Action Items

October, 2003

a newsletter for ACI's clients and their advisors

Planning For the Year-End

by Tobi Cogswell, Consulting Administrator

If you sponsor a defined contribution plan, it's likely that your plan year ends on December 31st. It's also probable that your plan requires 1,000 hours of service and employment on the last day of the plan year in order to receive an allocation of any employer contributions (other than safe harbor or top-heavy minimum contributions). If this fact pattern is true of your plan, this effectively means that you have until December 30th to make changes to your plan for 2003. Below are some changes you might want to consider:

Allocation Method

If you allocate your profit sharing contribution in the ratio of one participant's compensation to total compensation, consider an integrated allocation or a tiered allocation method.

Integrated allocations provide an additional contribution to those people earning in excess of the social security wage base ($87,000 in 2003). The logic behind this approach is that people who earn more than the wage base do not receive social security benefits on the excess earnings. Thus, the IRS permits employers to make additional profit sharing contributions on behalf of these individuals.

The tiered allocation method calculates the current contribution for each participant as a benefit at retirement. This approach recognizes that if an employer makes a profit sharing contribution on behalf of a young employee today, that same contribution often yields a lower retirement benefit to an older employee. For example, identical $100 profit sharing contributions made to a 55 year-old and a 25 year-old will result in different retirement benefits. Why? Because the 25 year-old will gain substantially more than his 55 year-old counterpart on this $100 contribution since he has an extra 30 years to accumulate earnings. This disparity can permit larger profit sharing allocations to highly compensated employees (who are generally older than most other employees) as long as mathematically equivalent retirement benefits are provided to staff. The following table illustrates this approach:

	Jane	John
Age	28	56
Annual Salary	$35,000	$150,000
Tiered Profit Sharing Allocation	$1,750	$30,000
Percentage of current salary	5%	20%
Monthly Benefit at age 65	$600.60	$655.42
Monthly Benefit at age 65 as a % of monthly pay	20.59%	5.24%

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Fiduciary Liability 101:
Who's a Fiduciary?

The question of who is a retirement plan fiduciary is one of the least understood in our industry. But now more than ever before, people who suspect they *might* be considered fiduciaries are seeking to confirm their status. With the Department of Labor becoming increasingly eager to investigate fiduciary breach claims, it's vital that a retirement plan's fiduciaries understand their responsibilities and liabilities.

So who is a fiduciary?
The dictionary defines a fiduciary as "a person to whom power is entrusted for the benefit of another." And so it is under retirement plan law. Under ERISA, a plan fiduciary is any person who:

1. Exercises any discretionary authority or control over a plan's management;
2. Exercises any authority or control over the management or disposition of a plan's assets;
3. Renders investment advice, for a fee or other compensation, with respect to plan funds or property; or
4. Has any discretionary authority or responsibility in the plan's administration.

The test for determining fiduciary status is a functional one. By that, we mean that if a person or an entity has or exercises any of the functions described by ERISA, the person or entity will become a "functional" fiduciary.

A retirement plan will always identify at least one "named" fiduciary. That named fiduciary will be a trustee, a person, group of people, such as a committee, or the sponsoring organization. In addition, however, other people can be functional fiduciaries based on the guidelines above. Common functional fiduciaries include executives responsible for selecting service providers, or HR staff members responsible for the day-to-day administration of a retirement plan. Often, both sets of individuals are surprised to discover that the Department of Labor considers them to be fiduciaries.

What to do?
The first step to managing fiduciary liability is to understand it. ACI's consultants can assist retirement plan fiduciaries in this process. Contact your plan administrator or one of our consultants for more information on these services.

At Long Last! Treasury Issues Proposed 401(k) Regulations

by Craig Handa, Consulting Actuary

The Treasury issued proposed regulations on July 17, 2003 which are a compilation of the statutory changes made to 401(k) plans since 1997, as well as further modification of some of these changes. The proposed regulations would become effective in the second plan year following the publication date of the final regulations. Since it is unlikely that the final regulations will be published this year, the proposed regulations likely will not take effect earlier than plan years beginning in 2006.

Following is a summary of a few of the items contained in the proposed regulations not already discussed elsewhere in this newsletter (see Page 5 for Selective QNECs):

- Corrective distributions for failed ADP or ACP tests must include earnings for the "gap period" (i.e., from the end of the plan year to the date of distribution). Currently, gap period earnings are only included in the corrective distributions if the 401(k) plan document provides for the distribution of gap period earnings. This rule would affect 401(k) plans that credit earnings to account balances during the gap period (i.e., daily-valued 401(k) plans or quarterly-valued 401(k) plans that do not make corrective distributions within the first quarter following the close of the testing year).

  For example, suppose you have a 401(k) plan where account balances are valued at the end of each quarter. The distributions made during a quarter are based on the accounts balances from the *prior* quarter. If corrective distributions have to be made for a failed 2006 ADP test, corrective distributions made after March 31, 2007 must include the gap period earnings from December 31, 2006 to the date of distribution. If the corrective distributions are made by March 31, 2007, then you would not be required to include the gap period earnings because the distributions would have been made before the next quarterly valuation date.

- The safe harbor 401(k) plan rules would prohibit allocation conditions on *any* matching contributions used to satisfy the safe harbor requirements. Examples of allocation conditions are working 1,000 hours of service during the plan year and being employed on the last day of the plan year.

  A safe harbor 401(k) plan that satisfies the safe harbor requirements for the ADP test through the 3% non-elective contribution *and* makes additional matching contributions would need to have the matching contributions available to all employees who are eligible to make elective deferrals during the plan year in order to satisfy the safe harbor requirements for the ACP test. This would include eligible employees who have terminated employment during the plan year. It is worth noting here that the 3% non-elective contribution used to satisfy the safe harbor requirements for the ACP test does not automatically exempt the 401(k) plan from the ACP test for matching contribu-

tions. There are other requirements which will need to be satisfied to avoid the ACP test.

- The pre-funding of elective deferrals and matching contributions on a deductible basis related to future service will no longer be permitted. Any pre-funded elective deferrals or matching contributions would be treated as a non-elective contribution (profit sharing contribution) that have to be allocated based on the allocation conditions for non-elective contributions. The employer would still have the obligation to contribute the elective deferrals and matching contributions to the 401(k) plan for the period in which they were pre-funding without taking into account the pre-funded contributions.

  Pre-funding generally occurs when a company's fiscal year is different from the plan year. For example, a company had a fiscal year ending September 30, 2006 and a plan year ending December 31, 2006. If this company decided that it wanted to deduct on its September 30, 2006 tax return the elective deferrals and matching contributions for the period from October 1, 2006 to December 31, 2006, the company would determine what those contributions are in that period and contribute that amount by September 30, 2006. Under the proposed regulations, that pre-funded amount would not be deductible on the September 30, 2006 tax return but on the September 30, 2007 tax return. That pre-funded amount would also be considered a non-elective contribution for the December 31, 2006 plan year, and the company is obligated to contribute the elective deferrals and matching contributions for that period on each payroll date.

The proposed regulations state that we may not rely upon them until they are finalized. In the meantime, the current rules should be used even if the proposed regulations would modify any guidance that has been issued by the IRS. In the case where the proposed regulations do not conflict with current guidance, they may provide insight into the interpretation of the 401(k) rules.

Safe Harbor 401(k) for 2004

by Tobi Cogswell, Consulting Administrator

Do you have a 401(k) plan that has been failing ADP/ACP tests year after year? Are you tired of making refunds to highly compensated participants, including yourself? Have you been limited in the amount of deferrals you can contribute due to poor participation by your non-highly compensated employees? Consider adding a safe harbor provision to your plan.

Safe harbor contributions can be made in one of two ways; as a profit sharing contribution or as a match. The profit sharing contribution is 3% of compensation. The matching contribution is generally 100% of the first 3% of compensation deferred, plus 50% of the next 2% of compensation deferred. All safe harbor contributions must be 100% vested and allocated without regard to hours worked or employment on the last day of the plan year. The benefits you reap, however, for this outlay to those who might not otherwise receive a contribution, are great.

By making safe harbor contributions, a plan automatically passes the ADP and ACP tests. Safe harbor contributions also permit all highly compensated participants to defer the maximum allowable, $13,000 in 2004 (plus a $3,000 catch-up if the participant is age 50 or older and the plan includes this provision), regardless of the deferral rate of non-highly compensated employees.

If using the profit sharing method and your plan is top heavy (more than 60% of the plan benefits are attributable to Key employees), safe harbor contributions satisfy the top heavy minimum. If using the profit sharing method and your plan has a tiered allocation (cross-tested) formula, safe harbor contributions satisfy the first 3% of the required Gateway contribution.

If using the matching method and your plan is top heavy, the safe harbor match may help satisfy the top heavy minimum. If you have poor participation, adding a safe harbor match, which benefits those participants who defer, may be more cost-effective than using the profit sharing method which benefits anyone who became a participant during the plan year. This, however, is highly dependent upon the size and demographics of your organization. Smaller organizations with primarily lower-paid workforces may see little increase in staff costs when implementing a safe harbor matching contribution. However, larger organizations, as well as those with many middle-income employees, may see a substantial increase in staff costs with a safe harbor match.

Although safe harbor contributions are generally discussed in terms of being allocated to all participants, the plan sponsor does have the option of not including highly compensated participants in the allocation. Safe harbor contributions also do not have to be allocated to anyone with less than one year of service or younger than age 21, so you may have a plan with very liberal eligibility and still take advantage of adding safe harbor provisions in a manageable way.

It is important to note that having a safe harbor plan requires notices to be distributed to participants prior to the beginning of a plan year, and in certain circumstances, once during the plan year. It also requires an amendment to the plan which we recommend you do on a year-by-year basis in order to avail yourself of maximum flexibility in terms of the operation of your plan. **For calendar-year plans, the first notice must be distributed no later than December 1, 2003 for the 2004 plan year.**

If you would like to learn more about safe harbor plans and whether this option might be right for you, contact your ACI plan administrator as soon as possible so that amendments and notices can be prepared for you on a timely basis.

Because Jane's monthly benefit at retirement—as a percentage of pay—is higher than John's, this allocation structure passes nondiscrimination tests.

Allocation Tiers

All participants in a particular allocation tier normally receive the same dollar amount or percentage of compensation. There could be more complicated allocation formula if desired. The actual contribution amounts are discretionary per tier—they may change from year to year. There are some statutory contributions that all non-highly compensated participants must receive if highly compensated employees receive contributions ("Gateway" contributions), but otherwise it is up to the plan sponsor to determine how much is contributed to each tier.

New Owner

If you currently have a tiered allocation formula, review the tiers to make sure they still meet your goals. For example, your plan may currently have John, Sara and James in Tier 1, and "all other participants" in Tier 2. Prior to 2003 John, Sara and James were 33.33% owners of the company. During 2003, Elizabeth became an owner of the company, with ownership now split equally among her, John, Sara and James. When calculating profit sharing allocations at year-end, Elizabeth will be in Tier 2 with "all other participants," because she is not specifically named as a member of Tier 1. Elizabeth may not be happy with this.

Family Members of Owners

Consideration must also be given if a child of an owner is hired and becomes a plan participant. Without modifying the plan document, the child will probably be put in the "staff" tier, yet by putting the child in his own tier—and possibly not providing him with a benefit—you might avoid an excessive increase in the staff allocation rate. This type of modification must be done before the end of the plan year.

High Performers

You may also wish to single out some participants for exemplary work performed during the year. By naming them into another tier (other than the "all other participants" tier), you have the flexibility of giving them a higher contribution. Remember that you do not have to designate the contribution amount for this tier in the plan document, only the members of the tier.

Tier Composition

You have great flexibility in structuring allocation tiers. Tiers may be defined by specific job classes, length of service, participants by name, etc. Two things must be kept in mind:

1. As long as it is not discretionary or in violation of any anti-discrimination legislation, a tier can be created.

2. As long as the tier does not have any direct effect upon the compensation of a participant, it is permitted. If a participant can say "put me in the $20,000 tier" and that participant's compensation is reduced to fund that contribution, you have now effectively created a "jumbo 401(k) plan, which is not permitted under the Internal Revenue Code.

Terminated Participants

Your plan has specific distribution procedures for paying out terminated participants. Distributions may be made on an annual basis after the valuation has been done for a specific year, or if you have a 401(k) plan with daily recordkeeping, the timing of distribution is probably "as soon as administratively feasible" after the date of termination.

Regardless of the procedure, most plans have at least several terminated participants with account balances that have not yet been paid out. You should take steps to make these distributions before the end of the year for several reasons, the most important being that terminees with account balances are included in the participant count for purposes of determining whether or not an independent audit is needed for your IRS Form 5500. The participant count is determined as of the first day of the plan year; therefore, if these participants are not paid out by year-end, you will find yourself in the situation of having to count them as participants for next year. Once you go over a count of 120, an audit by a qualified accountant will be required. Also, the longer you wait, the harder it may be to find some of these terminated participants.

All terminated participants should be contacted to remind them that they have a distribution due and to provide them with a tax notice which has information regarding various distribution options. This communication should be sent certified, both to confirm the address and to prove that you tried to contact them. After a certain amount of time (30 or 60 days) you can process an involuntary distribution *for participants with account balances of less than $5,000*. You simply prepare the distribution forms, sign as plan sponsor, and forward them to ACI for processing and forwarding to the recordkeeper. Federal Withholding will automatically be deducted and the participants will "officially" be out of the plan. You will no longer have to send them a Summary Annual Report each year, you will no longer have a responsibility to keep track of them for Minimum Distribution purposes, and they will not have to be reported on Schedule SSA.

For participants with account balances of greater than $5,000 you can only continue to remind them periodically that they have account balances and hope they withdraw from the plan.

Next Steps

If you would like to make some changes to your plan, what should you do? Schedule a meeting or phone call with your plan administrator to discuss changes you would like to incorporate for your plan year ending December 31, 2003. We can discuss your goals for the operation of the plan and suggest changes both for the 2003 year-end and future years.

WE'VE MOVED *As of August 25th, ACI moved into our new facility at **2377 Crenshaw Blvd. Suite 350, Torrance, CA 90501**. Our new phone number is **(310) 212-2600**; the new fax number is **(310) 212-2650**.*

*Visit our website at **www.acibenefits.com***
For an ACI brochure, contact Lace Greene at lace.greene@acibenefits.com

Selective QNECs Live On...

At Least Temporarily

by Jeff Wallace

After considerable delay, the IRS released proposed regulations related to 401(k) plans. A separate article in this issue of Action Items includes a summary of the significant elements of these regulations. Of particular interest, though, to 401(k) plan sponsors will be the reprieve—albeit temporary—of "selective QNECs," a valuable tool used to correct nondiscrimination test failures.

What is a QNEC?
A QNEC is a Qualified Non-Elective Contribution made by an employer to an employee's account. Simply put, it's a discretionary employer contribution that is made regardless of an employee's participation in a retirement plan. In effect, a QNEC looks a lot like a profit sharing contribution. Current regulations permit QNECs to be made on behalf of groups of employees or selectively to individual employees.

When are QNECs used?
QNECs are used in a variety of settings, but the approach that has been under IRS scrutiny is the use of "selective QNECs". These are typically used when a plan fails an Average Deferral Percentage (ADP) test.

How do selective QNECs work?
Under the current regulations, it is permissible for an employer to make a contribution on behalf of a non-highly compensated employee, and to consider that contribution a salary deferral for ADP testing purposes. The following example helps to illustrate the effectiveness of selective QNECs:

Employee	Tracy	Jane	Bill*
Highly Compensated or Non-Highly Compensated Employee	HCE	NHCE	NHCE
Compensation	$200K	$50K	$2.8K
Deferral	$10K	$2K	$0
Deferral %	5%	4%	0%

**Bill terminated service after the first month of the plan year.*

In this example, the average deferral percentage for non-highly compensated employees is 2%. The average deferral percentage for highly compensated employees is 5%. The maximum allowable deferral percentage, though, for highly compensated employees in this setting is 4%. Thus, the ADP test fails and corrective measures are required. These measures come in a variety of forms. The most common is refunds of deferrals to highly compensated employees. In this case, Tracy would need to receive a refund of $2,000 in order to decrease her deferral rate to 4%.

Enter the selective QNEC. In this example, the employer could make a contribution of $56 on behalf of Bill. This contribution, which amounts to 2% of Bill's compensation, increases the average deferral percentage for the non-highly compensated group to 3%, which allows the ADP test to pass.

This $56 contribution may be more palatable to an employer than a $2,000 refund to a key employee. Some employers might choose to make the QNEC on behalf of Jane, who is still employed by the company. The idea of making a contribution—regardless of the amount—on behalf of a terminee may be unthinkable to some employers. The difference in cost, though, is substantial: A 2% QNEC to Jane amounts to $1,000.

What's the problem with selective QNECs?
The IRS views selective QNECs as abusive because, under certain circumstances, employers can effectively nullify adverse ADP test results by making miniscule contributions to small groups of employees. While this approach is currently allowable under the letter of the law, the IRS feels that it is not within the spirit of the law. As a result, selective QNECs are essentially being eliminated under the proposed 401(k) regulations.

How much longer will plan sponsors be able utilize selective QNECs?
The proposed regulations will not go into effect until the first plan year that begins 12 months after publication of the final regulations. It appears unlikely that the final regulations will be published before January 1, 2004. Consequently, the regulations probably won't impact plans until the 2006 plan year, or later. For calendar-year plans, this means selective QNECs will likely still be available through the 2005 plan year. If you would like to utilize selective QNECs, contact your plan administrator to determine whether your document permits them.

Cash Balance Pension Plans

by Craig Handa, Consulting Actuary

Once again, cash balance pension plans are being challenged in court. Two recent court cases have ruled against the cash balance pension plans sponsored by IBM and Xerox. In the IBM case, the plaintiffs argued that there was age discrimination. In the Xerox case, the plaintiffs argued that there was an impermissible forfeiture on the part of employees who terminated employment before their normal retirement date.

In the IBM case, the plaintiffs claimed that the conversion from a traditional defined benefit pension plan to a cash balance pension plan violated provisions of the Employee Retirement Income Security Act of 1974 (ERISA) which prohibits the reduction of a participant's accrued benefit or the rate of benefit accrual on the basis of age. A participant's accrued benefit in a cash balance pension plan is based on his or her hypothetical account balance which is credited with hypothetical employer contributions (service credits) and interest credits. The court

See "Cash Balance" on page 6

Cash Balance *continued from page 5*

ruled that the IBM cash balance pension plan discriminated against older employees because the interest credits, which are considered part of the accrued benefit according to the IRS, are more valuable to younger employees as opposed to older employees.

In the Xerox case, the plaintiffs claimed that the lump sum amounts for employees who terminated employment before their normal retirement date were understated due to using a lower interest crediting rate different from the plan's interest crediting rate for employees who are still actively employed or who have retired. The court ruled that the Xerox cash balance pension plan miscalculated the lump sum amounts for about 13,000 former employees who terminated employment between 1990 and 2000 because the future interest credits are considered part of the accrued benefit according to the IRS and IRS Notice 96-8 states that the lump sum amounts must be determined using the plan's interest crediting rate.

The impact of the IBM decision could have a significant impact on both converted and new cash balance pension plans **if** the IBM decision is upheld on appeal (the case could ultimately reach the Supreme Court). In the meantime, we will wait to see what position the IRS will take, and what Congress will do to address the issues surrounding the unique characteristics of cash balance pension plans.

In an unfortunate development in Congress, on September 9, 2003, the House of Representatives approved an amendment to a Treasury appropriations bill (H.R. 2989) that would prohibit the Treasury from using funds to assist in turning over the IBM decision. The House bill now needs to be reconciled with an appropriations bill in the Senate (S. 1589). It is worth noting that the Senate bill does not contain an amendment similar to the House amendment

ACI In the News

SPEECHES

Pat Byrnes spoke at the **California CPA Education Foundation's** *Management of an Accounting Practice Conference* in San Francisco, September 29, and also in Los Angeles, September 30. His topic was "Retirement Plans in Accounting Practices". Pat also presented at the Foundation's August 12th *Retirement Planning Conference* in Los Angeles.

PUBLICATIONS

Pat wrote an article that will be included in the January, 2004 issue of **WORKSPAN**, the magazine of World at Work. His article, *Fiduciary Liability: It's Getting Personal*, focuses on the importance of understanding fiduciaries' roles and responsibilities and establishing procedures to ensure compliance with ERISA regulations. To receive a reprint of this article, contact Lace Greene at lace.greene@acibenefits.com.

October 15 Deadline

by Tobi Cogswell, Consulting Administrator

Has a Form 5558, Application for Extension of Time to File Certain Employee Plan Returns, been filed on behalf of your plan? How would you know?

The annual Form 5500 and related schedules are generally due to be filed with the EBSA 7 months after the end of your plan year. For a calendar year 2002 plan, the unextended due date for filing was July 31, 2003.

If your plan is on extension the due date for filing is October 15, 2003.

What do you need to do?
If you are waiting until September 15, 2003, the last day of your corporate extension, to fund your plans, we are waiting too. The financial schedule (Schedule H or Schedule I) may include receivable contributions, and if you have a defined benefit plan, the Schedule B cannot be certified by an Actuary until we have been provided with a confirmation of your contribution.

Please confirm your contribution to your ACI plan administrator as soon as possible after making your complete contribution. If you do not have a contribution confirmation form you may obtain one from your administrator.

Between now and October 15th we will be finalizing your Form 5500 and related schedules. If you are going to be on vacation or otherwise unable to sign and remit the forms to the EBSA on a timely basis, please contact your administrator as soon as possible to make other arrangements.

GUST Submission Period Extended

In late-August, the IRS released Revenue Procedure 2003-72, which extended until January 31, 2004, the deadline for submitting GUST-restated documents for determination letters. The Procedure requires restated documents either to be:

- Executed by September 30, 2003 and submitted to the IRS by January 31, 2004; or
- Executed between October 1, 2003 and January 31, 2004 and submitted by January 31, 2004 along with a $250 compliance fee.

It remains ACI's intention to complete all GUST restatements by September 30, 2003. However, clients wishing to temporarily delay the restatement may now do so provided they pay the IRS compliance fee. If your plan document has not been restated to comply with GUST, contact an ACI consultant or plan administrator to develop a timeline for completing the project.