THE EMPLOYEE BENEFIT
Forum
current issues in retirement benefit planning

NORTH CENTRAL TRUST COMPANY
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Correcting Excess 401(k) Contributions

SITUATION: Our 401(k) plan is tested annually to see whether it discriminates in favor of highly compensated employees. This year, our plan failed the "actual deferral percentage" (ADP) test for the first time.

QUESTION: What should we do?

ANSWER: To avoid possible plan disqualification, you need to take corrective measures.

DISCUSSION: The ADP test compares the average rate at which highly compensated employees defer salary with the average deferral rate for nonhighly compensated employees. The difference between highly paid and lower paid employees must be within certain defined limits. If it isn't, you must correct the excess contributions made by the highly compensated employees.

You have three choices for doing so.

Refunding. The plan can return the excess contributions and any plan income attributable to those contributions to the appropriate highly compensated employees within 12 months of the close of your plan year. The refunds will be taxable to the employees.

Recharacterization. Alternatively, the plan can recharacterize the excess contributions as after-tax contributions. To recharacterize the excess contributions, your plan must have a provision allowing after-tax contributions and the recharacterization must occur no later than 2½ months after plan year-end. The amounts recharacterized are includable in the highly compensated employees' income for federal income-tax purposes.

If allowed by the plan, an excess contribution made by an employee who is age 50 or older may be treated as a catch-up contribution, to the extent the employee hasn't already made the maximum allowable catch-up contribution for the year. This treatment avoids the need to recharacterize or refund the excess amount.

Additional contributions. Another alternative is to make additional qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs) to nonhighly compensated employees. Such contributions will be treated as elective contributions for ADP testing purposes until the plan satisfies the nondiscrimination test.

In this way, excess contributions can be eliminated. Take care when using this remedy. Generally, you need to limit QNECs to 5% or less of compensation. Otherwise, complicated restrictions apply.

Talk with your employee benefits professional if you think your plan may fail the nondiscrimination tests.

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Rightsizing Your Fidelity Bonding

When was the last time you checked your retirement plan's fidelity bond? As more assets accumulate in your plan or different individuals become responsible for managing the plan, bonding requirements may change.

The purpose of a fidelity bond is to protect the retirement plan against misappropriation of funds by individuals handling the plan's assets. Generally, under pension law (ERISA), every plan fiduciary — including the sponsoring employer, plan trustee, investment manager, and plan administrator — and any other person who handles plan money must be bonded.

The face amount of the bond must be at least 10% of the plan assets handled, with a minimum bond requirement of $1,000 and maximum, generally, of $500,000. (In certain situations, a higher bond may be required.) The bond amount must be fixed at the beginning of each plan year, so it's a good idea to check your fidelity bond as part of your annual plan review.

A New Way To Contribute

Starting in 2006, employers that sponsor 401(k) plans or 403(b) tax-sheltered annuities can voluntarily offer employees a new way to contribute to their plans — *after-tax* Roth contributions. Unlike traditional pretax plan contributions, Roth contributions are subject to current income taxes. Once in the plan, the contributions grow tax deferred. Withdrawals of both Roth contributions and their earnings are not taxed if certain tax law requirements are met.

Highly compensated employees who cannot contribute to Roth IRAs because their incomes are too high may welcome the opportunity to make Roth contributions to an employer's plan. Roth contributions also might appeal to younger employees who would potentially benefit from many years of tax-free growth.

Plans that offer Roth contributions must continue to offer traditional contributions and allow employees to choose between the two. Plans can be structured to allow employees to make both types of contributions at the same time. An employee's total deferrals for the year — Roth and pretax combined — cannot exceed the 2006 statutory limit of $15,000 ($20,000 for employees age 50 and older) or the plan's limit, if lower.

Roth money must be kept separate from other retirement plan assets. This could be done by separately designating Roth contributions and earnings in an employee's plan account, much the same way different contribution types are accounted for now (for example, salary deferrals versus employer contributions). Gains and losses also have to be allocated among the contribution sources. Similarly, payroll systems must be adapted to separate Roth contributions from other types of plan contributions.

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More Options for Hardship Distributions

401(k) hardship distributions are designed to give employees access to their plan accounts when they have an "immediate" and "heavy" financial need. If your plan allows such distributions, be aware that final regulations issued last year expand their availability — generally effective for plan years after 2005.

What are the changes? Employees are no longer required to take a plan loan before taking a hardship distribution if taking the loan would be counterproductive. For example, it would be counterproductive if an employee needed funds to buy a principal residence and having a plan loan would disqualify the employee from obtaining other necessary financing.

In addition, two new situations have been added to the list of "safe harbor" expenses that qualify for a hardship withdrawal: funeral expenses and costs to repair damage to a principal residence. The regulations also clarify that all medical expenses that meet the tax law's definition of a deductible medical expense — not just the amount that exceeds 7.5% of adjusted gross income — can be counted in determining whether the employee has an immediate and heavy need.

When can a 401(k) plan make a hardship distribution? It depends on the method used to define hardship. Where a plan uses the *facts-and-circumstances method*, the plan administrator reviews all relevant facts and circumstances in each individual situation. While the plan generally can allow a hardship distribution for any reason, it must have established rules to ensure that the distribution will be used for an immediate and heavy financial need.

Under the *safe-harbor method*, a plan can allow hardship distributions to be taken for the following reasons: (1) to pay medical expenses within prescribed limits; (2) to purchase a principal residence; (3) to cover post-secondary educational expenses for the participant, the participant's spouse, children or dependents; (4) to prevent eviction from or foreclosure on a principal residence; (5) to pay the funeral expenses of a spouse, parents, children, or dependents; and (6) to repair damage to the employee's principal residence that would qualify for the income-tax casualty loss deduction (without regard to whether the loss exceeds 10% of adjusted gross income).

Is need the only requirement? No, an employee should represent in writing that he or she cannot attain the funds through other means, such as reimbursement by insurance, liquidation of the employee's assets (unless liquidation would cause immediate and heavy need), cessation of elective or employee contributions to the plan, withdrawals/loans from employer plans, and borrowing from commercial sources on reasonable terms.

Plans using a safe harbor method of determining whether a distribution is necessary must restrict the employee from contributing to the plan for six months following the hardship distribution.

How much can be distributed? Hardship distributions generally are limited to the amount of total elective contributions minus the amount of any previous hardship distributions. The distribution cannot be more than the employee's immediate and heavy need — including the amount required to pay any federal, state, or local income taxes or penalties that are reasonably expected to result from the distribution.

What are the tax consequences of a hardship distribution? Hardship distributions are taxable to the employee and, possibly, subject to a 10% early withdrawal penalty if the employee is under age 59½. Distributions made because of disability or for qualifying medical expenses that *exceed* 7.5% of the taxpayer's adjusted gross income for the year of the distribution are excepted from the early withdrawal penalty.

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

2006 Cost-of-living Adjustments. The IRS has released the annual cost-of-living adjustments for various retirement plan limitations. Most of the limitations have increased for 2006. In addition, some limitations, such as the maximum 401(k) plan, 403(b) plan, SIMPLE plan, and 457 plan elective deferrals, are increased by statute. Also, in October, the Social Security Administration announced an increase in the Social Security taxable wage base effective January 1, 2006.

	2006	2005
Defined Contribution Plan Dollar Limit on Annual Additions	$44,000	$42,000
Defined Benefit Plan Limit on Annual Benefits	$175,000	$170,000
Maximum Compensation Used To Determine Benefits or Contributions	$220,000	$210,000
401(k), SARSEP, 403(b), and 457 Plan Deferrals/Catch-up	$15,000/$5,000	$14,000/$4,000
SIMPLE Deferrals/Catch-up	$10,000/$2,500	$10,000/$2,000
IRA Contribution/Catch-up	$4,000/$1,000	$4,000/$500
Compensation Defining Highly Compensated Employee	$100,000	$95,000
Compensation Defining Key Employee (Officer)	$140,000	$135,000
Social Security Taxable Wage Base	$94,200	$90,000

Electronic Transmission Guidance. The IRS has issued proposed regulations regarding the use of electronic media to provide notices to employee benefit plan participants and beneficiaries and to transmit elections or consents from them to such plans.

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