THE EMPLOYEE BENEFIT
Forum
current issues in retirement benefit planning

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A Costly Error

SITUATION: George's wife received benefits from her former employer's retirement plan for several years until her death. Then, the payments stopped because the plan had an election form on which she had indicated that she would take her benefits as a single-life annuity. George, however, had a copy of the same form that did *not* indicate a single-life annuity benefit choice. George thought he should receive survivor benefits and requested that the plan send him copies of the relevant documents. He received no response from the plan until after he had turned to the Department of Labor for help and brought suit against the plan.*

QUESTION: How quickly must a plan honor requests for plan documents by a plan participant or beneficiary?

ANSWER: Generally, a plan is required to provide plan documents to participants and their beneficiaries within 30 days of the request. If a plan does not comply in a timely manner, penalties may be imposed.

DISCUSSION: It took the plan two years from George's initial request to provide him with the documents he requested and to acknowledge his right to survivor benefits. Although the plan had a form signed by George waiving surviving spouse rights, the signature on that form had not been witnessed or notarized. So, George was entitled to survivor benefits of $277.90 a month.

A court judgment also awarded him $35,050 — $50 a day for the 701 days that elapsed between the plan's deadline for giving George the documents and the day on which the documents were actually provided. He also received over $19,000 in attorney's fees. A costly error indeed!

The plan's defense was disorganization due to a recent merger and poor recordkeeping by the former employer. A plan employee thought there might be a "lost page" with George's signature waiving survivor benefits that was notarized and witnessed. However, the court said that the disorganized state of the plan records should have alerted the plan to the possibility of missing documents. And it didn't explain the plan's failure to respond to George within 30 days.

COMMENT: While the plan's error was costly, it could have been worse. The statutory penalty for failing to honor a request for plan documents within 30 days is $110 a day. The court used its discretion and only fined the plan $50 a day for not responding to George's request.

* *Lowe v. McGraw-Hill Companies, Inc.*, 361 F.3d 335

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An Exception to the Rule

Generally, distributions from a qualified retirement plan made before age 59½ are subject to regular income tax and a 10% early distribution penalty tax. Distributions taken to pay medical expenses, however, may be excepted from this additional tax.

In order for medical expenses to qualify for the exception, they must be deductible expenses, unreimbursed by insurance or other reimbursement programs. They must also exceed 7.5% of the employee's adjusted gross income (AGI) for the year of distribution. However, employees don't have to itemize their deductions to take advantage of this exception to the 10% penalty.

Power Up Investments

With the overall U.S. stock market (as measured by the S&P 500 Index) posting a negative return for the first half of 2005, some plan participants may be remembering the down markets of 2000, 2001, and 2002 — and getting investment jitters. What can you do to keep these participants from becoming discouraged and moving their money from the stock investments they may need to achieve their retirement goals into fixed-income investments?

Asset Allocation and Diversification

A dose of employee education may be in order. Make sure your employees understand the principles of asset allocation and diversification and how applying these strategies to their plan investments works to their benefit.

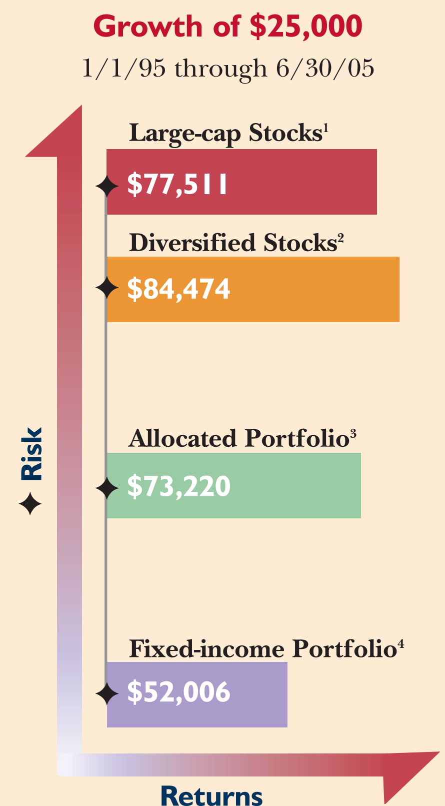
From a volatility perspective, an all-fixed-income portfolio may seem to many to be a "safe" and conservative approach to retirement investing. Over longer terms, though, the power of asset allocation and diversification becomes evident (see accompanying graph). Participants need to understand that diversifying their stock investments among several types of stocks, as well as allocating money to bonds and money market investments, can help them achieve the returns they need while providing some protection against stock market volatility.

Investment Choices

Considering the greater long-term growth potential of a diversified portfolio that includes stocks, you may want to review your plan's stock choices to make sure the plan offers participants the investments they need to adequately diversify their investments. We would be happy to help you with your review.

Growth of $25,000

1/1/95 through 6/30/05



[1] Represented by the S&P 500 Index

[2] 65% S&P 500 Index, 20% S&P 400 (mid-cap) Index, 10% S&P 600 (small-cap) Index, and 5% EAFE (international) Index, rebalanced annually

[3] 39% S&P 500 Index, 12% S&P 400 Index, 6% S&P 600 Index, 3% EAFE Index, 36% Lehman U.S. Aggregate Index, and 4% 3-month Treasury bills, rebalanced annually

[4] 90% Lehman Brothers U.S. Aggregate Index (bonds) and 10% 3-month Treasury bills, rebalanced annually

Sources: Russell Data Services and NPI

Safe Harbor 401(k) Plan — Right for You?

A 401(k) plan that fails the *actual deferral percentage* (ADP) nondiscrimination test typically must refund excess contributions to highly paid employees or recharacterize them as after-tax contributions. By adopting a safe harbor plan design, you can avoid annual ADP testing and the possibility of having to return or recharacterize contributions. You'll also avoid annual *actual contribution percentage* (ACP) testing. The following questions and answers may help if you're considering a safe harbor 401(k) plan.

How can we satisfy the safe harbor contribution requirements? You can choose a nonelective contribution of at least 3% of compensation or a qualifying matching formula.

The *basic matching formula* is 100% of the first 3% of compensation deferred, plus 50% of deferrals between 3% and 5% of compensation. An *enhanced matching formula* must provide matching contributions that equal or exceed those under the basic matching formula at any given deferral rate. (Other requirements apply.)

Can safe harbor matching contributions be stopped during the year? You can stop making safe harbor *matching* contributions during a plan year if you give your participants at least 30 days notice. But you'll have to perform both the ADP and ACP tests for the entire plan year.

Do we have any flexibility with nonelective contributions? A plan can call for either guaranteed or flexible contributions. You generally must make the guaranteed contribution for all employees who are eligible to make elective deferrals to your plan — regardless of your company's financial condition during the plan year. To eliminate future year contributions, you'd have to amend your plan *before the start of the new plan year* to remove the contribution provision.

With flexible contributions, you decide *each year* whether you'll provide the nonelective contribution. Employees must receive a "conditional notice" before the start of the plan year that you *may* make a safe harbor contribution and another notice by the start of your plan year's 12th month that the contribution is (or is not) being made. You don't have to test for discrimination if you contribute. If you don't contribute, the testing requirements apply.

What other requirements apply? You must provide a notice of rights and obligations under the safe harbor 401(k) plan to all eligible employees between 30 and 90 days before the start of *each* plan year. Employees who will become eligible during the year must be given reasonable advance notice. In addition:

- All safe harbor contributions are immediately 100% vested.
- You can't set conditions on the receipt of safe harbor contributions — for example, that plan participants be employed on the last day of the plan year or work at least 1,000 hours during the plan year. (However, the plan can have minimum age and service requirements that employees must meet before they are eligible for plan participation.)
- Safe harbor contributions can't be available for in-service withdrawal before age 59½.

Can we change our plan for this year? You can't add safe harbor provisions to an existing 401(k) plan during a plan year. Rather, you must amend your plan to add a safe harbor design for the next plan year. The amendment must be adopted before the first day of the new plan year.

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

RECENT DEVELOPMENTS
In Benefit Plans

Discretion Over Use of Corporate Funds Doesn't Create a Fiduciary. A federal appeals court recently ruled that a corporation's owners did not become plan fiduciaries simply because they had the discretion to pay unsegregated employer contributions to various ERISA-covered employee benefit plans from the corporate treasury. The court agreed with the lower courts' conclusions that the unpaid contributions were not "plan assets," though the plans' right to collect unpaid contributions was a plan asset. It was also determined that the amounts owed to the benefit plans could be discharged in bankruptcy.

Who's Saving for Retirement? According to the Employee Benefit Research Institute's *2005 Retirement Confidence Survey*, men are more likely than women to be currently contributing to their employer's retirement plan. However, some of this difference can be attributed to the fact that men are more likely (57%) than women (45%) to have an employer sponsored plan at work. And employees ages 35 to 54 are more likely to be currently contributing than younger employees. The surprise may be that employees age 55 and older are less likely to currently contribute.

% of Employees Who Contribute to an Employer's Plan

All	Men	Women	Ages 25-34	Ages 35-44	Ages 45-54	Ages 55+
42%	48%	36%	40%	45%	45%	36%

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