

Improperly Excluded Employees

SITUATION: We recently discovered that one of our employees became eligible to participate in our 401(k) plan in February. However, she was not notified of her eligibility, nor invited to attend our monthly enrollment meeting. We notified her as soon as we found the error, and she joined the plan on September 1.

QUESTION: Can we correct the mistake without being penalized for our error?

ANSWER: Yes. You can use the U.S. Department of Labor's recently updated Employee Plans Compliance Resolution System (EPCRS) to bring your plan back into compliance with the tax law. The Self-Correction Program (SCP) component of EPCRS lets a plan sponsor identify and correct operational failures without notifying the IRS or paying any fee.

DISCUSSION: Under the old EPCRS, employers could correct full-year exclusions by making a qualified nonelective employer contribution (QNEC) to the excluded employee's account to make up for the employee's "lost opportunity" to make elective deferrals (other than designated Roth contributions). The QNEC was calculated by multiplying the employee's compensation during the period of exclusion by the actual deferral percentage (ADP) of the employee's group — nonhighly compensated employee or highly compensated employee.

The new EPCRS allows employers to correct partial-year exclusions. And it adds a new correction method that is generally less costly

to employers: The employer must make a QNEC equal to 50% of the amount calculated under the old method.*

For example, let's say your employee is a nonhighly compensated employee whose compensation during the exclusion period was \$17,500. (You can use a prorated share of the annual compensation.) Your ADP for nonhighly compensated employees is 3%. To correct your error, you would need to make a QNEC of \$262.50 to the employee's plan account ($\$17,500 \text{ compensation} \times 3\% \text{ ADP} = \$525 \times 50\% = \$262.50$).**

If you make employer matching contributions, you would also have to make a contribution equal to the match on \$525. For instance, if your employer match is 50% of employee contributions up to 5% of compensation, your matching contribution would be \$262.50.**

The "missed deferral opportunity" correction method cannot be used until after any necessary ADP and ACP test failures have been corrected.

* Special rules apply to safe harbor 401(k) plans.

** Required contributions must be adjusted for earnings until the contributions are made.

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The State of Retirement

Employer-sponsored retirement plans play an integral role in Americans' retirement planning, according to a report recently released by the Investment Company Institute.* Here are the report's findings.

- Retirement assets reached an all-time high of \$14.5 trillion in 2005. This is a 7% increase over 2004. They now account for more than one third of all household financial assets.
- Nearly two thirds of retirement assets are held in employer-sponsored retirement plans.

- A significant portion of assets in IRAs was rolled over from employer plans.
- In 2005, 401(k) plan assets were up 8% to \$2.4 trillion. 401(k) plan assets have increased 55% since 2002.
- Assets in defined contribution plans and IRAs continued to grow more rapidly in 2005 than assets in other types of plans.
- In total, defined contribution plans and IRAs make up 51% of retirement assets, up from 39% in 1990.

* Peter Brady, Senior Economist, and Sara Holden, Senior Economist, *The U.S. Retirement Market, 2005*, Investment Company Institute, www.ici.org.

When Employers Delay

Employee deferred contributions to 401(k) plans must be deposited in the plan as soon as they can reasonably be segregated from the employer's general assets — which may be as soon as two or three days after they are withheld.* If an employer does not timely deposit employee contributions, the employer could be subject to an excise tax for participating in a prohibited transaction.

Excise Tax on Late Deposits

The excise tax is two-tiered. The initial tax is 15% of the “amount involved.” The second-tier tax applies if a prohibited transaction is not corrected during the taxable period. The second-tier excise tax is 100% of the amount involved.

New IRS Guidance

The IRS recently provided guidance on determining the “amount involved” for purposes of the 15% excise tax on late deposits. According to the guidance, the amount involved if an employer does not timely pay participant deferrals to its plan is based on interest on the deferrals. For late deposits that go uncorrected into a second plan year, the amount involved for the first year is interest on the undeposited amount. The amount involved for the second year is interest on the new balance owed to the plan.

* In no event should the deferrals be deposited later than the 15th business day of the month following the month the deferrals are withheld.

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The Pension Protection Act of 2006

Long-awaited pension reform is now law. The Pension Protection Act of 2006 (PPA) contains a broad range of provisions that affect retirement plans, sponsoring employers, and participating employees. Of particular interest to 401(k) plan sponsors, the law makes permanent all changes related to retirement plans made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). It also includes incentives to encourage greater participation in retirement savings plans.

What EGTRRA provisions have been made permanent? The higher maximum annual salary deferrals to 401(k), 403(b), and 457 plans are now permanent, as are catch-up contributions for individuals age 50 and older, increased maximum contributions to individual retirement accounts, the option to treat elective deferrals as after-tax Roth contributions (if the plan permits), and the Saver's Credit for lower income individuals who save for retirement.

Does the law address automatic enrollment? Yes. PPA includes rules that make 401(k) plans with an automatic enrollment feature eligible for safe harbor treatment under the actual deferral percentage (ADP) and actual contribution percentage (ACP) nondiscrimination tests. It also provides plan sponsors that meet the law's requirements with relief from fiduciary liability with respect to default investments for employees who fail to direct their plan account investments. And it eliminates conflicts with state laws on wage withholding without employee consent. These changes are generally effective for plan years beginning on or after January 1, 2008.

What about investment advice? As expected, PPA includes provisions for providing employees with professional investment advice. Under the law, a retirement plan service provider (a "fiduciary adviser") can provide advice and, if warranted, recommend its own funds as part of an investment advice arrangement without violating fiduciary rules if certain

requirements are met. The arrangement must either be "fee neutral" with respect to the investments chosen *or* use an unbiased computer model certified by an independent expert to create a recommended portfolio for a participant's consideration. These rules generally apply beginning in 2007.

How does the new law affect distributions? Distributions are affected in several ways. Beginning in 2007, non-spouse plan beneficiaries can roll over inherited benefits to their own IRAs. Previously, only surviving spouses could do this. Non-spouse beneficiaries generally must begin receiving distributions immediately. Surviving spouses can continue to defer payouts until they turn age 70½. In addition, hardship withdrawals are permitted for hardships affecting a plan beneficiary who is not the participant's spouse or dependent.

Starting in 2008, employees can directly roll over distributions from 401(k) and other qualified plans, 403(b) plans, and governmental 457 plans to Roth IRAs. These rollovers will be taxable events at the time of the rollover.

What's new in the area of reporting and disclosure? For plan years starting after 2006, sponsors of 401(k) and other defined contribution plans that allow participants to direct their own investments must provide benefit statements at least quarterly. Defined contribution plans that don't allow participant investment direction must provide statements at least once a year. The U.S. Department of Labor will issue model benefit statements showing the information sponsors should include.

These are only some of the many PPA changes that could affect your retirement plan.

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 adviser 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

Mandatory Electronic Filing.

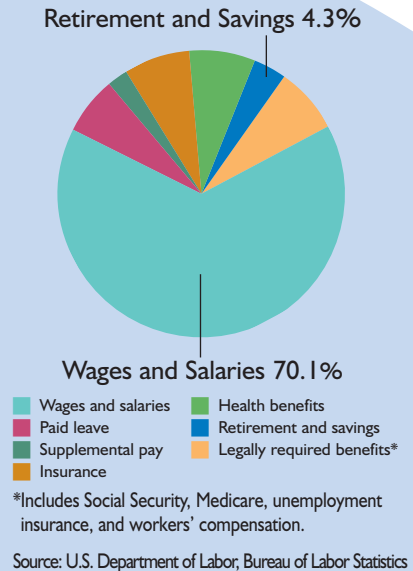
The U.S. Department of Labor's Employee Benefits Security Administration (EBSA) has issued a final regulation requiring retirement plans to file IRS Form 5500 annual reports electronically beginning with the 2008 plan year. EBSA and the IRS will be updating Form 5500. Among the proposed changes:

- Creation of a new short form for small plans whose assets are held in easy-to-value investments with regulated financial institutions,

- Removal of IRS-only schedules from the form, and
- Modification of the reporting rules for 403(b) plans to make them compatible with those of 401(k) plans.

Employee Compensation.

A recent report from the U.S. Department of Labor's Bureau of Labor Statistics pegs the average employer cost for employee compensation at \$26.86 per hour. Of this amount, \$1.15, or 4.3%, goes for retirement benefits.



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