions will be invested and meet certain default investment guidelines will be treated as satisfying ERISA section 404(c) even if a participant does not make an affirmative investment election.

9. A 401(k), 403(b) or governmental 457(b) plan that complies with the new ERISA 404(c) requirements and meets other notice requirements may permit a participant to withdraw automatic contributions at any time during a 90-day window period without penalty. A plan meeting these requirements can also make corrective distributions to pass nondiscrimination tests within 6 months of year end, rather than 2-1/2 months. Amounts withdrawn or distributed are taxable in the year of receipt.

F. Money Purchase Pension Plan.

1. In this type of defined contribution plan, contributions to the plan are fixed, but not the benefits. Contributions are based on a fixed percentage of annual compensation for all plan participants. Thus, under a 10% of compensation money purchase plan, an employee earning \$170,000.00 would receive a contribution of \$17,000.00 while an employee earning \$10,000.00 would receive a \$1,000.00 contribution.

2. As with all defined contribution plans, the benefits ultimately paid to a participant will depend upon the size of the annual contributions, the number of years contributions are made before retirement and investment gains and losses. Forfeitures may be used to reduce employer contributions or to increase benefits under the plan. IRC §401(a)(8).

3. The employer can deduct contributions to a money purchase plan up to the total of all annual additions for all participants; that is, the lesser of 100% of compensation or \$40,000.00 (adjusted, \$42,000 for 2005; \$44,000 for 2006) for each participant. However, the maximum deduction is 25% of the total compensation of all eligible participants.

G. Employee Stock Ownership Plan (ESOP) and other Plans Investing in Employer Stock.

1. Overview.

a. Tax qualified retirement plan

b. Invest primarily in employer stock

c. Leveraged purchase of employer stock

- d. Principal and interest tax deduction to company.
 - e. Useful for shareholder investment diversification
 - f. Potential tax deferred sale by shareholders
2. Employee Stock Ownership Plan C Corporation.
- a. Section 1042 tax deferred sale at 30% ESOP ownership
 - b. Potential for permanent tax deferred sale
 - c. Tax deductible dividends on Employer stock
 - d. Deduction up to 25% of pay, plus interest
 - e. Annual appraisal and repurchase liability
3. Employee Stock Ownership Plan S Corporation.
- a. ESOP can be up to 100% S-corp shareholder
 - b. Income on S-corp stock held by ESOP tax deferred
 - c. Useful for shareholder investment diversification
 - d. Section 1042 tax deferred sale not available to seller
 - e. Dividends not tax deductible
 - f. Leveraged purchase of stock
 - g. Principal and interest deduction limited to 25% of pay
4. Diversification of Investments in Employer Stock.
(effective Plan Years commencing after December 31, 2006)
- a. The Pension Protection Act of 2006 requires any defined contribution plan holding publicly traded employer securities to permit participants to diversify account balances invested in such employer securities. At least three materially different investment alternatives must be available.
 - b. The diversification requirements apply to employee elective deferrals and after-tax contributions.
 - c. Participants with 3 or more years of service must be permitted to diversify the investment of other contributions (e.g., employer matching or non-elective contributions). This rule is phased in

ratably over three years for securities acquired prior to 2007 (except for participants age 55 or older with 3 years of service by the first plan year beginning in 2006; such participants may diversify 100% in 2007).

<u>Plan Year</u>	<u>Applicable Percentage</u>
2007	33%
2008	66%
2009	100%

- d. These provisions do not apply to ESOPs that have no elective deferrals, after-tax contributions, or matching contributions and do not form part of another qualified plan. Collectively bargained plans and affected ESOPs have later effective dates.

H. Cross-Tested Profit-Sharing Plan.

26 CFR §1.401(a)(4)-8(b); Rev. Rul. 2001-30.

1. A cross-tested profit-sharing plan is a plan under which the contribution percentage formula for one category of participants is greater than the contribution percentage formula for other categories of participants.
2. To satisfy the nondiscrimination requirements of the IRC Section 401(a)(4) general test, participants are put into different "rate groups" and the rate groups are tested separately for nondiscrimination.
3. To determine rate groups, a cross-tested profit-sharing plan expresses each participant's allocation of employer contributions and forfeitures as an equivalent benefit rate rather than as an allocation rate. When equivalent benefit rates are used, the method is referred to as "cross-testing" because it analyzes the benefit that would be generated from the allocation as if the plan were a defined benefit plan.

Thus, whereas most defined contribution plans are tested for nondiscrimination based on the allocation of contributions and defined benefit plans are tested based on projected future benefits, cross-tested plans are defined contribution plans that are tested for nondiscrimination based on projected benefits.

4. Treasury Regulation Section 1.401(a)(4)-8(b) (published 6/29/01) effective first day of plan year commencing after December 31, 2001. Cross-tested/new comparability plans need (i) broadly available allocation rates that increase as an employee ages or accumulates additional service or (ii) satisfy a gateway with different allocation rates so that the percentage of pay allocation for HCEs is no more than three (3) times the percentage of pay allocation for NHCEs (safe harbor of 5% for NHCEs). The final regulations also contain a 7½% of compensation cap on any

contribution that may be required under the rules applicable to defined benefit/defined contribution combination plans.

5. It is often a good plan design to combine a cross-tested profit-sharing allocation formula with a safe harbor 401(k) plan. In this case, the 3% employer non-elective contribution option should be used for the 401(k) safe harbor since the 3% safe harbor contribution can count toward the cross-tested minimum gateway contributions. Employer matching contributions to a 401(k) plan do not count toward the gateway contributions.
6. The IRS National Office noted that it would issue a technical advice memorandum permitting a corrective amendment under Treasury Reg. §1.401(a)(4)-11(g) naming specific nonhighly compensated employees (NHCEs) and the amount of the additional contributions that they would receive. Treasury Reg. §1.410(b)-4 contains a prohibition on naming individuals where the average benefits test is used to pass coverage. However, in this case, coverage was passed under the ratio percentage test.

Treas. Reg. §1.401(a)(4)-11(g) requires that a corrective contribution have substance. Thus, an allocation to a terminated employee who is zero percent vested will not be recognized towards correction. In this case, the IRS approved a provision in the amendment granting an otherwise nonvested NHCE 20% vesting.

7. Guidance issued by the IRS in October, 2004 (the "Carol Gold Letter") seeks to limit the use of aggressive planning techniques in the design and operation of tax-qualified retirement plans. Such techniques are often intended to increase benefits for Highly Compensated Employees (HCEs) and to limit benefits for Non-Highly Compensated Employees (NHCEs). Plans covering extremely short service employees for purposes of satisfying coverage or contribution testing and plans providing large benefits as a percentage of pay to very low paid employees may be subject to increased scrutiny from the IRS. Such aggressive techniques are often associated with cross-tested plans and cash balance pension plans.
8. Cross-Tested Profit-Sharing Example.

\$ 44,000	–	§415 Maximum
<u>– 15,000</u>	–	Elective Deferral
\$ 29,000		
<u>÷ 220,000</u>	–	§401(a)(17) Compensation Limit
13.19%	–	HCE Allocation as Percentage of Pay
<u>÷ 3</u>		
4.4%	–	NHCE Gateway Allocation (includes 3% 401(k) Safe Harbor)

I. Target Benefit Pension Plan.

1. A target benefit plan is a type of defined contribution plan containing certain defined benefit characteristics including:
 - a. A targeted benefit geared to commence at the plan's normal retirement date; and
 - b. Contributions required to fund the targeted benefit are determined under the individual level premium funding method, based upon actuarial assumptions provided in the plan.
2. A target benefit plan is unlike a defined benefit plan in that individual accounts are maintained for the participants and the targeted assumptions are not adjusted for experience. Since a participant's actual benefit depends upon the value of his individual account, the targeted benefit is rarely, if ever, precisely met.
3. A target benefit plan is subject to the defined contribution annual addition limitations. If an employer desires to weigh contributions in favor of older employees and if the annual addition limitations are acceptable, a target benefit plan may be considered.
4. Since target benefit plans are defined contribution plans, they are not covered by the PBGC.
5. Under the regulations to IRC §401(a)(4), target benefit plans must be tested annually to assure that plan contributions do not discriminate in favor of Highly Compensated Employees ("HCEs").
6. Target benefit plans and age-based or cross-tested profit-sharing plans may be tested for nondiscrimination based on benefits, rather than on contributions.

J. Defined Benefit Pension Plan.

1. Under a defined benefit plan, the level of benefits is fixed and contributions are determined by an actuary to provide adequate funding to furnish those benefits at retirement.
2. Contributions to a defined benefit plan are mandatory, although some flexibility can be built into the plan, especially if credit balances can be accumulated in the funding standing account under the plan.
3. In the context of a closely held business, the primary issue is how much does the key employee want to shelter from taxes. The benefit formula is then, in effect, prepared in reverse to accomplish the goal of sheltering a specific amount of money.

4. The maximum benefit that can be funded is the lesser of \$160,000.00 (adjusted, \$170,000 for 2005; \$175,000 for 2006) or 100% of an employee's annual compensation for the three highest consecutive years of service. IRC §415(b). Effective for plan years ending after January 1, 2002, adjustments to the \$160,000.00 amount are no longer tied to Social Security normal retirement age. Rather, the \$160,000.00 amount is reduced for benefit payments commencing prior to Age 62 and increased for benefit payments commencing after Age 65. Benefits for participants with fewer than 10 years of participation under the plan must be proportionately reduced.
5. Rev. Rul. 2003-11 provides that a defined benefit plan may be amended to apply the \$200,000 compensation limit increase to determine benefits payable to former employees who retain benefits under the plan.
6. Rev. Rul. 2003-85 clarified that the transfer of surplus assets from a terminated defined benefit plan to a qualified replacement plan (as defined in IRC Section 4980(d)) is exempt from the Section 4980 excise tax even if the amount transferred exceeds 25% of the surplus assets.
7. Note: In a professional corporation, if the Defined Benefit Plan covers 26 or more employees, it may be subject to the PBGC rules and regulations.
8. Small employer defined benefit plans are becoming popular for three primary reasons:
 - a. The elimination of the prior benefit restrictions under IRC Section 415(e).
 - b. The increased benefit limits under EGTRRA.
 - c. The introduction of cash balance pension plans.
9. Formula Methods for Defined Benefit Plans. Although there can be an endless set of variations in selecting a formula for a defined benefit plan, the formula is based on such factors as: a fixed percentage of compensation over fixed number of years of service; a flat dollar amount payment; or a flat dollar amount or percentage of compensation for each year of service of a participant.
 - a. Flat Benefit Plan. The benefit under the Plan is a flat dollar amount after a specified number of years. For example, a participant who has at least 10 years of service will receive a benefit of \$100.00 per month at age 65; or
 - b. Fixed Benefit Plan. The benefit under the Plan is a fixed percentage of compensation — such as 10% of average monthly compensation starting at age 65; or

- c. Unit Benefit Plan. The benefit under the Plan is based on either a specified unit dollar amount multiplied by years of service or a percentage of compensation multiplied by years of service. For example, \$10.00 per month x years of service or 1% of compensation x years of service.

10. 2006 Pension Protection Act (PPA) changes to Defined Benefit Plans.

- a. Changes to Interest Rate Assumptions for Calculation of Lump-Sum Distributions.

A plan's lump sum payment under current law to a participant or beneficiary must be no less than the present value of the annuity to which the participant or beneficiary would have been entitled. For this calculation, the plan must use specified interest and mortality assumptions. The interest rate is the rate on 30-year Treasury bonds.

The PPA changes the interest rate assumption under IRC Section 417(e) from the 30-year Treasury rate to a corporate based yield curve.

Phase-In of New Interest Rate Assumptions		
Calendar Year	Interest Rate Components	Method
2006	100% of 30-Year Treasury	30-Year Treasury
2007	100% of 30-Year Treasury	30-Year Treasury
2008	20% Corp Bond Yield Curve + 80% of 30-Year Treasury	Mixed Rate
2009	40% Corp Bond Yield Curve + 80% of 30-Year Treasury	Mixed Rate
2010	60% Corp Bond Yield Curve + 80% of 30-Year Treasury	Mixed Rate
2011	80% Corp Bond Yield Curve + 80% of 30-Year Treasury	Mixed Rate
2012 and after	100% Corp Bond Yield Curve	Yield Curve Method

- b. Defined benefit plans must use segmented interest rates (based on expected payment dates) similar to the rates used for funding purposes to convert annuity benefits to lump sums. Interest rates will be based on corporate bond yields and the determination of current liabilities based on three segments of 0-5, 5-15, and over 15 years. This new method is effective beginning in 2008, but with a phase-in from 2008 to 2012.
- c. Defined benefit plans may provide in-service distributions to participants age 62 or older, *i.e.*, phased retirement, starting in plan years beginning in 2007.
- d. Effective for plan years after 2007 (with an extended effective date for collectively bargained plans), defined benefit and money purchase plans must offer a joint and 75% survivor annuity, as well

as an option with a survivor benefit between 50% and 75% (e.g., generally plans must offer both 50% and 75% survivor annuity options).

- e. Effective for plan years after 2007, single employer defined benefit pension plans must provide an annual funding notice to participants that includes, among other things, information regarding the plan's funded status, PBGC guarantees and limitations, plan asset allocations, and material plan amendments. This requirement is similar to the current rule for multiemployer pension plans.
- f. Effect on Executive Compensation. The employer may not set aside assets in a rabbi trust or other arrangement to provide nonqualified deferred compensation to its five top executives or other section 16 "insiders" if its qualified defined benefit plan is at-risk, if the employer is in bankruptcy, or during the 12-month period beginning six months before the termination of an underfunded plan. Effective August 17, 2006.
- g. Eligible Combined Plan – DB(k). Effective for plan years commencing in 2010, PPA provides for an "eligible combined plan" for sponsors with fewer than 500 employees that offers a combination of defined benefit plan features and 401(k) deferrals. The plan would operate under the respective defined benefit and 401(k) rules, but would be treated as a single plan for trust and reporting purposes if certain safe harbor provisions are included. The arrangement would be deemed to comply with the ADP/ACP requirements and the top-heavy rules, as long as it is not aggregated with other plans.
 - i. The DB component must offer one of the following benefit formulas:
 - (a) 1% of final average pay up to 20 years of service; or
 - (b) a cash balance formula that increases the accrual rate with the participant's age (a cash balance formula must comply with the vesting and interest credit rules in the PPA).
 - ii. The 401(k) feature would be required to provide:
 - (a) automatic enrollment at a 4% rate;
 - (b) vested match equal to 50% on the first 4% of compensation deferred; and

(c) vesting on other company provided accruals and contributions over three years of service.

iii. Plan will file a single Form 5500.

h. New Funding Rules In 2008. Pre-PPA DB funding rules have two parts. First, the rules impose a basic minimum funding amount. Second, certain underfunded plans are subject to an additional funding requirement (the "deficit reduction contribution") required for a plan year in which the plan's funded current liability percentage is less than 90%. In order to satisfy the minimum funding standard, plans have been required to maintain a minimum funding standard account.

Beginning with the 2008 plan year, the Act repeals the current-law funding rules, including the requirement that a funding standard account be maintained by single-employer plans. The Act includes an entirely new set of rules for determining minimum required contributions. ERISA §303; Code §430 (new). The Minimum Required Contribution is the sum of the Target Normal Cost (value of benefits expected to accrue during the year) plus an amortization of the Funding Shortfall (called the Shortfall Amortization Charge).

Plans in At-Risk Status will have a larger Funding Target due to the required use of more conservative At-Risk assumptions. This, in turn, will create a larger Minimum Required Contribution.

i. Determining The Required Contribution. Under the Act, the minimum required contribution is determined based upon a comparison of the value of the plan's assets (reduced by any prefunding balance and funding standard carryover balance) to the plan's funding target. A plan's funding target is the present value of all benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost is the present value of benefits expected to accrue or be earned during the plan year. Thus, unlike the current rules where the funding target is essentially 90%, the funding target under the new rules will be 100%. However, the 100% funding target funding is phased in for plans that were in existence but not subject to the deficit reduction contribution rules for 2007. Code §430(c)(5)(B).

If the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance) equals or exceeds the plan's funding target for a plan year, then the minimum required contribution is the target normal cost for the plan year reduced by the excess (but not below zero). Code §430(a)(2).

If the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance) is less than the plan's

funding target for a plan year, then the minimum required contribution will be the sum of: (1) the target normal cost for the plan year, (2) the shortfall amortization charge (if any) for the plan year, and (3) waiver amortization charge (if any), for the plan year. Code §430(a)(1).

Shortfalls are amortized over seven years. A shortfall amortization charge for a plan year is the aggregate total (but not less than zero) of the shortfall amortization installments for the plan year with respect to the shortfall amortization bases for such plan year and each of the six preceding plan years. Code §430(c).

Except in the case of a plan in "at risk" status, a plan's target normal cost is the present value of benefits expected to accrue or be earned during the plan year. For this purpose, if a benefit attributable to services performed in a preceding year is increased due to any increase in compensation during the current plan year, the increase is to be treated as having accrued during the current plan year. Code §430(b).

The Act recognizes two kinds of credit balances: (1) a credit balance existing when the Pension Protection Act is enacted (i.e., a "funding standard carryover balance" — Code §430(f)(1)(B)) and (2) credit balances created after the Pension Protection Act (a "prefunding balance"). Plan sponsors may elect whether to maintain a prefunding balance as well as elect to maintain a funding standard carryover balance until the balance is reduced to zero. Code §430(f)(1)(A), (B). In addition, plan sponsors may be eligible to elect to apply the prefunding and funding standard carryover balances against the minimum required contribution or against the value of plan assets or to reduce the balance at any time. Code §430(f)(2).

- j. **Funding Target Attainment Percentage.** The Funding Target Attainment Percentage (FTAP) is the ratio of plan assets, reduced by both pre- and post-Act credit balances, to the plan's funding target. Many provisions of the PPA depend on a calculation of a plan's funding target attainment percentage.
- k. **At-Risk Plans.** PPA imposes a number of requirements on plans with an asset/liability ratio of less than 80%, and additional burdens if the plan's asset/liability ratio is less than 60%. If the asset/liability ratio is less than 80%, the plan can't use a credit balance to reduce contributions. It can't amend the plan to increase benefits. It's ability to pay lump sums is restricted. If the asset/liability ratio is less than 60%, accruals must be frozen, no lump sums or shutdown benefits can be paid.

The "80% test" is not fully phased in until 2011. Prior to 2011, it is:

In 2008	65%
In 2009	70%
In 2010	75%

Additionally, plans in at-risk status for less than five years (not taking into account pre-2008 years) have at-risk liability valuation phased-in.

In making those asset liability comparisons, generally (and ignoring the special treatment of pre-PPA credit balances), the plan cannot take its credit balance into account. For example, if the plan has assets of \$84 million, liabilities of \$100 million and a credit balance of \$5 million, the plan has an asset/liability ratio of 79% $((84 - 5)/100)$.

The plan also has the option of reducing the credit balance and thereby "increasing" assets. In the example above, for instance, the plan could reduce the credit balance by \$1 million and increase your assets to \$80 million. The plan would then be 80% funded and could be amended (so long as, after the amendment, the asset/liability ratio is not less than 80%), pay unrestricted lump sums, and use the remaining (\$4 million) credit balance to satisfy funding obligations. However, the plan never would receive the \$1 million credit balance it exchanged for assets.

I. Increased Deduction Limits.

DB Deduction Limits. Generally, plans can deduct contributions up to 100% of the plan's current liability. Contributions in excess of the limit are subject to a 10% excise tax.

For taxable years beginning in 2006 and 2007, the maximum deductible contribution is not less than the excess (if any) of (1) 150% of the plan's current liability, over (2) the value of plan assets.

For taxable years beginning in 2008, the maximum deductible contribution is the greater of: (1) the excess (if any) of the sum of the plan's funding target, the plan's target normal cost, and a cushion amount, over the value of plan assets (as determined under the minimum funding rules); and (2) the minimum required contribution for the year. If the plan is not "at-risk", then (1) will not be less than the excess (if any) of the sum of the plan's funding target and target normal cost, determined as if the plan was in "at-risk" status, over the value of the plan assets. The cushion amount is (a) 50% of the plan's funding target for the plan year plus (b) the amount by which the plan's funding target would

increase if determined by taking into account increases in participants' compensation for future years, or if the plan does not base benefits attributable to past service on compensation, on the basis of the average annual benefit increases over the previous six years. If the plan is covered by the PBGC insurance program, future increases in the compensation limit under 401(a)(17) may be projected. Code §404(o).

Combined DB/DC Deduction Limit. Employers that sponsor both defined benefit plans and defined contribution plans face a combined limit on deductible contributions. The Act provides that for plan years beginning in 2008, contributions to a PBGC-covered defined benefit plan are deductible without affecting the combined limit. For other plans covering at least one common participant, such as defined contribution plans, only contributions in excess of 6% of compensation count towards the combined limit, and that 6% does not count 401(k) deferrals. Code §§404(a)(7)(C)(iii) and (iv), effective for contributions for taxable years beginning in 2006.

This allows \$20,000 in 401(k) contributions (for those 50 and over) plus an additional deductible \$13,200 of employer contributions to PSP per HCE (6% x \$220,000). Total per participant DC contributions in 2006 are \$33,200.

- m. **Payment of Lump Sum Benefits.** Plan may not pay at all where adjusted FTAP is less than 60%; restricted where adjusted FTAP is between 60% and 80%.

Interest Rate Assumption for Applying Benefit Limitations to Lump Sum Distributions. The Pension Funding Equity Act of 2005 provided (through 2005) for a conversion at 5.5%.

The Act provides, effective for distributions made after December 31, 2005, that the rate cannot be less than the greater of (a) 5.5% (and the applicable mortality table under Section 417(e)), (b) 105% of the minimum distribution lump sum interest rate and applicable mortality table of §417(e)(3), or (c) the rate specified in the plan, and the plan's mortality table. Code §415(b)(2)(E). This retroactive effect could reduce lump sums already paid.

K. Cash Balance Pension Plan.

A cash balance pension plan is a defined benefit plan that defines an employee's benefit as the amount credited to an account. The account receives allocations (usually expressed as a percentage of pay) as the employee works. The account is also credited with interest adjustments until it is paid to the employee.

- 1. How is a cash balance plan different from defined contribution plans? Like other defined benefit plans, a cash balance plan defines an

employee's retirement benefit by a formula, and the employee's retirement benefit does not depend either on the employer's contributions to the plan or on the investment performance of the plan's assets, as it would in a defined contribution plan.

2. How is a cash balance plan different from other defined benefit plans? A cash balance plan defines an employee's benefit as the amount credited to an account, while other defined benefit plans typically define an employee's benefit as a series of monthly payments.
3. Accrued benefit. An accrued benefit is the portion of an employee's normal retirement benefit that he or she has earned at a given point in his or her career.
 - a. Under a cash balance or hybrid plan, accrued benefit is often expressed as the employee's hypothetical account balance. For example, an employee might receive an allocation equal to 4% of pay each year he or she works, and the employee's account might be credited with interest at 5%, compounded annually, until it is paid.

In Notice 96-8, the IRS proposed standards for lump-sum calculations under cash balance plans and stated that, as defined benefit plans, the accrued benefit must be expressed in terms of an annuity benefit at normal retirement age.

- b. Under a traditional defined benefit plan, the accrued benefit is the amount the employee would receive as a monthly annuity for life commencing at age 65. For example, if an employee enters a final average pay plan at age 35, works until age 40, and earns average monthly pay of \$1,000, that employee's accrued benefit might be \$50 (1% x \$1,000 x 5 years). If the same employee works until age 55 and his or her average monthly pay increases to \$4,000, the accrued benefit would increase to \$800 (1% x \$4,000 x 20 years).
4. The IRS and the DOL are both currently reviewing their positions on certain cash balance plans. The agencies are seeking to determine whether the conversion of ongoing defined benefit plans into cash balance plans can result in a reduction of future benefits for older employees and possible ADEA violations.
5. In *Cooper v. IBM Personal Pension Plan and IBM Corp.* (7th Cir. August 7, 2006) the U.S. Court of Appeals for the 7th Circuit reversed a judgment by a federal district court that a cash balance plan design reduces both the accrued benefit and the rate of benefit accrual on the basis of the participant's age and violated age discrimination rules under ERISA.
6. In *Berger v. Xerox Corporation Retirement Income Guarantee Plan* (U.S. 7th Cir. Ct. App., August 1 2003), the U.S. 7th Circuit Court of Appeals essentially supported the position taken by the IRS in Notice 96-8 that

accrued benefits under a cash balance plan are not determined merely by a participant's cash balance account. Such hypothetical account balance must be projected forward to Normal Retirement Age at the rate at which interest is credited under the plan and then discounted back in accordance with IRC Section 401(a)(17) to the participant's age at the time of distribution. This calculation is referred to as the "whip-saw" effect.

7. 2006 PPA changes to Cash Balance Plans.

(effective for periods beginning on or after June 29, 2005, except as noted)

- a. A participant's accrued benefit must be at least as great as that of any similarly situated younger individual who is or could be a participant in the plan.
- b. The "interest credits" provided under the plan must not be at a rate that exceeds a "market rate of return", though the plan may provide for a reasonable minimum guaranteed rate of return or for interest crediting at the greater of a fixed or variable rate.
- c. The Act prohibits the use of "wearaway" provisions previously used in many defined benefit plan conversions. As a result, if a traditional defined benefit plan is converted to a cash balance plan, a participant's accrued benefit must be the sum of (1) his or her accrued benefit determined prior to the conversion, plus (2) the benefit accrued for years of service after the conversion.
- d. The Act provides that a plan need not project a participant's benefit forward to normal retirement age using the plan's interest rate assumptions and then discount it back using the Code-required interest rate, thus avoiding the "whipsaw" result mandated by IRS Notice 96-8 and several court decisions. For purposes of calculating lump sums and certain other optional forms, a plan can now treat the present value of a participant's accrued benefit as being equal to his or her hypothetical account balance (effective for distributions after August 17, 2006).
- e. Cash balance and other hybrid plans must provide vesting no less rapid than 3-year cliff vesting (100% vesting after 3 years of service). Effective in 2008.

8. Advantages of Cash Balance Plan Over Traditional Defined Benefit Plan for Professional Corporations.

- a. In a traditional defined benefit plan partners will have different levels of accrued benefits and the levels of accrued benefits will not precisely match the contributions made on each partner's behalf.

- b. A cash balance plan focuses on account balances. This permits partners to accrue equal levels of benefits under the plan and allows the levels of accrued benefits to equal the contributions made on each partner's behalf plus the rate of investment return under each plan.
 - c. A cash balance plan can be designed to provide different levels of benefits for different classes or tiers of employees. For example, partners could receive an allocation of \$25,000 per year while other employees receive an allocation of 5% of pay.
 - d. The benefit formula in a cash balance plan can also be designed to provide precisely different levels of benefits to different partners. These levels of benefits could fluctuate from year-to-year if desired by the partners.
- L. Defined Benefit and Cash Balance Plans can provide greater benefits and larger contributions for employees than Defined Contribution Plans.
- 1. Generally, defined benefit and cash balance plans should only be considered (in the small plan context) if contributions greater than \$44,000 (\$49,000 for employees age 50 or older) per year are desired for individual employees.
 - 2. Since the repeal of IRC §415(e), current or prior participation in a defined contribution plan no longer limits the level of benefits that a participant can accrue in a defined benefit plan.
 - 3. Deductible contributions by an employer to any combination of defined benefit and defined contribution plans are limited to the greater of:
 - a. the amount needed to satisfy the minimum funding requirements of the defined benefit plan; or
 - b. 25% of the aggregate compensation of the covered employees. IRC §404(a)(7).
 - 4. 2006 PPA Changes to Deduction Limits. For 2006 and 2007, the defined benefit maximum deductible contribution limits are increased to an amount equal to 1.5 times the plan's excess of liabilities over assets, and the combined plan limit disregards contributions to a defined contribution plan up to 6% of compensation. For 2008 and later years, different, but in many cases more generous limits take effect, which include ignoring contributions to any single-employer defined benefit plan covered by the PBGC for purposes of the combined plan limit. IRC Sections 404(a)(7) and 4972.

a. One person plan example after 2006 PPA:

Defined benefit plan contribution:	\$ _____
Profit sharing 6% of compensation (\$220,000 x .06)	\$ 13,200
401(k) elective deferral:	\$ 15,000
401(k) catch-up (Age 50+)	\$ 5,000

5. Example of maximum contributions for employees under a defined benefit plan:

<u>Age</u>	<u>Level Annual Contribution at 5% Interest</u>
35	\$ 72,340
45	\$118,975
55	\$182,389

6. Example of maximum contributions for employees under a combination of defined benefit and defined contribution plans:

<u>Age</u>	<u>Contribution Limit</u>
35	\$116,340
45	\$162,975
55	\$231,389

7. Investment results in a defined benefit plan can be used to reduce the employer costs of the plan in the long term if the investment results exceed the assumed rate of return under the plan.

However, if the assumed rate of return is greater than the actual investment performance of plan assets, the employer cost of the plan will increase.

M. Section 412(i) Plan

1. An insurance contract plan (or fully insured plan) under IRC §412(i) (a "412(i) plan") is a defined benefit pension plan that is funded exclusively by individual insurance contracts and meets the following requirements:

- a. The insurance contracts provide for level annual premiums from the time the employee commences plan participation until retirement age.
- b. Benefits under the plan are equal to the benefits provided under the contracts.
- c. Benefits are guaranteed by an insurance company licensed to do business in the state in which the plan is located.

- d. Premiums are paid timely or the contracts have been reinstated.
- e. No rights under the contracts were subject to a security interest during the plan year.
- f. No policy loans were outstanding during the plan year.
- g. An employee's accrued benefit under the plan is not less than the cash surrender value of his insurance contracts.

A plan funded exclusively by a group insurance or group annuity contract is considered an insurance contract plan if the contract has the requisite characteristics of individual contracts. IRC §412(i); Treas. Reg. §1.412(i)-1; IRC §411(b)(1)(F).

- 2. One of the advantages of a 412(i) plan is that the maximum deductible (and required) contribution in the first few years of the plan is substantially greater than the maximum deductible contribution to a regular defined benefit plan. This is because the annuity settlement rate is based on the guaranteed interest rate, which can be as low as 3%, and the anticipated (and probably the actual) investment return is quite low.
- 3. A few of the disadvantages of a 412(i) plan are:
 - a. The employee cost is higher for the same reasons that the owners cost is higher (as noted in section 2 above).
 - b. The investment returns are low (but they are guaranteed).
 - c. If a plan is terminated within the first few years, the cash value may be small. In later years, the large deposits may cause the plan to exceed the IRC §415 limits and the plan may need to be frozen for a few years before retirement.
 - d. The employer/plan sponsor is wedded to a specific insurance company for the plan.
- 4. IR-2004-2 (issued by the IRS on February 13, 2004) noted that recent IRS guidance on §412(i) is targeted at specific abuses with respect to such plans.

The guidance covers three specific issues. First, a set of new proposed regulations states that any life insurance contract transferred from an employer or a tax-qualified plan to an employee must be taxed at its full fair market value. Some firms have promoted an arrangement where an employer establishes a §412(i) plan under which the contributions made to the plan, which are deducted by the employer, are used to purchase a specially designed life insurance contract. Generally, these special policies are made available only to highly compensated employees. The insurance contract is designed so that the cash surrender value is

temporarily depressed, so that it is significantly below the premiums paid. The contract is distributed or sold to the employee for the amount of the current cash surrender value during the period the cash surrender value is depressed; however the contract is structured so that the cash surrender value increases significantly after it is transferred to the employee. Use of this springing cash value life insurance gives employers tax deductions for amounts far in excess of what the employee recognizes in income. These regulations, which will be effective for transfers made on or after February 13, 2004, will prevent taxpayers from using artificial devices to understate the value of the contract. A revenue procedure issued February 13, 2004 along with the proposed regulations provides a temporary safe harbor for determining fair market value.

Second, Revenue Ruling 2004-20 states that an employer cannot buy excessive life insurance (*i.e.*, insurance contracts where the death benefits exceed the death benefits provided to the employee's beneficiaries under the terms of the plan, with the balance of the proceeds reverting to the plan as a return on investment) in order to claim large tax deductions. These arrangements generally will be listed transactions for tax-shelter reporting purposes.

Third, Revenue Ruling 2004-21 states that a §412(i) plan cannot use differences in life insurance contracts to discriminate in favor of highly paid employees.

N. Section 403(b) Plan

1. Overview. A Section 403(b) plan, also known as a tax-sheltered annuity (TSA) plan, is a retirement plan for employees of public schools, employees of tax-exempt organizations, and certain ministers. The plan is referred to as a 403(b) plan because it is established pursuant to Section 403(b) of the Internal Revenue Code. Any "eligible employee" can participate in a 403(b) plan. An "eligible employee" includes employees of tax-exempt organizations established under Section 501(c)(3) of the Internal Revenue Code, employees of public school systems who are involved in the day to day operations of a school, employees of cooperative hospital service organizations, and certain ministers. IRC §403(b)(1)(A). See also IRS Publication 571. Therefore, a 403(b) plan may be available as a retirement plan for physicians and other employees of tax-exempt employers such as hospitals and universities.

See IRS Publication 571 (revised March 2006) for a good overview of Section 403(b) plans.

2. Contributions.
 - a. Contributions may be made to 403(b) accounts through elective deferrals made under a salary reduction agreement, non-elective contributions made by the employer, and after-tax contributions. With the enactment of the Economic Growth Tax Reform and

Reconciliation Act of 2001 ("EGTRRA"), 403(b) plans are subject to the same §415(c) contribution limits as defined contribution plans. The §402(g) limit on elective deferrals through a salary reduction agreement is \$15,000 for 2006 (\$14,000 for 2005). The limit on total contributions for 2006 is \$44,000 (2005 is \$42,000) (adjusted by COLA). Catch-up contributions (\$4,000 for 2005 and \$5,000 for 2006) also apply for employees who have attained age 50.

- b. For §402(g) purposes, elective deferrals do not include:
 - i. contributions pursuant to a one-time irrevocable election made at or before initial eligibility; or
 - ii. contributions made as a condition of employment. Prop. Reg. 1.402(g)(3)-1(b).

These contributions are still subject to FICA taxes.

- 3. Nondiscrimination. The basic nondiscrimination requirements that apply to qualified retirement plans also apply to 403(b) plans with respect to non-elective contributions and matching contributions of the employer. IRC §403(b)(12)(A)(i). For elective deferrals under a salary reduction agreement, a separate "universal availability" non-discrimination rule applies. If any employee of the employer sponsoring the 403(b) plan can make elective deferral referrals, the plan is discriminatory unless the opportunity to make elective deferrals of more than \$200 is available to all employees on a basis that does not discriminate in favor of highly compensated employees. IRC §403(b)(12)(A)(ii). Basically, any employee with compensation from the employer of at least \$200 per year must be permitted to make elective deferrals to a 403(b) plan adopted by the employer.
- 4. Investments. Participants in a 403(b) plan cannot invest in individual stocks. Instead, their choices are: (1) an annuity contract, which is a contract provided through an insurance company; (2) a custodial account, which is an account invested in mutual funds; or (3) a retirement income account set up for church employees. IRC §§403(b)(1), 403(b)(7), 403(b)(9). Since the assets of a 403(b) plan are generally held in a custodial account (unlike other retirement plans where assets are held in a trust), at least one federal court of appeals has questioned whether 403(b) accounts are entitled to the protection from creditor claims afforded to other tax-qualified retirement plans.
- 5. Distributions. Generally, a distribution cannot be made from a 403(b) account until the employee: (1) reaches age 59½; (2) has a severance from employment; (3) dies; (4) becomes disabled; or (5) in the case of a salary reduction contribution, encounters financial hardship. IRC §403(b)(11). The proposed §403(b) regulations permit 403(b) plans to be terminated and distributions can be made pursuant to the termination of the plan.

Required minimum distributions from a 403(b) plan must be received by April 1 of the calendar year following the later of the calendar year in which a plan participant becomes 70½ or the calendar year in which the plan participant retires. Treas. Reg. §1.403(b)-3, Q & A-1. Generally, a plan participant can roll-over tax free all or any part of a distribution from a 403(b) plan to a traditional IRA or an eligible retirement plan. IRC §§403(b)(8), 402(c).

6. Catch-Up Contributions.

a. Under §402(g)(7), for employees with 15 or more years of service with a qualified organization, the §402(g) limit is increased by the least of:

- i. \$3,000;
- ii. \$15,000, reduced by prior deferrals under this catch-up provision; or
- iii. \$5,000 multiplied by years of service with the organization, reduced by prior year elective deferrals at the organization.

b. The proposed regulations confirm that the age 50 catch-up contributions and the §402(g)(7) catch-up contributions can be made for the same year.

- i. Amounts above the general §402(g)(7) are treated first as 402(g)(7) catch-up contributions and then as age 50 catch-up contributions. §1.403(b)-4(c)(3)(iv).
- ii. Employees may be using up their \$15,000 cumulative catch-up limits without knowing it.

c. Maximum 403(b) deferral (2006):

\$ 15,000	–	deferral
5,000	–	Age 50 catch-up
<u>+ 3,000</u>	–	402(g)(7) catch-up
\$ 23,000		

7. Plan Terminations. Prop. Reg. §1.403(b)-10(a).

a. A 403(b) plan may be terminated and its accounts may be distributed if the employer (and any other member of the controlled group) does not make contributions to an alternative 403(b) contract or account outside of the plan from the date of termination until 12 months after distribution of all assets from the terminated plan.

- b. An exception applies if fewer than 2% of the employees who were eligible under the terminated plan are eligible under the alternative 403(b) contract or account.
- c. All accumulations under the terminated plan must be distributed as soon as administratively practicable after the termination.

III. OTHER RETIREMENT PLANS.

A. Section 457 Plan.

- 1. IRC Section 457 governs the tax treatment of certain deferred compensation plans maintained by state or local governments or tax-qualified organizations. Any amount of compensation deferred by an employee or independent contractor under an "eligible deferred compensation plan" of a state or local government or a tax-exempt organization is includible in income for federal tax purposes only for the taxable year in which such compensation is paid or otherwise made available to such individual. IRC §457(a).
- 2. An "eligible deferred compensation plan" under Section 457(b) is a plan that meets the following requirements:
 - a. the plan provides that only individuals who perform service for the employer may be participants;
 - b. the plan is established and maintained by a state, political subdivision of a state, or agency, or instrumentality of a state or political subdivision of a state, or any other organization (other than a governmental unit) exempt from federal tax;
 - c. the maximum amount which may be deferred under the plan for a taxable year shall not exceed the applicable dollar amount \$14,000 for 2005; \$15,000 for 2006. Catch-up contributions (\$4,000 for 2005; \$5,000 for 2006) also apply to Section 457(b) Plans.
 - d. compensation may be deferred for any calendar month only if an agreement providing for such deferral has been entered into before the beginning of such month;
 - e. amounts may not be made available to participants or beneficiaries earlier than the calendar year in which the participant attains age 59½, the participant separates from service with the employer, or the participant is faced with an unforeseeable emergency;
 - f. meets the minimum distribution requirements of IRC §401(a)(9) (*e.g.*, distributions must commence not later than age 70½); and
 - g. all amounts of compensation deferred under the plan, all property and rights purchased with such amounts, and all income

attributable to such amounts, property, or rights shall remain solely the property and rights of the employer, subject to the claims of the employer's general creditors. IRC §457(b).

3. One important issue to note is that under EGTRRA, an individual is no longer required to coordinate the maximum annual deferral amount for a 457(b) plan (*e.g.*, an "eligible plan") with contributions made to a 401(k) or 403(b) plan. Therefore, a physician or other employee can defer the maximum applicable dollar amount to each plan. For example, in 2006, an employee can defer \$15,000 in a 403(b) or 401(k) plan and also defer an additional \$15,000 in a 457(b) plan (with an additional \$5,000 catch-up contribution to each plan if the employee is age 50 or older).
4. If a plan does not meet the statutory definition of an "eligible deferred compensation plan", the amounts held are not deferred for tax purposes and instead are taxable to the individual in the year the amounts are no longer subject to a "substantial risk of forfeiture" IRC §457(f). An "ineligible plan" under IRC §457(f) is a type of non-qualified deferred compensation plan. The rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services. Therefore, once an individual has performed all services necessary to receive payment at any point in the future, the deferred amount is taxed as compensation to the individual.

B. Simplified Employee Pensions (SEP)

1. SEP Requirements. I.R.C. §408(k).
 - a. A SEP is an individual retirement account which is employer-funded and can accept an expanded rate of contributions. An employer's annual contribution to a SEP on behalf of each employee is limited to the lesser of (a) 25% of the employee's compensation (not reduced for employee contributions to the SEP), or (b) \$40,000 (adjusted, \$42,000 for 2005; \$44,000 for 2006). For 2001, the limits were 15% of compensation and \$35,000. I.R.C. §§408(j) and 415(c)(1)(A). The SEP/IRA is owned by the employee, who may be self-employed.
 - b. The employer must contribute to the SEP on behalf of each employee who:
 - i. Has attained age twenty-one;
 - ii. Has performed service for the employer for at least three of the immediately preceding five years;
 - iii. Has performed service for the employer during the year for which the contribution is made (regardless of whether the employee is still employed by the employer at the end of

such year) and has received at least \$450 (adjusted for COLA) in compensation for such year; and

- iv. Non-resident aliens with no income from U.S. sources and employees covered by a collective bargaining agreement with whom retirement benefits have been the subject of good faith bargaining may be excluded from participation. I.R.C. §408(k)(2). Prop. Regs. §1.408-7(d) and §1.219-3(b)(2).
- c. To establish a SEP, an employer must execute a written instrument which must include:
 - i. The name of the employer;
 - ii. The requirements for participation;
 - iii. The signature of an appropriate official;
 - iv. A definite formula for the allocation of employer contributions which specifies the manner in which the allocation is determined and what requirements an employee must satisfy to share in the allocation. Prop. Reg. §1.408-7(e); and
 - v. No minimum funding standards are imposed for a SEP.
- d. Withdrawals from a SEP must be permitted. Therefore, employer contributions cannot be conditioned on their retention in the plan and withdrawals cannot be prohibited. I.R.C. §408(k).
- e. SEPs are subject to the top-heavy rules. A top-heavy SEP is subject to the defined contribution plan minimum contribution rules. I.R.C. §§408(k)(1); 416(c)(2).
- f. SEPs may be integrated with social security in the same manner as a qualified defined contribution plan. I.R.C. §408(k)(3)(1). An employer cannot maintain an integrated SEP if the employer has an integrated qualified plan (*e.g.*, pension, profit-sharing or stock bonus) during the same year. I.R.C. §§408(k)(3)(D); 401(1)(4)(F).
- g. Employer contributions to a SEP may either be made on the basis of a calendar year or on the basis of the employer's non-calendar taxable year. Employer contributions on account of a given calendar year or taxable year must be contributed by the due date (plus extensions) for the employer's tax return for such year. I.R.C. §404(h)(1)(A).
- h. Contributions by an employer may not discriminate in favor of highly compensated employees and must bear a uniform

relationship to compensation (excluding compensation in excess of \$200,000, adjusted, \$210,000 for 2005; \$220,000 for 2006). I.R.C. §408(k)(3)(C).

- i. Contributions must also be made to SEPs on behalf of employees who have attained age 70½ I.R.C. §219(b)(2).
2. Salary Reduction Simplified Employee Pensions (SARSEPS). I.R.C. §408(k)(6).
 - a. A SARSEP may be maintained by an employer who did not have more than twenty-five employees who were eligible to participate at any time during the preceding taxable year. Employees may elect to receive cash or make elective deferrals to a SARSEP. The elective deferrals are subject to the same \$14,000 (indexed) limit applicable to §401(k) plans and are aggregated with §401(k) elective deferrals for the purposes of such limit.
 - b. The election is available only if at least fifty percent of the eligible employees elect to make such deferrals. Additionally, the deferral percentage for each highly compensated employee cannot be more than 125% of the average deferral percentage for non-highly compensated employees. I.R.C. §408(k)(6)(C).
 - c. State or local governments and tax-exempt organizations cannot adopt SARSEPS. I.R.C. §408(k)(6)(E).
 - d. FICA and FUTA must be withheld from employee elective deferrals to SARSEPS.
 - e. Note: SARSEPs repealed. Employers are not permitted to establish SARSEPs after 1996. SARSEPs established prior to 1997 may continue to receive contributions under the pre-1997 rules. Employees hired after 1996 may participate in SARSEPs established before 1997. I.R.C. §408(k)(6)(H).
 3. SEP Establishment and Contribution Deadlines. IRS Publication 560.
 - a. Deadline for setting up a SEP. You can set up a SEP for a year as late as the due date (including extensions) of your income tax return for that year.
 - b. Time limit for making contributions. To deduct contributions for a year, you must make the contributions by the due date (including extensions) of your tax return for the year.

Please note: A SEP is a type of employer-sponsored IRA and is not a tax-qualified plan under IRC Section 401(a). SEPs do not enjoy the protection from creditor claims afforded to tax-qualified

plans under ERISA §206(d) and IRC §401(a)(13), but are protected in bankruptcy under the 2005 Bankruptcy Act.

C. SIMPLE IRA.

I.R.C. §408(p)

1. Savings Incentive Match Plans for Employees (SIMPLE Plans).

Employers with 100 or fewer employees who received at least \$5000 in compensation in the preceding year may adopt a SIMPLE plan *if they do not maintain another qualified plan (i.e., a qualified plan, a SEP or a 403(b)).*

- a. Employer may not maintain a plan to which any employee receives an allocation of contributions or an increase in accrued benefits for plan years beginning or ending in that calendar year.
- b. However, an employer may adopt and maintain a SIMPLE IRA for noncollectively bargaining employees even if it maintains a qualified plan for collectively bargained employees. I.R.C. §408(p)(2)(D)(I), as amended by the 1998 Act.

2. Employees May Contribute by *Salary Reduction Up to \$10,000 (2003: \$8,000; 2004: \$9,000; 2005 and 2006: \$10,000)* of Compensation Per Year (Up to 100% of Earned Income or Compensation).

a. Catch-up contributions for individuals who have attained age 50:

2002:	\$ 500
2003:	\$1,000
2004:	\$1,500
2005:	\$2,000
2006:	\$2,500

3. Employer Must Satisfy One of Two Contribution Formulas.

- a. Employer must match 100% of contributions up to three percent of compensation.
 - i. Employer can reduce the total match to less than three percent of compensation (but not less than one percent of compensation) in two out of five years.
 - ii. In order to apply the lower matching percentage, the employer must notify employees of the lower percentage within a reasonable time prior to the sixty-day election period during which employees are allowed to determine whether to participate in the SIMPLE plan.

- b. Employer may elect to make a nonelective contribution of two percent of compensation for each eligible employee who has earned at least \$5000 of compensation from the employer during the year.
- 4. Compensation Limited to \$200,000 (adjusted, \$210,000 for 2005; \$220,000 for 2006) for Two Percent Non-Elective Contributions (But Not for Matching Contribution). §408(p)(2)(B)(ii).
 - a. Maximum contribution is \$10,000 elective deferral plus \$10,000 matching contribution.
 - b. Matching contributions on behalf of self-employed persons to SIMPLE IRAs are not treated as elective contributions and, therefore, are not subject to the \$10,000 limit on elective deferrals. I.R.C. §408(p)(8).
- 5. Eligibility Requirements.

Employees may participate in SIMPLE Plan if they:

- a. Received at least \$5000 in compensation from the employer during any two preceding years; and
- b. Are reasonably expected to receive at least \$5,000 in compensation during the year.

Employees who are covered under a collective bargaining agreement and certain nonresident aliens may be excluded from participation.

- 6. Contributions Are 100% Vested.
- 7. Overall Elective Deferral Limitation Applies to SIMPLE.

Elective deferrals to SIMPLE IRAs are subject to the overall \$14,000 (adjusted) limit on elective deferrals to retirement plans under I.R.C. §402(g). The §402(g) limit is a cumulative limitation applying to all elective deferrals by an individual in a given year made under §401(k), §403(b), §408(k) (SARSEPs) and §408(p) (SIMPLES). I.R.C. §402(g)(3).

- 8. Two-Year Grace Period.

Employers who maintain a SIMPLE plan but who fail to be eligible in subsequent years (*i.e.*, employer has 100 or more employees in subsequent years) may continue to maintain the plan for a transition period following a merger or acquisition. The transition period begins on the date of the transaction and ends on the last day of the second calendar year following the calendar year in which the transaction occurs. I.R.C. §408(p)(10), as amended by the 1998 Act.

9. Sixty-Day Election Period.

Eligible employees may elect to make elective deferrals during the sixty-day period before the beginning of the year (or before the employee becomes eligible to participate). A plan may also allow a participant to modify salary reduction contribution percentages during the year.

10. Twenty-Five Percent Additional Tax for Early Withdrawals.

Employees who withdraw contributions during the two-year period beginning on the date that they first commenced participation in the SIMPLE plan will be assessed a twenty-five percent additional tax. I.R.C. Section 72(t).

11. Timetable for Elective Deferrals.

Employer must contribute elective deferrals to employee's account not later than thirty days after the last day of the month for which the contributions are made. Employer contributions must be made by the due date for the employer tax return (plus extensions) for the year on behalf of which the contributions are made.

12. Reporting Requirements.

Employer must notify employees of their rights to make salary deferrals to the SIMPLE plan and the contribution alternative elected by the employer (*i.e.*, three percent match or two percent nonelective contribution) immediately prior to the employee's sixty-day election period.

a. Trustee must annually provide the employer with a summary description and the employer must distribute the summary description to each eligible employee prior to the sixty-day election period.

b. IRS Forms 5304-SIMPLE and 5305-SIMPLE provide a model sixty-day notification form. The summary description requirement can be satisfied by providing the employee with a completed copy of the first two pages of applicable Form.

13. Please note: A SIMPLE-IRA is a type of Employer-sponsored IRA and is not a tax-qualified plan under IRC Section 401(a). A SIMPLE-IRA does not enjoy the protection from creditor claims afforded to tax-qualified plans under ERISA §206(d) and IRC §401(a)(13), but is protected in bankruptcy under the 2005 Bankruptcy Act.

14. COMPARISON OF SIMPLE-IRA TO SAFE HARBOR 401(k)
 - a. SIMPLE-IRA
 - i. defer up to \$10,000 (plus \$2,500 catch-up).
 - ii. 3% employer match or 2% employer non-elective contribution.
 - iii. no additional employer contributions are permitted.
 - b. Safe Harbor 401(k)
 - i. defer up to \$15,000 (plus \$5,000 catch-up).
 - ii. 4% employer match or 3% employer non-elective contribution.
 - iii. additional employer matching or profit-sharing contributions are permitted.

IV. EGTRRA RETIREMENT PLAN PROVISIONS.

Note: the EGTRAA Retirement Plan provisions were made permanent by the Pension Protection Act of 2006. They had previously been scheduled to sunset in 2010.

A. Enhanced Deduction Limitations for Plan Contributions.

IRC §404.

1. Deduction limitation for contributions to profit sharing plans (pre-EGTRRA) (plan years commencing prior to January 1, 2002):
 - a. Compensation is defined for §404 purposes as excluding employee elective deferrals.
 - b. Elective deferrals count as employer contributions for purposes of the deduction limitations.
 - c. Deduction limit is 15% of the aggregate compensation of covered employees.
2. Deduction limitation for contributions to profit sharing plans (post EGTRRA) (plan years commencing on or after January 1, 2002):
 - a. Compensation is defined for §404 purposes as including employee elective deferrals. IRC §404(a).
 - b. Elective deferrals do not count as employer contributions for purposes of the deduction limitations. IRC §404(n).

- c. Deduction limit is 25% of the aggregate compensation of covered employees. IRC §404(a)(3).

I. Example I. Change in IRC Section 404 Deduction.

<u>2001</u>		<u>2002</u>
\$ 1,000,000	Participant Compensation	\$ 1,000,000
- 100,000	Participant Deferrals	100,000
<u>900,000</u>	Section 404 Compensation	1,000,000
x .15	Section 404 Deduction %	x .25
135,000	Maximum Contribution	250,000
- 100,000	Adjustment for Deferrals	- 0
\$ 35,000	Maximum Employer Contribution	\$ 250,000

II. Example II. Maximum Contribution for Corporation with One Plan Participant.

A. Profit-Sharing Without 401(k)

\$ 176,000	Compensation
x .25	
<u>44,000</u>	Profit-Sharing
+ 176,000	Compensation
\$ 220,000	Total \$ Needed for Maximum Contribution

B. Profit-Sharing With 401(k)

\$ 116,000	Compensation (Including 401(k) Deferral)
x .25	
<u>29,000</u>	Profit-Sharing
+ 15,000	401(k) Deferral
\$ 44,000	
+ 5,000	Catch-Up Deferral (50 Years of Age)
\$ 49,000	Total Contributions
\$ 116,000	Compensation (Including 401(k) Deferral)
+ 29,000	Profit-Sharing
\$ 145,000	Total \$ Needed for Maximum Contribution

C. Summary for 2005

- Without 401(k): need \$220,000 to contribute \$44,000 to plan.
- With 401(k): need \$145,000 to contribute \$44,000 to plan (\$49,000 if age 50 or older).

III. Example III. 60 Year-Old with Self-Employment Income.

\$ 30,000	Compensation
x .2	
6,000	Profit-Sharing
+ 15,000	401(k) Deferral
21,000	
+ 5,000	Catch-Up Deferral
\$ 26,000	Total Contribution to Plan

B. Increases in Benefit and Contribution Limits.

The following provisions are effective for years beginning after December 31, 2001, except those provisions pertaining to defined benefit plans are effective for years ending after December 31, 2001.

1. Compensation Limitation. The limit on compensation that may be taken into account under a qualified plan increases to \$200,000 (\$210,000 for 2005; \$220,000 for 2006) from \$170,000. This limit will be indexed in \$5,000 increments. (Act Section 611 amending IRC Section 401(a)(17))
2. Limit on Annual Additions to Defined Contribution Plans. The dollar limit on annual additions to a defined contribution plan increases from \$35,000 to \$40,000 (\$42,000 for 2005; \$44,000 for 2006). This amount will be indexed in \$1,000 increments. In addition, the related compensation limit for annual additions is increased to 100% of compensation from 25%. (Act Section 611 amending IRC Section 415(c))
3. Limit on Annual Benefits Under Defined Benefit Plans. The annual benefit limit under a defined benefit plan is increased from \$140,000 to \$160,000 (\$170,000 for 2005; \$175,000 for 2006). The dollar limit is reduced for benefit commencement before age 62 and increased for benefit commencement after age 65. (Act Section 611 amending IRC Section 415(b))
4. Elective Deferral Limitations. The dollar limit on annual elective deferrals to 401(k) plans, 403(b) annuities, and salary reduction SEPs is increased to \$11,000 in 2002. In 2003 and thereafter, the limits are increased in \$1,000 annual increments until the limits reach \$15,000 in 2006, with indexing in \$500 increments thereafter. The maximum annual elective deferrals that may be made to a SIMPLE plan is increased to \$7,000 in 2002. In 2003 and thereafter, the SIMPLE plan deferral limit is increased in \$1,000 annual increments until the limit reaches \$10,000 in 2005. Beginning after 2005, the \$10,000 dollar limit is indexed in \$500 increments (\$10,000 for 2006). (Act Section 611 amending IRC Section 402(g))
5. Additional Salary Reduction Catch-up Contributions. Effective for taxable years beginning after December 31, 2001, the otherwise applicable dollar limits on elective deferrals for a 401(k) plan, a 403(b) annuity, SEP,

or SIMPLE or deferrals under an eligible 457 plan are increased for individuals who have attained at least age 50 by the end of the year. The additional amount of elective contributions that may be made by an eligible individual participating in such a plan is the lesser of (1) the applicable dollar amount (see table below) or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year. (Act Section 631 adding IRC Section 414(v))

- a. Catch-up amount for 401(k), 403(b), SEP or 457 Plan; 2002: \$1,000; 2003: \$2,000; 2004: \$3,000; 2005: \$4,000; 2006 and thereafter: \$5,000.
- b. Catch-up amount for SIMPLE; 2001: \$500; 2003: \$1,000; 2004: \$1,500; 2005: \$2,000; 2006 and thereafter: \$2,500.

C. Provisions Affecting 401(k) Plans and Matching Contributions.

1. Faster Vesting of Employer Matching Contributions. In 2001, a plan must vest a participant's matching contributions using either a 5-year cliff vesting schedule or a 3 to 7 year graded vesting schedule. Effective for contributions for a plan years beginning after December 31, 2001 (with a delayed effective date for plans maintained pursuant to a collective bargaining agreement), faster vesting schedules will apply to employer matching contributions. A plan must use either a 3-year cliff vesting schedule or a 2 to 6 year graded vesting schedule with 20% annual increments. (Act Section 633 amending IRC Section 411(a))
2. Hardship Distributions. For plans using the IRS's safe harbor hardship rules to determine immediate and heavy financial need, the IRS is directed to revise its regulations to provide that the period an employee is prohibited from making elective and employee contributions is reduced to 6 months (previously 12 months). The revised regulations apply to years beginning after December 31, 2001. In addition, the Act provides that an eligible rollover distribution will not include any distribution, which is made upon hardship of the employee, not just those made with respect to elective deferrals. (Act Section 636 amending Treas. Reg. Section 1.40(k)-1(d))
3. 401(k) and 401(m) Multiple Use Test Repealed. The multiple use test for 401(k) and 401(m) plans is repealed for plan years beginning after December 31, 2001. (Act Section 666 amending IRC Section 401(m)(9))
4. Repeal of "Same Desk" Rule. Prior to 2002, distributions may not be made from a 401(k) plan, 403(b) annuity, or 457 plan prior to the occurrence of certain events, such as "separation from service." Under the "same desk" rule, separation from service occurs only upon death, retirement, resignation, or discharge, and not when an employee continues service at the same job for a different employer as the result of a merger or liquidation. Effective for distributions after December 31, 2001, the same desk rule is repealed and, distributions from 401(k) plans, 403(b)

annuities, and eligible 457 plans may occur upon "severance from employment" rather than "separation from service." (Act Section 646 amending IRC Section 401(k))

5. Restrictions on Investment of Elective Deferrals in Qualifying Employer Securities and Qualifying Employer Real Property. The Taxpayer Relief Act of 1997 extended the 10% limitation on investments in qualifying employer securities and qualifying employer real property under ERISA Section 407(a) to elective deferrals under Section 401(k) plans. Under EGTRRA, this change will not apply to any elective deferral, which is invested in assets consisting of qualifying employer securities, qualifying employer real property, or both, if such assets were acquired before January 1, 1999. (Act Section 655 amending ERISA Section 407)
6. 401(k) Coverage Test Relief for Tax Exempt Organizations. Coverage testing relief has been granted to enable tax exempt employers with for-profit subsidiaries to sponsor a 403(b) tax sheltered annuity and a 401(k) plan or a 401(m) plan if (1) no employee of such charitable tax exempt entity is eligible to participate in the 401(k) or 401(m) plan, and (2) at least 95% of the employees who are not employees of the tax exempt charitable employer are eligible to participate in the Section 401(k) or 401(m) plan. (Act Section 664 amending Treas. Reg. 1.410(b)-6(g))

D. Provisions Affecting Employee Stock Ownership Plans.

1. S Corporation ESOPs. For plan years beginning after December 31, 2004, certain S corporations which sponsor an ESOP must prohibit the allocation of S corporation employer securities to certain disqualified persons. A "disqualified person" is a person who (1) has "deemed owned shares" constituting more than 10% of all of the deemed owned shares of the corporation's stock, or (2) is a member of a family that has more than 20% of the deemed owned shares. "Family" includes spouses, ancestors, descendants, siblings, and siblings' descendants. "Deemed owned shares" include (1) shares allocated to a participant's ESOP account, (2) the participant's portion of the shares in any unallocated account, such as a loan suspense account, assuming that all such shares become allocated in the same proportion as the most recent stock allocation under the plan, and (3) any synthetic equity. "Deemed owned shares" do not include shares held outright by an individual outside of the ESOP. If disqualified persons own, or are deemed to own, 50% or more of the stock of the S corporation at any time during a plan year, such year will be deemed to be a "nonallocation year." During a nonallocation year, the plan will be treated as having made a distribution of any amount allocated to such disqualified person during such year. The S corporation will be liable for a 50% excise tax based on the amount allocated. EGTRRA also prohibits the use of "synthetic equity" where an S corporation sponsors an ESOP. "Synthetic equity" is any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future or similar right to a future cash payment based on the value of such stock or appreciation

in such value. The S corporation will be subject to the 50% excise tax for any year in which a disqualified person has an interest in synthetic equity. These provisions will also apply to S corporation ESOPs established after March 14, 2001 or ESOPs established before that date which hold employer securities that elect S corporation status. (Act Section 656 adding new IRC Section 408(p) and amending IRC Section 4979A)

2. Section 404(k) Dividend Deductions. The deduction for dividends paid in cash on employer stock held by an ESOP has been expanded to include dividends payable at the election of participants (1) in cash directly to plan participant or beneficiaries, (2) to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of that plan year, or (3) to the plan and reinvested in qualifying employer securities. The standard for disallowing abusive dividends has been broadened. This provision is effective for taxable years beginning after December 31, 2001. (Act Section 662 amending IRC Section 404(k))

E. Defined Benefit Plan Funding.

1. Full Funding Limit. The full funding limit for defined benefit plans currently is the excess, if any, of (1) the lesser of (a) the accrued liability under the plan or (b) 160% of the plan's current liability, over (2) the value of the plan's assets. EGTRRA gradually increases and then repeals the current liability full funding limit. The current liability full funding limit is 165% of current liability for plan years beginning in 2002 and 170% of current liability for plan years beginning in 2003. The current liability full funding limit is repealed for plan years beginning in 2004 and thereafter. (Act Section 651 amending IRC Section 412(c)(7))
2. Maximum Contribution Deduction Rules. The special rule allowing deductible contributions up to the amount of the unfunded current liability is extended to virtually all defined benefit plans. Formerly, this rule applied only to plans with more than 100 participants. Also, in the year of termination, defined benefit plans will be permitted to deduct 100% of the termination liability. Effective for plan years beginning after December 31, 2001. (Act Section 652 amending IRC Section 404(a)(1))

F. Modification of Top-Heavy Rules. (Plan Years Beginning After 12/31/2001).

1. Definition of Top-Heavy Plan. A plan consisting of a cash-or-deferred arrangement which satisfies the design-based safe harbor of Section 401(k)(12) and matching contributions which satisfy the design-based safe harbor of Section 401(m)(11) is not a top-heavy plan. In addition, distributions made during the "1-year period ending on the determination date" will be taken into account in determining whether a plan is top-heavy (the prior law includes a five-year rule with respect to distributions). However, the five-year rule continues to apply to in-service distributions. Also, accrued benefits are not taken into account where the participant has

not performed services for the employer during the one year period prior to the date of the top-heavy determination.

2. Definition of Key Employee Simplified. Under the new provisions, an employee will be considered a key employee if, during the prior year, the employee was (i) an officer with compensation in excess of \$130,000 (\$135,000 for 2005; \$140,000 for 2006), (ii) a five-percent owner, or (iii) a one-percent owner with compensation in excess of \$150,000. The prior law regarding the number of officers who shall be treated as key employees remains the same.
3. Minimum Benefit for Non-Key Employees. Matching contributions may now be taken into account with respect to each non-key employee for purposes of satisfying the minimum contribution requirement of Section 416(c)(2)(A). In addition, for purposes of the minimum benefit requirements with respect to defined benefit plans under Section 416(c)(1), a year of service does not include any year in which no key employee or former key employee benefits under the plan (as determined under Section 410(b)). (Act Section 613 amending IRC Section 416)

G. Individual Retirement Arrangements (Including Roth IRAs).

1. Increase in Annual Contribution Limits. Effective for taxable years beginning after December 31, 2001, the maximum annual dollar contribution limit for IRA contributions increases as follows: (1) for 2002 through 2004, from \$2,000 to \$3,000; (2) for 2005 to 2007, \$4,000; and (3) for 2008 to \$5,000. After 2008, the limit is adjusted annually for inflation in \$500 increments. (Act Section 601 amending IRC Section 219(b))
2. Additional Catch-Up Contributions. Effective for taxable years beginning after December 31, 2001, individuals who have attained age 50 may make additional catch-up IRA contributions. The otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who has attained age 50 before the end of the taxable year is increased by \$500 for 2002 through 2005, and \$1,000 for 2006 and thereafter.. (Act Section 601 amending IRC Section 219(b))
3. Deemed IRAs Under Employer Plans. Effective for plan years beginning after December 31, 2002, if an eligible retirement plan permits employees to make voluntary employee contributions to a separate account or annuity that (1) is established under the plan, and (2) meets the requirements applicable to either traditional IRAs or Roth IRAs, then the separate account or annuity is deemed a traditional IRA or a Roth IRA, as applicable, for all purposes of the IRC. The deemed IRA, and contributions thereto, are not subject to the IRC rules pertaining to the eligible retirement plan. In addition, the deemed IRA, and contributions thereto, are not taken into account in applying such rules to any other contributions under the plan. The deemed IRA is subject to the exclusive benefit and fiduciary rules of ERISA to the extent otherwise applicable to

the plan, but is not subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements applicable to the eligible retirement plan. An eligible retirement plan is a 401(a) qualified plan, a 403(b) annuity, or a governmental 457 plan. (Act Section 602 amending IRC Section 408)

4. Option to Treat Elective Deferrals as Roth Contributions. Effective for taxable years beginning after December 31, 2005, a 401(k) plan or a 403(b) annuity is permitted to include a "qualified Roth contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as Roth contributions. Unlike deemed IRAs, a qualified Roth contribution program under a 401(k) plan or a 403(b) annuity is not treated as an IRA and is generally subject to the rules otherwise applicable to the 401(k) plan or 403(b) annuity. (Action Section 617 adding new IRC Section 402A)

H. Rollovers of Retirement Plan and IRA distributions.

Effective for distributions made after December 31, 2000, the rollover provisions effecting retirement plan and IRA distributions have been significantly expanded by EGTRRA.

1. In general. An eligible rollover distribution from a qualified retirement plan, 403(b) annuity, or a governmental 457 plan generally may be rolled over to any such plan or arrangement, although these plans are not required to accept rollovers. Similarly, IRA distributions may also be rolled over to a qualified plan, 403(b) annuity, or governmental 457 plan that accepts rollovers. (Act Section 641 amending IRC Sections 402(c)(8), 403(b)(8), and 457(e))
2. Rollover of After-Tax Contributions. Employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA, so long as the qualified plan provides separate accounting for such contributions. However, after-tax contributions (including nondeductible IRA contributions) may not be rolled over from an IRA to a qualified plan, 403(b) annuity, or governmental 457 plan. Rollovers of after-tax contributions from one qualified plan to another qualified plan are permitted only through direct rollovers (Act Section 643 amending IRC Section 402(c))
3. Expansion of Spousal Rollovers. A surviving spouse may roll over distributions not only to an IRA, but also to a qualified retirement plan, 403(b) annuity, or governmental 457 plan in which he or she participates. (Act Section 641 amending IRC Section 402(c)(9))
4. Rollover notice requirements. The rollover notice required to be provided by administrators of qualified retirement plans and 403(b) annuities must include an explanation of the distribution provisions under the eligible recipient plans that may be different from those applicable to distributions

under the distributing plan. (Act Section 641 amending IRC Section 402(f))

5. Sixty-Day Rollover Requirement. Under the prior law, the IRS could only waive the 60-day requirement for rollovers during military service in a combat zone or by reason of a Presidentially declared disaster. The Act allows a waiver of the 60-day rollover period if failure to waive the requirement would be against equity or good conscience. (Act Section 642 amending IRC Section 408)

I. Modifications to Coverdell Education Savings Accounts (Previously Called Education IRAs).

1. Annual Contribution Limit & Phase-Out of Contribution Limit. The Act increases the annual aggregate contribution limit to education IRAs from \$500 to \$2,000. The phase-out range for married taxpayers filing a joint return was also increased to \$190,000 to \$200,000 of adjusted gross income, twice the range for single taxpayers.
2. Qualified Education Expenses. The definition of qualified education expenses that may be paid tax-free from a Coverdell Education Savings Account has been expanded to include "qualified elementary and secondary school expenses." The definition also includes the purchase of any computer technology, equipment, or Internet access that is used by the beneficiary and his/her family while he/she is in school. Software must be educational in nature to be a qualified expense.
3. Contributions by Persons Other Than Individuals. Regardless of income, corporations and other entities are allowed to make contributions to Coverdell Education Savings Accounts.
4. Contributions Permitted Until April 15. Individuals who contribute to a Coverdell Education Savings Account may make a contribution for a year until April 15 of the following year. (Act Section 401 amending IRC Section 530)

J. Incentives for Small Businesses to Establish New Retirement Plans.

1. Tax Credit. Effective with respect to costs paid or incurred in taxable years beginning after December 31, 2001 and with respect to plans established after such date. The Act provides a tax credit for a small business that adopts a new qualified defined benefit or defined contribution plan. The credit is in an amount equal to 50% of the qualified startup costs paid or incurred by the taxpayer during the taxable year. The dollar limitation with respect to the credit is \$500 for each of the first three years of the plan.

The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of \$5,000. In order for an employer to be eligible for the credit, the plan

must cover at least one nonhighly compensated employee. The term qualified startup costs means any ordinary and necessary expenses of an eligible employer which are paid or incurred in connection with the establishment or administration of the plan or the retirement-related education of employees with respect to such plan. (Act Section 619 adding new IRC Section 45E)

The small employer pension plan startup cost credit is a general business credit. The 50% of qualifying expenses that are effectively offset by the tax credit are not deductible; the other 50% of the qualifying expenses (and other expenses) are deductible to the extent permitted under present law. (Act Section 619 adding new IRC Section 45E)

2. Determination Letter User Fees. Effective for determination letter requests made after December 31, 2001, employers with 100 or fewer employees which have at least one nonhighly compensated employee participating in the plan are not required to pay a user fee for a determination letter request with respect to the qualified status of a retirement plan that the employer maintains if the request is made before the later of (1) the last day of the fifth plan year of the plan or (2) the end of any applicable remedial amendment period with respect to the plan that begins before the end of the fifth plan year of the plan (Act Section 620)

K. Plan Loans for S Corporation Shareholders, Partners, and Sole Proprietors.

Generally, a loan from a qualified plan to an "owner-employee" is a prohibited transaction. Effective for years beginning after December 31, 2001, a loan from a qualified plan to a sole proprietor, 10% or more partner or 5% or more S corporation shareholder is exempt from the prohibited transaction rules. However, loans from an IRA continue to be prohibited to an owner of an IRA. (Act Section 612 amending to IRC Section 4975(f)(6))

V. PROTECTION OF QUALIFIED PLAN ASSETS FROM CREDITORS.

A. ERISA and Internal Revenue Code Anti-Alienation Provisions.

ERISA §206(d) [29 USC §1056(d)(1)] and Internal Revenue Code (IRC) §401(a)(13) provide that qualified plans must contain provisions prohibiting the assignment or alienation of plan benefits. With the exception of Qualified Domestic Relations Orders under IRC §414(p) and federal tax levies and judgments [Treas. Reg. §1.401(a)-13(b)(2)], a participant's benefits under a tax-qualified plan have been insulated from creditors' claims. The anti-alienation rules of ERISA and the IRC have been amended by The Taxpayer Relief Act of 1997 to include three additional exceptions to offset a participant's benefits under a plan where the participant has breached a fiduciary duty or committed a crime against the plan and is ordered to pay the plan by a criminal or civil judgment or consent decree. IRC §401(a)(13)(C) and (D); ERISA §206(d)(4) and (5).

1. In Field Service Advice Memorandum (FSA) 199930039, the IRS stated that a plan is not required to honor a levy by the IRS with respect to funds

held by the plan on behalf of a taxpayer if the taxpayer is not entitled to an immediate distribution from the plan at the time the levy is received.

The Ninth Circuit Court of Appeals has held that the IRS cannot enforce a lien in bankruptcy prior to the time that the participant is entitled to a distribution from a tax-qualified retirement plan. *U.S. v. Snyder*, 343 F.3d 1171 (9th Cir. 2003).

2. In Chief Counsel Advice Memorandum (CCA) 199936042, the participant was eligible to elect early retirement under the plan. The IRS' position under such circumstances is that the IRS may step in the participant's shoes and make the early retirement election. Where spousal consent is required for a distribution in a form other than a qualified joint and survivor payments, the IRS may not elect another form of benefit without the spouse's consent.
3. In CCA 200249001 the IRS Chief Counsel states that although a federal tax lien attaches to a taxpayer's vested interest in a pension plan, the levy does not reach amounts payable to a beneficiary as death benefits even where the levy occurs prior to the death of the taxpayer.
4. In Private Letter Ruling 200342007 the IRS ruled that "the general anti-alienation rule of Code Section 401(a)(13) does not preclude a court's garnishing the account balance of a fined participant in a qualified pension plan in order to collect a fine imposed in a federal criminal action."

The IRS cited favorably three recent federal district court cases which concluded that ERISA plans are subject to garnishment to satisfy criminal fines pursuant to the Federal Debt Collection Procedures Act of 1977 ("FDCPA"). See: *United States v. Tyson*, No. 02-X-73808 (E.D. Mich. April 9, 2003); *United States v. Clark*, No. 02-X-74872 (E.D. Mich. June 11, 2003); *United States v. Rice*, 196 F. Supp. 1196 (N.D. Okla. 2002).

The IRS accepted the reasoning of the courts which held that section 3713(c) of the FDCPA (which provides that "an order of restitution ... is a lien in favor of the United States on all property of the person fined as if the liability of the person fined were liability for a tax assessed under the Internal Revenue Code ...") was to be treated as if it were a tax lien so that it fell within the exception to the anti-alienation provision listed in Treasury Regulation section 1.40(a)-13(b)(2)(ii) for "collection by the United States on a judgment resulting from an unpaid tax assessment".

5. In PLR 200426027, the IRS further reviewed the issues regarding the treatment by retirement plans of federal criminal penalties assessed against a plan participant. Citing the *Tyson* and *Clark* cases as authority, the IRS reiterated its position that federal court judgments imposing a fine payable to the United States or enforcing an order of restitution are to be treated as tax liabilities. Based on this position, the IRS issued five separate rulings in the PLR:

- i. Honoring such garnishment orders will not result in the failure of the plan to meet the anti-alienation provisions of IRC §401(a)(13). This conclusion applies regardless of whether the purpose of the garnishment is to collect (a) a fine payable to the United States Government; (b) criminal restitution amounts payable to the U.S. Government; (c) criminal restitution amounts payable to the U.S. Government for the benefit of private parties; or (d) criminal restitution amounts payable to the U.S. Government for the benefit of a state or local governmental entity.
- ii. A plan will not violate the exclusive benefit rule of IRC §401(a)(2) when paying some or all of a participant's or beneficiary's benefit to the U.S. Government when ordered to do so pursuant to an order of garnishment.
- iii. The lien created pursuant to 18 U.S.C. §36(c) attaches immediately, but the U.S. Government (1) cannot collect from the plan until the participant or beneficiary has a right to a distribution under the plan, (2) steps into the shoes of the participant or the beneficiary and can elect distribution on behalf of that person when the person could elect a distribution; and (3) is subject to the qualified joint and survivor annuity rules and other plan provisions to the same extent as the participant or beneficiary.
- iv. Citing *Murillo v. Commission*, T.C. Memo 1998-13, payments made pursuant to the orders of garnishment are not subject to the 10% additional income tax imposed under IRC §72(t).
- v. Payments made pursuant to such orders may be treated as "eligible rollover distributions" subject to the mandatory 20% federal income tax withholding requirements.

B. General Creditors of the Sponsoring Employer.

The general creditors of a corporation or other sponsoring employer cannot reach the assets contained in such employer's qualified retirement plan. The statutory rationale is that a qualified retirement plan is established for the exclusive benefit of the employees and their beneficiaries. IRC §401(a)(1); Treas. Reg. §1.401-1(b). Furthermore, the terms of the trust must be such as to make it impossible, prior to the satisfaction of all liabilities to the employees and their beneficiaries, for any part of the funds to be diverted to purposes other than the exclusive benefit of the employees and their beneficiaries. IRC §401(a)(2); Treas. Reg. §1.401-2. Since the settlor/employer does not have any significant rights with respect to the trust assets, its creditors have no rights regarding the trust assets.

C. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

1. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act") makes significant changes in bankruptcy rules and adds specific protections for tax-qualified retirement plans and IRAs. The 2005 Act is effective for bankruptcy petitions filed on or after October 17, 2005.
2. The 2005 Act exempts retirement plan assets from a debtor's bankruptcy estate if such assets are held by a tax-qualified retirement plan, a section 403(b) plan, a section 457 plan, or an IRA (including traditional IRAs, Roth IRAs, SEPs and SIMPLEs). The retirement plan exemption applies regardless of whether the debtor elects the federal or state bankruptcy exemptions.
3. The exemption for IRAs is limited to \$1,000,000. However, the \$1,000,000 limit does not apply to employer-sponsored IRAs (*e.g.*, SEPs or SIMPLEs). Additionally, rollovers into IRAs from qualified plans are also exempt from the \$1,000,000 limit.
4. The 2005 Act exempts assets in retirement plans that satisfy the applicable requirements of the Internal Revenue Code. A retirement plan is deemed to be qualified under the 2005 Act if it has received a favorable determination letter from the IRS. If the plan has not received a favorable determination letter, the debtor must demonstrate that: (a) neither the IRS nor a court has made a determination that the plan is not qualified, and (b) (i) the plan is in substantial compliance with the Internal Revenue Code, or (ii) the plan is not in substantial compliance but the debtor is not materially responsible for the failure.
5. The 2005 Act exempts payroll deductions to repay plan loans from the automatic stay provisions. Therefore, payroll deduction repayments may continue during the pendency of the bankruptcy proceeding. Additionally, retirement plan loan obligations are not discharged in bankruptcy.
6. In summary, under the 2005 Act, qualified plan, SEP, and SIMPLE assets are protected with no dollar limitation. IRAs and Roth IRAs are protected to \$1,000,000. However, rollover assets in an IRA are not subject to the \$1,000,000 limit. The 2005 Bankruptcy Act only applies to assets in bankruptcy. One must look to state law for protection of IRA assets in state law (*e.g.*, garnishment) actions.

D. *Patterson v. Shumate*.

1. In 1992, the U.S. Supreme Court resolved a split among the U.S. Circuit Courts of Appeals by holding that ERISA's prohibition against the assignment or alienation of pension plan benefits is a restriction on the transfer of a debtor's beneficial interest in a trust that is enforceable under applicable non-bankruptcy law. Thus, a debtor's interest in an ERISA pension plan is excluded from the bankruptcy estate and not subject to

attachment by creditors' claims. *Patterson v. Shumate*, 112 S. Ct. 2242 (1992).

2. The Supreme Court stated that Bankruptcy Code §541(c)(2) "encompasses any relevant non-bankruptcy law, including federal law such as ERISA." 112 S. Ct. at 2244. The Court also noted that its decision ensures that treatment of pension benefits will not vary because of a beneficiary's bankruptcy status and gives full effect to ERISA's goal of protecting pension benefits.

E. *Yates v. Hendon*.

1. *In Raymond B. Yates, M.D., P.C. Profit Sharing Plan et al. v. Hendon, Trustee*, 124 S. Ct. 1330 (U.S. Sup. Ct. 2004), the United States Supreme Court held that the working owner of a business (here, the sole shareholder and president of a professional corporation) may qualify as a "participant" in a pension plan covered by ERISA. If the plan covers one or more employees other than the business owner and his or her spouse, the working owner may participate on equal terms with other plan participants. Such a working owner, in common with other employees, qualifies for the protections ERISA affords plan participants and is governed by the rights and remedies ERISA specifies.
2. The impact of the holding of the Supreme Court in *Yates* is that the retirement plan benefits of a business owner are protected from the claims of creditors and exempt from bankruptcy if at least one non-owner employee (other than the owner's spouse) is also a participant in the retirement plan.
3. The Supreme Court reversed the previous decision of the U.S. Sixth Circuit Court of Appeals in *In re Yates*, 287 F.3d 521 (6th Cir. 2002) that a sole owner had no standing under ERISA to assert its creditor protection provisions even if the retirement plan also covered non-owner employees.

The position of the Sixth Circuit was that Dr. Yates, as a sole shareholder, was not an "employee" for purposes of ERISA and, therefore, was not entitled to ERISA creditor protection. The Supreme Court rejected the position of the Sixth Circuit that a working owner may rank only as an "employer" and not also as an "employee" for purposes of ERISA-sheltered plan protection.

F. Owner-Only Plans Are At Risk Outside of Bankruptcy.

1. Since *Patterson*, several U.S. Bankruptcy Courts have ruled that assets in a sole proprietor's retirement plan may be attached by creditors when the sole proprietor goes bankrupt. The bankruptcy courts have held that a pension plan that benefits only the owner of a small business is not "ERISA-qualified." ERISA is meant to benefit common-law employees, the courts have noted, while a sole proprietor is an employer. *In re Witwer*, 148 B.R. 930 (Dec., 1992, Cal.); *In re Lane*, 149 B.R. 760 (Jan.,

1993, N.Y.); *In re Hall*, 151 B.R. 412 (Feb., 1993, Michigan). *In re Watson*, 192 B.R. 238 (Feb., 1998, Nevada), *affd.* 22 EBC 1091 (9th Cir., Dec. 1998). Thus, it is still possible for a retirement plan that covers *only* the owners of a business to be attached by the bankruptcy creditors of the owner/plan participant.

Department of Labor Regulations provide that a husband and wife who solely own a corporation are not employees for retirement plan purposes. The Regulations further provide that a plan which covers only partners or only a sole proprietor is not covered under Title I of ERISA. However, a plan under which one or more common-law employees (in addition to the owners) are participants will be covered under Title I making ERISA protections applicable to all participants (not just the common-law employees). 29 C.F.R. §2510.3-3(b), (c)(1). Thus, inclusion of one or more non-owner employees transforms a non-ERISA plan into an ERISA-qualified plan and thereby protects the plan assets from the claims of creditors.

2. In *Yates v. Hendon*, cited above, the U.S. Supreme Court noted that Department of Labor Advisory Opinion 99-04A interprets 29 CFR §2510.3-3 to mean that the statutory term "employee benefit plan" does not include a plan whose only participants are the owner and his or her spouse, but does include a plan that covers as participants one or more common-law employees, in addition to the self-employed individuals. The Supreme Court noted that "[t]his agency view...merits the Judiciary's respectful consideration."
3. In *Lowenschuss v. Selnick*, 117 F.3d 673 (9th Cir. 1999) the Ninth Circuit held that:
 - a. An employee pension benefit plan that had been properly established and maintained pursuant to ERISA can lose its ERISA-qualified status for bankruptcy purposes through the mere attrition of non-owner participants where it covered only the owner-employee at the time of the bankruptcy filing, and
4. The 2005 Bankruptcy Act appears to draw no distinction between owner-only plans and other qualified plans with respect to bankruptcy exemption.

G. 403(b) Plans May Not Be Protected Outside of Bankruptcy.

1. The United States Sixth Circuit Court of Appeals held in *Rhiel v. Adams*, No. 03-8011 (6th Cir. December 10, 2003) that only assets that are held "in a trust" are excludable from property of the bankruptcy estate by 11 U.S.C. §541(c)(2).

The Bankruptcy Court for the Southern District of Ohio held that the 403(b) plans (for the husband and wife) were "ERISA-qualified" as contemplated by the Supreme Court in *Patterson v. Shumate*. As such,

they were not the property of the (bankruptcy) estate, and were not subject to administration by the (bankruptcy) Trustee.

The Sixth Circuit reversed the Bankruptcy Court and remanded the case for further proceedings based on the fact that the debtors had not shown that the section 541(c)(2) "in a trust" language had been satisfied. The Sixth Circuit held that only assets of an ERISA plan held in a trust would be excluded from the bankruptcy estate and that assets in a custodial account may not be excluded.

2. The 2005 Bankruptcy Act specifically protects 403(b) plans and does not distinguish between trust and custodial accounts. It is unclear how the 6th Circuit will interpret its decision in Rhiel outside of bankruptcy.

H. ERISA Protections Do Not Apply to Funds After Distribution From Retirement Plan.

The United States Court of Appeals for the First Circuit held that the anti-alienation provisions of ERISA and the IRC do not restrict the alienation of pension benefits that have already been distributed to plan participants or beneficiaries. Once the benefits have been distributed from the plan, a creditor's rights are enforceable against the beneficiary, but not against the plan itself. *Hoult v. Hoult*, No. 02-2128 (U.S. First Circuit Court of Appeals, 2004).

I. Creditor Protection for IRAs and Other Non-ERISA Plans Outside of Bankruptcy.

1. Individual Retirement Accounts, simplified employee pension plans (SEPs), SIMPLE IRAs, government plans and most church plans are not covered under the non-alienation provisions of either ERISA or the IRC and, therefore, a participant's benefits under such plans are subject to creditors' claims outside of bankruptcy unless protected under state law. See ERISA §§4(b) and 201; IRC §401(a); 29 CFR §2510.3-2(d).

- a. Effective March, 1999, Ohio H.B. No. 108 amended Ohio Revised Code ("ORC") Section 2329.66(A)(10)(c) to exempt Individual Retirement Accounts, Roth IRAs, and Coverdell Education Savings Accounts from execution, garnishment, attachment or sale to satisfy a judgment or order. Although SEPs and SIMPLE IRAs are types of IRAs, they are not protected under these provisions of Ohio law. Amounts rolled over from a SEP or SIMPLE to a rollover IRA are, however, protected from creditor claims.

- b. Note: In *Lampkins v. Golden*, 2002 U.S. App. LEXIS 900, 2002-1 USTC par. 50,216 (6th Cir. 2002), the U.S. Court of Appeals for the 6th Circuit held that a Michigan statute exempting SEPs and IRAs from creditor claims was preempted by ERISA and, therefore, a SEP/IRA was subject to garnishment. Since it is unclear whether Lampkins is limited to SEPs or could be broadly interpreted to cover all IRAs, all IRAs in the 6th Circuit may be subject to creditor claims.

In *In re: Christine P. Mitchell*, 2002 Bankr. Lexis 1217 (Bankr. N.D. Ohio 2002), the court held that O.R.C. §2329.66(A)(10)(c) was not preempted by ERISA and that the debtor's IRA was exempt from bankruptcy. The court noted that while a SEP-IRA is an employer sponsored plan, a regular IRA is not and, therefore, *Lampkins* does not apply to non-SEP IRAs. It should, however, still apply to SIMPLE-IRAs as employer-sponsored plans. See also: *In re: Robert and Lynne Fixel*. 286 B.R. 638 (Bankr. N.D. Ohio 2002). In re: Buzza, 287 B.R. 417 (Bankr. S.D. Ohio 2002).

2. In *United States v. Vondette*, No. 02-1528(L); No. 02-1519 (CON) (2d. Cir. Dec. 16, 2003), the U.S. Court of Appeals for the Second Circuit held that the IRAs of a taxpayer convicted of drug-trafficking and money laundering are subject to criminal forfeiture when all of the drug profits cannot be located. The Second Circuit held that ERISA and its anti-alienation provisions do not apply to IRAs.
3. The United States Supreme Court reversed the 8th Circuit Court of Appeals in *Rousey v. Jacoway*, 347 F.3d 689 (8th Cir. 2003) holding that IRAs are not exempt in bankruptcy under federal laws. The U.S. Supreme Court held that IRAs are protected to the extent that the IRA assets are reasonably necessary for the individual's support. *Rousey v. Jacoway*, 125 S. Ct. 1561 (2005). *Rousey* has been superseded by the 2005 Bankruptcy Act and bankruptcy protection for IRAs is no longer limited by the "reasonably necessary for support" restriction.
4. The 2005 Bankruptcy Act protects IRA assets up to \$1,000,000. SEPs, SIMPLEs, and rollover assets are protected in excess of the \$1,000,000 limit. State law with respect to the protection of IRA assets still applies for purposes of state law (*e.g.*, garnishment) actions.

VI. CONTROLLED GROUPS AND AFFILIATED SERVICE GROUPS. I.R.C. §§ 414(b), (c) and (m)

A. Controlled Groups. I.R.C. §§ 414(b) and (c) and 1563(a).

The employees of all sole proprietorships, partnerships and corporations that are members of a controlled group must be aggregated for retirement plan purposes.

1. Parent-subsidiary controlled group.

One or more chains of businesses connected through ownership with a common parent organization if at least eighty percent of the control or value of the organizations is controlled by one organization. IRC §1563(a)(1)

EXAMPLE:

Parent:



100%

100%

Subsidiaries:



40%

40%

Subsidiary:



Result: A is the common parent of a controlled group consisting of A, B, C and P.

2. Brother-sister controlled group.

Two or more organizations if five or fewer persons who are individuals, estates or trusts own at least *eighty percent* of the total control or value of each entity *and* the same five or fewer persons together own more than *fifty percent* of the value or voting power of each entity. For purposes of the fifty percent test, ownership is included only to the extent that it is identical with respect to each organization. I.R.C. § 1563(a)(2)(B), *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982).

EXAMPLE:

Individuals	Corporations		Identical Ownership
	X	Y	
A	20%	33%	20%
B	20%	33%	20%
C	20%	33%	20%
D	20%	1%	1%
E	20%	0%	
TOTAL	100%	100%	61%

- a. Eighty percent common ownership for purposes of § 1563(a)(2)(A) eighty percent ownership test.
- b. Sixty-one percent identical ownership for purposes of § 1563(a)(2)(B) more than fifty percent ownership test.

- c. Therefore, corporations X and Y are members of a brother-sister controlled group of corporations.
- 3. Controlled groups for purposes of I.R.C. Section 415 limitations. I.R.C. § 415(h). Applies to parent-subsidiary controlled group only.
 - a. For purposes of applying the controlled group rules of §§ 414(b) and (c) to the annual addition limitations and annual benefit limitations of § 415, the phrase "more than 50%" shall be substituted for the phrase "at least 80%" each place it appears in § 1562(a)(1).
 - b. Therefore, for purposes of determining a parent-subsidiary controlled group with respect to the § 415 limitations, a controlled group will be based on one entity having more than 50% of the control or value of other organizations.
- 4. Family member constructive ownership rules for controlled groups. I.R.C. § 1563(e).
 - a. Spouse.

An individual is considered as owning stock in a corporation owned directly or indirectly by or for his spouse except for an organization where all of the following conditions are satisfied for a taxable year.

- i. The individual does not own directly any stock in the corporation;
 - ii. The individual is not a director or employee and does not participate in the management of such corporation;
 - iii. Not more than fifty percent of such corporation's gross income for such taxable year was derived from royalties, rents, dividends, interest and annuities; and
 - iv. Such stock is not subject to conditions which substantially restrict or limit the spouse's right to dispose of such stock and which run in favor of the individual or his children who have not attained the age of twenty-one years. I.R.C. § 1563(e)(5).
- b. Minor children.

An individual is considered as owning stock owned, directly or indirectly, by or for his children who have not attained the age of twenty-one and, if the individual has not attained age twenty-one, the stock owned, directly or indirectly, by or for his parents. I.R.C. § 1563(e)(6)(A).

- c. Adult children, parents and grandparents.

An individual who owns more than fifty percent of the voting power or fifty percent of the value of a corporation shall be considered as owning the stock in a corporation owned, directly or indirectly, by or for his parents, grandparents, grandchildren and children who have attained age twenty-one. I.R.C. § 1563(e)(6)(B).

- d. There are also constructive ownership rules for stock options owned and attribution from partnerships, estates, trusts and corporations. I.R.C. §§ 1563(e)(1), (2), (3) and (4).

- e. Example.

- i. Al and his children, Barb and Chuck, own X Corporation.

- ii. Al owns forty percent of X Corporation; Barb, age twenty, owns thirty percent; and Chuck, age twenty-five, owns thirty percent.

- iii. What percent of ownership in X Corporation is attributed to Al?

- (a) The thirty percent interest of Al's minor child, Barb, is attributed to Al and Al is treated as owning both his own forty percent and Barb's thirty percent for a total of seventy percent.

- (b) Because Al is treated as owning more than fifty percent, the thirty percent owned by his adult child, Chuck, is also attributed to Al and Al is considered to own 100% of X Corporation.

B. Affiliated Service Groups. I.R.C. § 414(m).

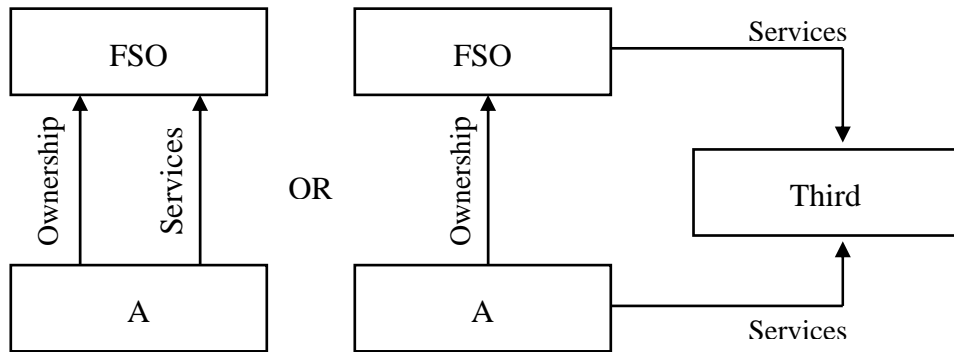
- 1. The affiliated service group rules of I.R.C. § 414(m) preclude a self-employed person from establishing a Keogh plan for just one entity if there are two or more organizations that constitute an affiliated service group which, for qualified plan purposes, would be aggregated into a single employer.

An affiliated service group is an entity (incorporated or unincorporated) which is either a service or management-type group. It consists of a First Service Organization (FSO) plus an A, B or A and B organization.

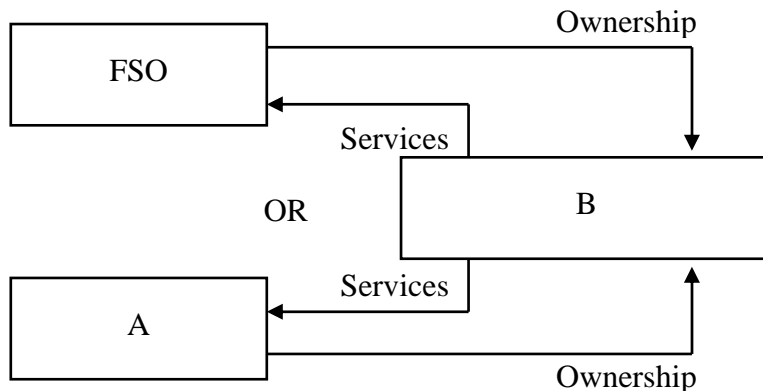
- a. An A organization is a shareholder or partner in the FSO *and* regularly performs services for the FSO or is associated with the FSO in performing services for third parties. I.R.C. § 414(m)(2)(A).

- b. Although a B organization does not have to be a service organization, it does have to provide services to the FSO or an A organization which their employees would normally perform. Furthermore, at least ten percent or more of the interest in the B organization has to be held by officers or highly compensated employees of the FSO or A organization. I.R.C. § 414(m)(2)(B).
- c. I.R.C. § 414(m)(6)(B) states that in determining ownership, the principles of I.R.C. § 318(a) shall apply. Under § 318(a)(1), an individual is considered to own stock owned by his spouse, children, grandchildren and parents. Additionally, § 318(a)(3) provides that if fifty percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

A ORGANIZATION



B ORGANIZATION



- 2. Section 414(m)(5) also includes “certain organizations performing management functions” in the affiliated service group definition. Section 414(m)(5) states that the term affiliated service group also includes a group consisting of:

- a. An organization the principal business of which is performing, on a regular and continuing basis, management functions for one organization (or for one organization and other organizations related to such one organization); and
 - b. The organization (and related organizations) for which such functions are so performed by the organization described in a. (i.e., the management organization).
3. Unless the controlled group or affiliated service group rules apply, a director of a corporation can establish a Keogh plan pertaining to his director's fees. A director in his capacity as such is not considered to be an employee of the organization of which he is a director. Rev. Rule 80-87, 72-86; PLR 7839059. However, this result may not apply to a professional corporation due to the affiliated service group rules since such corporations constitute FSOs. The sole-proprietorship would be the director, which is a service organization because capital is not a material income-producing factor (Reg. § 1.414(m)-2(f)(1)) and, thus, would be considered an A organization.