

RECENT DEVELOPMENTS AFFECTING RETIREMENT PLANS AND DEFERRED COMPENSATION

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- I. New Nonqualified Deferred Compensation Legislation—Code Section 409A
 - A. Changes rules for nonqualified deferred compensation (NQDC) plans.
 1. NQDC Plan is any plan that provides for the deferral of compensation, other than:
 - a. a qualified retirement plan (under Code section 401(a), 403(b), or 457(b)); and
 - b. any bona fide vacation, sick leave, compensatory time, disability pay, or death benefit plan.
 2. Severance pay plans are covered.
 3. Includes elective (voluntary employee contributions) and nonelective (employer contributions) deferral arrangements.
 - B. Consequences of failure to comply
 1. All compensation deferred under the plan for all taxable years is included in the employee's gross income for the first taxable year in which it is not subject to a substantial risk of forfeiture.
 2. In addition to regular income taxes, the employee must pay additional taxes equal to 20% of the amount included in income, together with interest at the underpayment rate plus 1% on the underpayments resulting from the prior years' deferrals.

C. New Distribution Restrictions

1. Compensation deferred under a NQDC Plan may not be distributed earlier than:
 - a. separation from service;
 - b. disability (social security definition of disability used in determining disability--requires that employee be unable to engage in any gainful activity by reason of the disability);
 - c. death;
 - d. a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of the compensation;
 - e. a change in ownership or control of the employer; or
 - f. occurrence of an unforeseeable emergency.
2. Distributions cannot be linked to distributions under a qualified plan, as is commonly done under SERPs.
3. Distribution timing and method cannot be elected at the time of termination of employment—must be specified before the services are performed.

D. Accelerating, Postponing and Changing Distributions

1. With limited exceptions, an NQDC plan may not accelerate the distribution of benefits.
2. Postponing distribution and changing form of distribution is permitted only if the following three conditions are satisfied:
 - a. election cannot take effect for a least 12 months after it is made;
 - b. election must defer the first scheduled payment by at least five years; and
 - c. election must be made at least 12 months before the first scheduled payment.

E. Elections to Defer Compensation

1. Generally, an election to defer compensation must be made by the end of the taxable year preceding the taxable year to which it relates.

F. Funding Rules

1. No offshore (outside of the United States) funding.
2. Rabbi trusts are still permitted.

G. Effective Date of Changes

1. Generally applies to deferral made after 2004 and to pre-2005 deferrals that are subject to a substantial risk of forfeiture on January 1, 2005.
2. If NQDC plan materially amended after October 3, 2004, all pre-2005 deferrals will be subject to new rules.
 - a. amending plan solely to comply with 409A is not a material modification, but adding a permitted feature like hardship withdrawal is a material modification.

H. What should employers do now?

1. Review all potentially affected plans and employment agreements with counsel to see if changes needed.
2. Plans must be amended by December 31, 2005 to comply with 409A.
3. Additional guidance on 409A will be released by IRS during 2005.

II. New IRS Determination Letter Procedures for Qualified Retirement Plans

A. Remedial Amendment Period

1. This is the period of time allowed by the IRS during which all required changes to a qualified plan must be made, and, if required, during which the plan must be submitted to the IRS for a favorable determination letter.
2. The GUST remedial amendment period has closed, and we are currently within the EGTRRA remedial amendment period.
3. The EGTRRA remedial amendment period will end not earlier than December 31, 2005, and IRS Announcement 2004-71 includes a proposed revenue procedure which would extend this period under a new staggered system.

B. Proposed Staggered Remedial Amendment Period System

1. Individually designed plans
 - a. Plans would be assigned to one of five 5-year remedial amendment period cycles (cycles A-E) determined by the last number of the sponsoring employer's tax identification number, and the plan sponsors would only have to apply for a new determination letter once every five years under the following chart:

Last Digit TIN	Plan's Cycle	Determination Letter Filing Period	Last Day EGTRRA RAP
1 or 6	A	2/1/06 – 1/31/07	1/31/07
2 or 7	B	2/1/07 – 1/31/08	1/31/08
3 or 8	C	2/1/08 – 1/31/09	1/31/09
4 or 9	D	2/1/09 – 1/31/10	1/31/10
5 or 0	E	2/1/10 – 1/31/11	1/31/11

2. Preapproved plans (volume submitter plans, master and prototype plans)
 - a. Regular 6-year amendment/approval cycles will be established.
 - b. For defined contribution plans, the preapproved plan sponsor (bank, insurance company, Corbel, etc.) will have from February 1, 2005 through January 31 or October 31, 2006 (the latter date applies to a “mass submitter”) to apply to the IRS for an determination letter on EGTRRA changes.
 - c. Employers will generally have two years to adopt the pre-approved plan—the actual deadline will be announced by the IRS at a later date.
 - d. Preapproved plan sponsor will not have to reapply to IRS for 6 years.
 - e. Deadlines for defined benefit plans are pushed back one year.

III. New Automatic Rollover Rules for Retirement Plans

- A. Most plans currently provide that if a terminated participant’s vested plan benefit does not exceed \$5,000, the plan will automatically cashout (make a mandatory lump sum distribution) the participant’s benefit.
- B. Effective on and after March 28, 2005, qualified plans may not make a mandatory distribution to a terminated participant of a benefit exceeding \$1,000 without the Participant’s consent.
- C. If no participant consent is given to a distribution exceeding \$1,000, the plan must make an automatic rollover to an IRA established for the participant.
- D. Plans that will comply with the new automatic rollover rules will need to enter into a written agreement with an IRA provider and comply with the new rules administratively by December 31, 2005. Plan should suspend making mandatory distributions in excess of \$1,000 on and after March 28, 2005 until new procedures are in place. Plan should adopt good faith model amendment by the end of the first plan year ending after March 28, 2005.
- E. Plans that do not want to comply with the new rules can amend the plan by the end of the first play year ending after March 28, 2005 to provide that the plan’s mandatory distribution provisions will apply only to benefits of \$1,000 or less.

IV. Designated Roth Contributions

- A. Beginning in 2006, a 401(k) plan may permit employees to designate some or all of their elective contributions as Roth contributions.
- B. Designated Roth contributions are included in the participants' gross income for the year of the deferral.
- C. Qualified distributions of designated Roth contributions and their earnings will be tax-free.
- D. A 401(k) plan must be amended to permit designated Roth contributions, and such contributions must be maintained in a separate account.
- E. Designated Roth contributions must satisfy the requirements applicable to pre-tax elective contributions, including:
 - 1. Must be nonforfeitable and subject to same distribution restrictions as pre-tax elective contributions.
 - 2. The designated Roth contributions count toward the annual dollar limit on elective deferrals (\$15,000 in 2006).
 - 3. Designated Roth contributions are included with pre-tax elective contributions under the actual deferral percentage (ADP) test.
- F. A qualified distribution of designated Roth contributions must meet two requirements:
 - 1. The distribution must occur after the five-taxable-year period beginning with the first taxable year for which the participant made the designated Roth contribution.
 - 2. The distribution must be made at or after age 59½, or on account of death or disability.

- G. Should employers amend their 401(k) plans to permit designated Roth contributions?
 - 1. Whether an employee is better off making an after-tax designated Roth contribution or a pre-tax contribution depends on a number of factors, but primarily depends on whether the employee's tax rate at the time of the contribution is higher or lower than his or her tax rate at the time of the anticipated distribution.
 - 2. All other things equal, if the employee anticipates that his or her tax rate will be higher at the time of the distribution, it is advantageous for the employee to make the designated Roth contribution.
 - 3. If the employee anticipates that his or her tax rates will go down in the future, it is generally preferable to make pre-tax 401(k) contributions.
- H. Disadvantages of Roth 401(k) Plan
 - 1. Substantial additional administrative burdens associated with maintenance of separate accounts, tracking five-year aging, changes to websites and participant statements, rollover elections, tracking and reporting tax basis, etc.
 - 2. EGTRRA sunset provision could cause this whole new Code Section 402A to go away in 2011.
 - 3. We do not anticipate a rush among plan sponsors to add designated Roth contributions to their 401(k) plans.
- I. Designated Roth contributions will be extended by Regulations to 403(b) plans in the future.
- V. 403(b) Plan Changes Under Proposed Regulations
 - A. 403(b) plans are available to schools and to 501(c)(3) exempt organizations.
 - B. In November 2004, the IRS issued comprehensive proposed regulations under 403(b), to be effective for years beginning after 2005.

C. Written plan requirement

1. For the first time, all 403(b) plans will have to be set forth in a written plan document or documents that contain all material terms and conditions for eligibility, benefits, limitations and time and form of distribution.
 - a. Optional provisions, like loans and hardship withdrawals, must be set forth.
 - b. No need for single plan document; could have a wrap document to supplement an annuity contract.
2. Creating a plan document will not automatically make the plan subject to ERISA. However, employer may undertake responsibilities pursuant to the plan document that may cause loss of the ERISA exemption.

D. Change in nondiscrimination rules applicable to 403(b) plans

1. Safe harbors provided in Notice 89-23 have been repealed.
2. 403(b) plans will now be subject to the same nondiscrimination rules on all employer contributions (other than elective deferrals) as apply to qualified plans.
 - a. Elective 403(b) contributions are not subject to an ADP test, although matching employer 403(b) plan contributions remain subject to 401(m).
3. New “Universal Availability” testing rules
 - a. All employees normally working more than 20 hours per week must be able to make salary reduction contributions of at least \$200.
 - b. The universal availability requirement is performed on a common-law employer basis, not on a controlled group basis.

- E. Regulations allow termination of a 403(b) plan.
 - 1. Plan termination rules are similar to 401(k) plan termination rules, i.e., 403(b) plan can not be terminated if another entity in same controlled group makes contributions to another 403(b) plan within twelve months before and after the date of plan termination.
 - 2. All 403(b) plan assets must be distributed as soon as administratively practicable; can be accomplished by delivery to employee of fully paid individual annuity contract.

- F. New controlled group rules for exempt organizations
 - 1. Common control exists when 80 percent or more of the directors of one organization are either representatives of or directly or indirectly controlled by the other organization.
 - 2. The Regulations also allow permissive aggregation of tax exempt organizations if they maintain a single plan and they regularly coordinate their day-to-day activities.