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## End-of-Year Planning

by *Tobi Cogswell, Consulting Administrator*

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As the end of the year approaches, you may wish to review your goals and expectations with your ACI plan administrator and determine if any changes should be made to your retirement plan. Typically, a calendar-year defined contribution plan can be amended as late as December 30th in order to take advantage of changes for the 2004 year. Even if your particular plan is one that cannot be changed for 2004, planning for the 2005 year can, and should, be done at this time.

Some things to consider, although the following is not an exhaustive list:

- 1) If you do not have employment on the last day of the plan year, or an hours requirement, as a requirement for an employee contribution, you may be allocating contributions and forfeitures to terminated participants. In some circumstances this is appropriate, but in other cases you may not wish to do this. An amendment to add last day employment must be signed by December 31, 2004, for the 2005 year end.
- 2) If you have a 401(k) plan that consistently fails the ADP and ACP tests, you may wish to add safe harbor provisions for the 2005 plan year end. There are two ways to take advantage of safe harbor and you should work with your ACI plan administrator to determine which is best for you. Notices to employees must be distributed no later than December 1, 2004, for the 2005 year end.
- 3) If you made any acquisitions during the year, be sure to check your plan document for the definition of an eligible employee. Normally there could be a multi-year transition period before having to take into consideration the employees inherited through an acquisition, but you should work with your plan administrator to determine when (or if) you want to recognize the acquired employees, and how you would like to handle any plans of the acquired company.



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- 4) If you have catch-up provisions in your plan, be sure they have been offered to all participants who attained age 50 in the current year or in prior years. For the 2005 year, please be sure to offer the catch up to all participants attaining age 50 in 2005.
- 5) If you have 401(k) provisions in your plan, you may want to add a lump sum deferral option in the month of December. This will enable participants who were conservative during the year to defer either all or a portion of their checks in December. This amendment must be signed by November 30, 2004, for the 2004 year end.
- 6) If you have a cross-tested allocation in your plan, you may be able to amend the tier structure to give you maximum flexibility by putting everyone in their own tier. This will not work with all structures, but may be worth discussing.
- 7) If you have newly eligible family members you may wish to review your plan provisions with your plan administrator.
- 8) If the demographics of your company have significantly changed during the year you may wish to review your plan provisions with your plan administrator.
- 9) If you down-sized during the year, you may wish to review not only your plan provisions, but make the determination of whether a partial termination occurred. This will have an effect on vesting, distributions and forfeitures.
- 10) If you are age 45 and older, are currently in a defined contribution plan but would like to have higher contributions each year, you may wish to consider a defined benefit plan.
- 11) If you have a defined benefit plan and your assets have

<b>End-of-Year Considerations</b>	
✓	<b>Requirements for an allocation</b>
✓	<b>Safe-Harbor 401(k) for 2005</b>
✓	<b>Acquisitions during the year</b>
✓	<b>Catch-up provisions</b>
✓	<b>Lump Sum Deferral option at year-end</b>
✓	<b>Cross-testing tiers</b>
✓	<b>Newly eligible family members</b>
✓	<b>Change in demographics</b>
✓	<b>Sales or down-sizing during the year</b>
✓	<b>Possible Defined Benefit plan candidate</b>
✓	<b>Defined Benefit assets</b>
✓	<b>Distributions to terminees with account balances</b>
✓	<b>Compliance with 404(c)</b>

fluctuated greatly during the year, this may impact the required annual contribution. You may wish to do a preliminary valuation for budgeting purposes.

- 12) Pay out your terminees with account balances! You may be paying participant charges on these accounts, and they are considered participants for purposes of determining an audit is required for your plan.
- 13) If your plan has participant-directed investments and you would like to take steps to insulate yourself from fiduciary liability, consider beginning the process to comply with ERISA section 404(c). If you would like information regarding this subject, please contact your plan administrator.

We welcome the opportunity to meet with you to discuss any of the above items or answer any of your questions.

Visit our website at [www.acibenefits.com](http://www.acibenefits.com)  
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# Voluntary Correcting Compliance Issues in Retirement Plans: *Part 1*

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Both the Internal Revenue Service (IRS) and the Department of Labor (DOL) have jurisdiction over most qualified retirement plans. There are some exceptions to this general rule (there are some plans that are governed exclusively by the IRS and, conversely, some plans that are governed exclusively by the DOL) but most retirement plans must comply with rules issued by both agencies. This is certainly true for most 401(k) plans. Because of the number and complexity of the rules issued by both agencies, it is easy for an employer to violate one or more of them – often unknowingly. Fortunately, both the IRS and the DOL have programs that allow employers to voluntarily correct compliance errors. Such programs are generally referred to as “remedial programs” in the retirement plan community. This is the first in a series of articles that focuses on those remedial programs and how they operate. In this article, we discuss the IRS’s remedial program.

The Employee Plans Compliance Resolution Systems (EPCRS) is the remedial program for the IRS and is made up of three component programs: (i) the Voluntary Compliance Program (VCP); (ii) the Self-Correction Program (SCP); and (iii) the Audit Closing Agreement Program (Audit CAP). Audit CAP is the component of EPCRS that allows employers to correct certain compliance issues discovered in the course of an IRS audit. (Because this article focuses on voluntary compliance, a discussion of Audit CAP is beyond its scope.) VCP and SCP allow employers to correct certain compliance failures voluntarily. EPCRS and the component program programs have been around the retirement community for many years and are well developed. In fact, certain compliance issues occur with such regularity that the IRS has provided “safe-harbor” methods of correction. There are legitimate reasons why an employer may not want to correct a compliance issue in the manner prescribed in the safe-harbor and in such cases, the correction methodology can be negotiated directly with the IRS. This is generally done through VCP since the IRS is not involved in the correction of a compliance failure under SCP (see below).

## **The Voluntary Correction Program**

One of the more common issues corrected through VCP is the failure to follow the specific terms of a retirement plan document. The IRS takes the position that such a failure subjects the plan to the loss of its tax-qualified status (called “disqualification”). This means that the sponsoring employer may not prop-

erly take a deduction for any contributions it has made to the plan, and participants must include the dollar amount of contributions (to the extent they are fully vested) in their income. Disqualification is an extreme result and most failures can be successfully corrected through VCP before disqualification becomes an issue.

Participating in VCP requires the filing of a VCP submission and the payment of a compliance fee to the IRS. VCP also requires that the plan, and any affected participants, be placed in the same – or similar – position it would have been in had the failure not occurred. The filing of the VCP submission is generally followed by a period of negotiation with the IRS on the methodology and terms of correction. At the end of that process, the employer should receive a statement from the IRS (called a “Compliance Statement”) describing the failure, the method of correction and indicating that the plan’s qualified status will not be jeopardized because of the failure.

## **The Self-Correction Program**

SCP allows employers to correct certain compliance failures without submitting them to the IRS. SCP consists of two components depending on whether or not the failure is “significant” (as defined in EPCRS). Significant failures may be corrected without IRS approval as long as they are substantially corrected by the end of the plan year following the year in which it was discovered. An “insignificant” failure may be corrected at any time. Determining whether a failure is significant or insignificant is a complex process that depends on the facts and circumstances of the failure as applied to a list of factors identified in EPCRS. In addition, the decision to correct a failure through SCP, and the methodology for correcting the failure, should be documented in the case the plan is subsequently audited by the IRS.

In the next installment, we will discuss a few case studies that illustrate some practical application of VCP and SCP.

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# Season of the Small Start-up Plan

*The fourth quarter is about to start!*

by Jeff Wallace

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Between October and December of any particular year, ACI implements between 40 and 50 new retirement plans, many of which have five or fewer participants.

## Why the rush?

Often times, many small businesses simply don't know for certain that they're going to have a good year until the fourth quarter. Once they realize they're going to be very profitable—and pay substantial taxes—business owners begin looking for savings opportunities, preferably those that are tax-advantaged. Thus begins the rush!

## Picking the Right Plan: Large Deductions vs. Flexibility

There are now more retirement plan options for small businesses than ever before. When working with small businesses, the first things we try to ascertain are the desired contribution level and the degree of flexibility the business owner needs to maintain. A client who wants to make substantial tax-deferred contributions to a retirement plan may appear to be a prime candidate for a defined benefit plan. But if that client's cash flow tends to be very inconsistent, they probably need more contribution flexibility than is available through a defined benefit plan. By discussing these two important points, we can begin to identify the most appropriate plan for the business owner.

## Retirement Plan Options

Ignoring SEPs and the various forms of SIMPLE plans, which have significant limitations, small business retirement plans fall into two categories: Defined contribution plans and defined benefit plans.

## Defined Contribution Plans

Defined contribution (DC) plans include 401(k) plans, profit sharing plans, and “solo 401(k)” plans for owner-only businesses.

### Advantages

- DC plans permit total contribution flexibility for participants and plan sponsors. Except in unusual circumstances, contributions are not required.
- DC plans are the less expensive to maintain than defined benefit plans. DC plans are often less sophisticated and do not require annual certification by an actuary.

### Disadvantages

- The maximum annual contribution to a DC plan is \$41,000 per participant in 2004.

- There is an annual deductible contribution limit of 25% of “covered compensation.”

## Defined Benefit Plans

Defined Benefit (DB) plans are the “traditional” pension plan that provide a pre-established benefit at retirement for all participants.

### Advantages

- Tax-deferred (and deductible) contributions to defined benefit plans can be much larger than those in a DC plan. The table below illustrates maximum projected contributions based upon participant ages:

Current Age	Projected Retirement Age	Maximum Initial DB Contribution
45	55	\$96,000
48	58	\$112,000
50	60	\$124,000
55	65	\$128,000
58	65	\$141,000
60	65	\$150,000
65	70	\$194,000

- The maximum deductible contribution to a DB plan is whatever is required under the plan's benefit formula. The 25% of covered compensation limit does not apply.

### Disadvantages

- DB plans are generally more expensive to maintain than DC plans, because they tend to be more sophisticated and require annual certification by an actuary. However, when these additional costs are weighed against the tax savings on the larger deductible contributions, the costs are often easily justified.

## Combined DB/DC Plans

Depending upon a business owner's goals and the size of the business, ACI may recommend a “combo” arrangement, which includes both a DB and a DC plan. These arrangements permit deductible contributions to be focused on business owners and key employees, while keeping staff costs at a minimum. In essence, the bulk of the DB plan benefits are allocated to the owners and key employees, and DC benefits are paid primarily to other employees. The result can be significant contributions to owners and key employees (\$150,000+), with staff costs of between 7.5% and 11% of compensation.

## Questions?

Contact an ACI consultant or your plan administrator with any questions regarding small business retirement plans. ACI offers competitively-priced, customized plan designs to meet the needs of businesses of all sizes.

# Retirement Plan Basics:

## Plan forfeitures

*Following is an excerpt from Retirement Plan Basics: An Administrator's Guide to Key Issues, a publication of ACI. This document is designed to help ACI's clients understand many of the complex issues associated with the maintenance of retirement plans. This article, which focuses on forfeitures, is particularly timely as many sponsors need to determine how to handle forfeitures at plan year-end, which is rapidly approaching for plans operating on a calendar-year basis.*

### ***Why is this issue important?***

Forfeitures are frequently ignored or mishandled by plan sponsors. Substantial penalties may apply if forfeitures are not handled correctly.

### ***What is forfeiture?***

Forfeitures are unvested employer contributions. A forfeiture occurs when a participant in a retirement plan has a break in service with the employer (termination, resignation, extended leave of absence) and has not been with the Company long enough to become fully vested in the employer contributions to the retirement plan. When the participant receives a distribution from the plan, the unvested portion of the employer contribution is forfeited.

### ***When does a forfeiture occur?***

Forfeitures may occur at different times. Your plan document

will specify when forfeitures occur in your plan. In general, forfeitures may occur:

- Upon distribution of plan benefits
- Upon termination of a participant who is 0% vested
- At the end of the year in which the benefit distribution occurred
- After five consecutive one-year breaks in service
- Immediately upon termination

### ***When does a forfeiture become available for use?***

Plan sponsors may use forfeitures at different times, depending upon how they are described in the plan document. In general, forfeitures become available for use at:

- The end of the plan year in which the distribution occurs
- The end of the second plan year after the distribution occurs
- The end of the plan year following the plan year in which a one-year break in service occurred
- The first day of the plan year following termination or distribution

### ***What can a plan sponsor do with forfeitures?***

Plan sponsors may use forfeitures to pay plan-related expenses (administration fees, investment advisor fees, etc.). The plan document may also specify other acceptable uses for forfeitures, including:

- Reducing employer contributions
- Allocating to remaining participants
- Restoring participant accounts
- Correcting defects in prior distributions

*See "Forfeitures" on page 6*

## Cash Balance Plan Update

At the moment, there are only two items to report on the cash balance front: First, no new regulations have been released related to age discrimination arguments. Second, we've recently learned that the Treasury Department is planning to release new regulations aimed at establishing a minimum Normal Retirement Age in qualified retirement plans. The target of these regulations would appear to be cash balance pension plans with "non-traditional" retirement ages (generally five years of service, regardless of age), which the Treasury has previously approved.

There are numerous valid reasons for plan sponsors to include non-traditional retirement ages in their retirement plans. The two most prevalent cited reasons are:

- Avoiding the "Whipsaw effect," wherein a partici-

pant who terminates service earlier than actuarially projected receives a payout in excess of his theoretical account balance; and

- Allowing participants to roll cash balance assets into a 401(k) plan. This benefits plan sponsors by reducing fiduciary liability in the cash balance plan by permitting participants to roll large cash balance account balances into a 401(k) plan that is compliant with ERISA Section 404(c). Once these rollovers occur, the cash balance plan's fiduciaries are no longer liable for the account balances and—if the 401(k) is truly 404(c) compliant—the 401(k) plan's fiduciaries avoid liability for participant investment decisions. From a participant's perspective, the non-traditional retirement age allows them to manage their retirement savings in a manner that is congruent with their personal investment philosophy, rather than being subject to the low crediting rates normally associated with cash balance plans.

# Deemed IRA Update

## A good idea, but pitfalls abound

Deemed IRAs were introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001. In concept, they seem like a good idea: Allow participants to open IRA accounts within your qualified plan. Participants benefited from greater simplicity: They no longer need to work with multiple vendors to establish and maintain their retirement accounts. Plan sponsors benefit by having more assets in the corporate retirement plan, which often helps drive down plan-related costs.

But there are some serious drawbacks to permitting deemed IRAs:

### **Qualification**

The most troubling drawback has to do with a deemed IRAs potential impact on a plan's qualified status. The IRS has taken the position that if a deemed IRA fails to meet standard IRA requirements at any time, the entire corporate plan could be disqualified.

### **Recordkeeping**

Deemed IRAs must be tracked separately from other plan assets, though the assets themselves can be commingled if the proper documentation is in place. At this time, few recordkeepers have the capacity to actually track these accounts.

### **Administrative Costs**

IRAs will increase the administrative requirements of plans, resulting in either more time on the part of plan sponsors or higher administrative fees to outside vendors who assist with these accounts. Because of the qualification issue, strictly adhering to IRA rules will be critical to protecting non-IRA assets in the plan.

### **Fiduciary Liability**

As plan assets increase, so does fiduciary liability. Thus, permitting deemed IRAs will also increase the personal liability of the plan's fiduciaries.

Plan sponsors are not required to offer deemed IRAs to plan participants. It's difficult to imagine anyone introducing this provision until the qualification and fiduciary liability issues are addressed and—hopefully—resolved. It can only be a matter of time before most recordkeepers are in a position to handle deemed IRAs, but like individually directed brokerage accounts within “standard” 401(k) arrangements, their broad acceptance will likely be very limited.

## “Forfeitures” Continued from page 5

### *When are forfeitures to be used?*

In general, once forfeitures become available for use, they should be applied within the plan year in which they become available.

If a former participant is re-hired, he or she must have the opportunity to restore his or her forfeiture before incurring five consecutive breaks in service. The plan document will determine whether the restoration of the participant's account balance will come from unallocated forfeitures, trust earnings, or employer contributions.

## **ACI In the News**



### **Speeches**

On August 17<sup>th</sup>, Pat spoke at Lincoln Financial Group's 2004 National Sales Conference. His presentation, “*The Cash Balance Sweet Spot: Who, What, When & Why*” focused on identifying appropriate settings for cash balance plans.

On September 15<sup>th</sup>, Jack Cross spoke at the Los Angeles Chapter Management of Accounting Practice Committee, hosted by Reish Luftman Reicher & Cohen. The topic of his presentation, “*Super Charging Retirement Plans*,” focused on how organizations can maximize deductions and benefits in a tax advantageous manner.

### **Articles**

Pat co-authored an article with Fred Reish of Reish Luftman Reicher & Cohen in the September issue of the *Journal of Financial Service Professionals* ([www.financialpro.org](http://www.financialpro.org)) entitled “Retirement Plan Fiduciary Liability and Its Abatement under ERISA Sec. 404(c).” For a copy of the article, please contact Lace Greene at [lace.greene@acibenefits.com](mailto:lace.greene@acibenefits.com).

### **Continuing Education Presentations**

Each year, ACI prepares a number of presentations related to employee benefits and compensation issues. Many of the presentations are eligible for continuing education credit and have been presented at various professional conferences. For a complete list of ACI's 2004 presentation topics, go to our website at [www.acibenefits.com](http://www.acibenefits.com).

*Action Items is published quarterly.  
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