



FBA NEWS NOTES

Winter 2005

NEWS AND INFORMATION ON EMPLOYEE BENEFIT PLANS

IRS Announces 2006 Limitations For Qualified Retirement Plans

In IRS News Release 2005-120, the IRS announced the 2006 Benefit and Contribution Limits as adjusted for cost-of-living increases.

Limitation Type	IRC Section	2006	2005
Defined Benefit Plan <i>Maximum Benefit Limit</i>	415(b)(1)(A)	\$175,000	\$170,000
Defined Contribution Plan <i>Maximum Contribution Limit</i>	415(c)(1)(A)	\$44,000	\$42,000
Annual Compensation Limit <i>All Plans</i>	401(a)(17), 404(1), 408(k)(3)(C) and 408(k)(6) (D)(iii)	\$220,000	\$210,000
Elective Deferrals Limit <i>401(k) and 403(B) Plans</i>	402(g)(1)	\$15,000	\$14,000
Elective Deferrals Limit <i>457(B) and 457(C) Plans</i>	457(b)(2) and 457(c)(1)	\$15,000	\$14,000
Catch-Up Contribution Limit <i>401(k), 403(B) and 457 Plans</i>	414(v)(2)(B)(i)	\$5,000	\$4,000
Highly Compensated Employee <i>Compensation Breakpoint</i>	414(q)(1)(B)	\$100,000	\$95,000
Key Employees <i>Officer Compensation Breakpoint</i>	416(i)(1)(A)(i)	\$140,000	\$135,000
Key Employee <i>1% Owner Compensation Breakpoint</i>	416(i)(1)(A)(i)	\$150,000	\$150,000
SIMPLE Retirement Accounts <i>Deferral Limit</i>	408(p)(2)(B) and 401(k)(11)(B)	\$10,000	\$10,000
SIMPLE Catch – Up Contribution Limit	414(v)(2)(B)(ii)	\$2,500	\$2,000
SEP <i>Employee Covered Compensation</i>	408(k)(2)(C)	\$450	\$450
Social Security Wage Base <i>(No limit for Medicare tax)</i>	N/A	\$94,200	\$90,000
Social Security Benefit COLA <i>Cost-of-Living Adjustments</i>	N/A	4.1%	2.70%
FICA Tax <i>Employer and Employees</i>	N/A	7.65%	7.65%
Social Security/Medicare Tax <i>Employer and Employees</i>	N/A	6.2%/1.45%	6.2%/1.45%
FICA Tax <i>Self Employed Workers</i>	N/A	15.30%	15.30%
Social Security/Medicare Tax <i>Self Employed Workers</i>	N/A	12.4%/2.90%	12.4%/2.90%

Disaster Relief for Retirement Plans

In the aftermath of Hurricane Katrina, the Internal Revenue Service (IRS), the Department of Labor (DOL), and Congress have provided broad-based relief for affected plan sponsors and participants. Congress recently passed the Katrina Emergency Tax Relief Act of 2005 (KETRA), which the President signed on Friday, September 23, 2005. The IRS and DOL have also issued guidance for employee benefit plans affected by Hurricane Katrina. In an effort to make sure that all potentially affected plan sponsors and participants are aware of the available relief, we are providing this summary of some of the important provisions.

Katrina Emergency Tax Relief Act of 2005 (KETRA).

The Katrina Emergency Tax Relief Act of 2005 (KETRA), provides, among other things, a waiver of the 10% early distribution penalty and other tax relief for certain distributions from qualified plans (including 401(k) plans) and increased limits for plan loans made to Katrina victims.

First, we must know what participants and plans are affected by KETRA?

An *Affected Plan* is an employee benefit plan for which any of the following were located in one of these Hurricane Katrina disaster areas (defined below) at the time of Hurricane Katrina:

- For a single employer plan (disregarding controlled group rules) the principal place of business of the employer that maintains the plan;
- For a plan covering employees of more than one employer (disregarding controlled group rules) the principal place of business that employ more than 50% of the active participants covered by the plan;
- The office of the plan or the plan administrator; or
- The office of the primary record keeper serving the plan.

An *Affected Individual* is a participant, qualified beneficiary, or claimant who:

- Resided, lived, or worked in one of the Hurricane Katrina disaster areas at the time of Hurricane Katrina; or
- Is covered by an Affected Plan.

Hurricane Katrina disaster areas are the counties and parishes in Louisiana, Mississippi, or Alabama that have been (or are later) designated as disaster areas eligible for Individual Assistance by the Federal Emergency Management Agency (FEMA) because of the devastation caused by Hurricane Katrina. Information regarding the counties and parishes in these states that are eligible for Individual Assistance as a result of Hurricane Katrina can be found on the FEMA website, at www.fema.gov/press/2005/resources_katrina.shtm.

This summary focuses on the tax relief provisions that apply to 401(k) plans:

(1) Qualified Hurricane Katrina Distributions Not Subject to 10% Penalty. A distribution from an eligible retirement plan (including 401(k) plans) made on or after August 25, 2005, and before January 1, 2007, to an individual whose principal place of abode on August 28, 2005 is located in a Hurricane Katrina disaster area and who has sustained economic loss by reason of Hurricane Katrina. Qualified Hurricane Katrina distributions are limited to \$100,000 in the aggregate (regardless of whether received in one or more taxable years), and they are not subject to the 10% early distribution penalty. Furthermore, qualified Hurricane Katrina distributions are not subject to the 20% withholding that normally applies to eligible rollover distributions.

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Qualified Hurricane Katrina distributions may be made only to plan participants who lived in a disaster area – a narrower group than that covered by the IRS & DOL relief previously granted for Katrina-related hardship distributions (see the following article).

(2) Income Tax Treatment of Qualified Hurricane Katrina Distributions. Participants who receive qualified Hurricane Katrina distributions have two taxable options. First, income from a qualified Hurricane Katrina distributions may be included ratably over a three-year period beginning with the year of the distribution (1/3 each taxable year). Second, a covered participant can re-contribute any portion of a qualified Hurricane Katrina distribution to an eligible retirement plan during the three-year period beginning the day after the date on which the distribution is received. These repayments are treated, for tax purposes, as timely rollover contributions and thus will defer taxation. If the recipient individual has already paid tax on the distribution, and re-contributed the distribution to an eligible retirement plan within the three-year period, that individual may claim a refund of the tax that relates to the distribution amount that was previously included in income.

(3) Re-contribution of Pre-Hurricane Katrina Hardship Distributions for Principal Residence. A special re-contribution rule applies to certain hardship distributions that were made before Hurricane Katrina to purchase or construct a principal residence in a Hurricane Katrina disaster area. If the hardship distribution was received after February 28, 2005, and before August 29, 2005, the individual may contribute any portion of the distribution amount to an eligible retirement plan; the amount will be treated as a timely rollover contribution.

(4) Special Participant Loan Rules that Provide Relief under KETRA. There are two parts to this provision concerning participant loans:

(A) *Increased Loan Limits* – The maximum dollar amount for outstanding loans is increased to \$100,000 from \$50,000. More specifically, a participant loan is allowed to the extent that the loan, when added to the outstanding balance of all loans to the participant under all plans maintained by the employer, does not exceed the lesser of (1) \$100,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one year period ending on the date before the new loan is made over the outstanding balance of loans from the plan on the date the loan is made, or (2) the greater of \$10,000 of the participant's accrued vested benefit.

(B) *Loan Repayment Extensions* - Qualifying loans outstanding on or after August 25, 2005, with any loan payment due between August 25, 2005 and December 31, 2006 may be delayed for one year.

Subsequent payments are to be adjusted to reflect the interest accrued during the delayed payment. The period of delay is also disregarded for purposes of the otherwise – applicable maximum term of a loan which is not used to purchase a principal residence (5 years). The fact that the usual level amortization requirement is not met due to the delay is also regarded for purposes of qualifying the loan.

Plan Amendments – This amendment provision provides that any amendment related to KETRA provisions will need to be adopted before the last day of the first plan year beginning on or after January 1, 2007, unless the Secretary of the Treasury provides a later date. The amendment is generally required to be made retroactive to the effective date of the changes.

IRS and DOL Provides Relief for Hardship Withdrawals and Plan Loans for Hurricane Katrina Victims.

The IRS and DOL (Announcement 2005-70 and DOL press release of Sept. 15) relaxed several procedural and administrative rules that would normally apply to retirement plan loans and hardship withdrawals. As a result, plan participants will have greater access to their plan accounts with less red tape.

(1) Hardship Withdrawals - To qualify for this relief, a hardship distribution must have been made on account of Hurricane Katrina and must be made on or after August 29, 2005, and no later than March 31, 2006.

- Employees and former employees whose principal residence or work place was in a designated Katrina disaster area as of August 29, 2005 are eligible.
- Any lineal ascendant or descendant, dependent or spouse of such a person also qualifies.
- Plans that don't currently have hardship provisions can now grant withdrawals and take until the end of the plan year beginning immediately after December 31, 2005 to adopt enabling plan amendments.
- Plans won't have to follow normal procedural rules as long as they make a good-faith effort to comply and, as soon as practical, make a "reasonable attempt to assemble any foregone documentation." This waiver of the usual procedures applies to distributions made from August 29, 2005 through March 31, 2006.
- A plan may make a hardship distribution for any need related to Hurricane Katrina; usual limits on the kinds of reasons participants must cite do not apply.
- After receiving a distribution, the recipient can renew the making of contributions without observing the usual waiting period.
- A plan may not use money in QNEC or QMAC accounts or earnings on elective contributions for these distributions.
- A plan administrator may rely on the representations made by the participant and need not make any independent verification of reasons, unless the administrator has actual knowledge to the contrary.

(2) Loans – As noted above, the IRS and DOL on Sept. 15 gave plan sponsors relief from strict Code and ERISA restrictions so that plans could provide loans and hardship distributions. In general the eligibility rules and relaxed procedures for hardship withdrawals (see above) also apply to loans. However, for loans, the recipient must state the reasons that satisfy Code Section 72(p). DOL Regulations provide that no more than 50% of a participant's vested account balance can be used to meet the ERISA security requirement. Most plans are designed to use the participant's vested account balance as security for the loan, and therefore plans generally limit plan loans to 50% of the vested account balance. Without an announcement of further relief from the ERISA security requirement, plans will need to obtain security outside the plan for loans in excess of 50% of a qualified individual's vested balance.

DOL Provides Relief for Delayed Participant Contributions, Loan Repayments, and Blackout Notices.

This Katrina enforcement policy provides relief that relates to the deadlines for depositing participant contributions and loan repayments in a plan's trust and to blackout notice requirements, and it applies to certain employers, plan sponsors (as well as service providers to those employers), and plans that are located in the Hurricane Katrina disaster areas.

(1) Participant Contributions and Loan Repayments. The DOL recognized that some employers and service providers located in the affected areas would not be able to forward participant contributions and loan repayments within the normal timeframes. Consequently, the DOL indicated that it will not solely on the basis of failure attributable to Hurricane Katrina, enforce its contribution deadline requirements with respect to a temporary delay in the forwarding of such payments as long as the affected

employer or service provider acts reasonably, prudently, and in the interest of employees to comply as soon as practical under the circumstances.

- (2) **Blackout Notices.** The DOL will not enforce the blackout notice requirements on Katrina-affected plans. Therefore, it will not require a Katrina-affected plan fiduciary to make a written determination ordinarily needed to lift the requirement of 30 days' notice to participants and beneficiaries whose rights will be subject to a "blackout period" (that is – any period of suspension, limitation, or restriction of more than three consecutive business days on the ability to direct investments, obtain loans, or acquire distributions).

DOL Grants Extension for Form 5500s

The DOL has extended the filing deadline of Form 5500 and Form 5500 EZ annual report/returns for employee benefit plans affected by Hurricane Katrina. Under this relief, Form 5500 submissions required to be filed after August 29, 2005 are generally granted an extension until February 28, 2006.

FBA, Ltd. Note

Filing extensions have also been granted for employee benefit plans affected by Hurricane Rita and Hurricane Wilma. For those in the Hurricane Rita affected areas, an extension until February 28, 2006 has been granted for Form 5500 submissions required to be filed after September 23, 2005. The same extension has been granted for those in Hurricane Wilma affected areas, but only for Form 5500 submissions required to be filed after October 23, 2005.

The extension applies to plan administrators, employers and other entities located in the areas directly affected, as identified by the Federal Emergency Management Agency. The extension also applies to firms located outside the affected areas who are unable to obtain the necessary information from service providers, banks or insurance companies whose operations were directly affected by the hurricanes. ♦

Additional Relief for COBRA, HIPAA, and ERISA Claims Procedures

The DOL and IRS have announced additional relief for victims of Hurricane Katrina in the form of an **extension of certain time frames** that would otherwise apply under the COBRA provisions and HIPAA Portability of ERISA and the Code, and under the ERISA claims procedure requirements.

- (1) **COBRA** – For affected individuals, the period from August 29, 2005 through February 28, 2006, must be disregarded when determining (a) the COBRA election period of a qualified beneficiary (a minimum of 60 days); (b) whether a qualified beneficiary's COBRA premium payments are timely; or (c) the date by which individuals must notify a plan of a qualifying event or determination of disability. The same period is disregarded when determining the date by which affected plans must provide COBRA election notices.
- (2) **HIPAA Portability** – For affected individuals, the period from August 29, 2005 through February 28, 2006, must be disregarded when determining (a) the period for requesting special enrollment (a minimum of 30 days); (b) whether a child was covered under creditable coverage within 30 days after birth adoption, or placement for adoption (so that the child cannot be subject to a PCE); or (c) whether an individual has had a 63-day break in coverage. This period is also disregarded when determining the date by which an affected plan must provide an automatic certificate of creditable coverage under the HIPAA certification rules.
- (3) **ERISA Claims Procedure** – For affected individuals, the time frames for filing a benefit claim or an appeal of an adverse benefit determination under an ERISA plan's claims procedures must be determined without regard to the period from August 29, 2005 through February 28, 2006.

Employers and administrators whose plans cover affected individuals will want to familiarize themselves with this guidance and should plan for its impact on plan administration. ♦

Additional Information on Disaster Relief

For more information about this disaster relief, please contact your legal counsel. You may also obtain additional information from: The Internal Revenue Service – www.irs.gov at "Help for Hurricane Victims" (See Release # IR-2005-105, Sept. 15, 2005, and Announcement 2005-70).

The Department of Labor – www.dol.gov/ebsa/ at "U.S. Labor Department Action Helps Hurricane Victims Access 401(k) Plans," and "DOL Extends Annual Reports Deadline". ♦

Roth 401(k) - Designated Roth Contributions

We have had a number of questions about whether a 401(k) plan should be amended to offer the designated Roth option. “Designated Roth contributions” are elective deferrals that a participant can irrevocably designate to be made on an after-tax basis, rather than on a pre-tax basis. Designated Roth contributions will be treated as taxable wages in the year of deferral (and will be subject to income and employment tax withholding). However, qualified distribution of designated Roth contributions and earnings will be tax-free. Guidance on designated Roth contributions is provided under Internal Revenue Code section 402A, added by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Beginning in 2006, a 401(k) plan may permit employees to designate some or all of their elective contributions as Roth contributions, which in essence creates a “Roth 401(k).” This summary provides an overview of the more significant considerations with respect to the implantation of a Roth 401(k) plan.

FBA, Ltd. Note

Under EGTRRA sunset provision, after December 31, 2010 the Internal Revenue Code is to be applied as if section 402A had never been enacted. While it is likely that the expiration date of many provisions of EGTRRA will be extended, plan sponsors should at least consider that a Roth 401(k) plan implemented in 2006 may only be five-year program. If Congress allows Code Section 402A to expire, participants will be able to roll designated Roth contributions into a Roth IRA without incurring penalties.

Proposed Repeal – Plan sponsors should also be aware the Rep. Benjamin Cardin (D-Md.) recently introduced the Pension Preservation and Savings Expansion Act of 2005, which includes a provision that would repeal the designated Roth contribution option.

(1) Designated Roth Contributions. The proposed regulations define “designated Roth contributions” as elective contributions under a qualified cash or deferral arrangement that are:

- Designated irrevocably by the employee at the time of the cash or deferred election as Roth contributions.
- Includible in the employee’s income at the time the employee would receive the contribution amounts in cash if he/she had not made cash or deferred election.
- Maintained by a Separate Account.

Designated Roth contributions must satisfy the requirements already applicable to pretax elective contributions made under 401(k) plans. Thus, for example, they:

- Are subject to non-forfeitability and distribution restrictions applicable to pretax elective contributions.
- Count toward the annual dollar amount limit on elective deferrals (\$15,000 in 2006) and catch-up contributions (\$5,000 in 2006).
- Are included with pretax elective contributions under the actual deferral percentage (ADP) nondiscrimination test.
- Are subject to required minimum distribution rules.

(2) Corrective Distributions for Curing a Failed ADP Test. If corrective distributions of designated Roth contributions are made to HCEs in order to cure a failed ADP test, the amount of the corrective distribution attributable to the designated Roth contribution is not included in the HCE’s income, but any earnings on those contributions that are distributed will be included in the HCE’s income. The proposed regulations would allow the employee to elect whether the corrective distribution is made from designated Roth contributions or elective deferrals if the employee has made both types of deferrals for the year and if the plan provides for such an election. (The proposed regulations also provide a similar rule under the correction methods if a plan fails to satisfy the actual contribution percentage (ACP) test under section 401(m)).

(3) Rollovers. The plan document must include the rollover restrictions in Code Section 402A, which requires that designated Roth contributions may be rolled over only to another plan maintaining designated Roth contribution accounts or to a Roth IRA. It appears that money rolled over to a Roth IRA would no longer be subject to the required minimum distribution rules.

(4) Taxation of Distributions. The proposed regulations do not address the taxation of distributions on designated Roth contributions from a 401(k) plan.

However, section 402A and the legislative history indicate that a qualified distribution from a designated Roth contribution account, including earnings, would not be includible in income and would not be subject to the 10% tax on early withdrawals. Conversely, a distribution from a designated Roth contribution account that is not a qualified distribution would be includible in income to the extent attributable to earnings and would be subject to the 10% tax on early withdrawals (unless an exception applies).

A “qualified distribution” must meet two conditions:

(A) It must occur after the five-year-taxable-period beginning with the first taxable year for which the participant made a designated Roth contribution to the plan (although this can change where a rollover of designated Roth contributions was made to the plan).

(B) It must be made at or after age 59-1/2, or on account of death or disability.

[The qualified special purpose distributions available under a Roth IRA (such as up to \$10,000 for a first-time home purchase) are not available as qualified distributions for designated Roth contributions.]

(5) Pros and Cons. Whether a participant would be better off making designated Roth contributions or pretax contributions can depend on many individualized factors, including whether the participant’s tax rate at distribution is higher or lower than at contribution, how much the participant has available to save and for how long, whether the participant has other deferral opportunities (i.e. a non-qualified plan), how the participant invests outside of the 401(k) plan and what state tax laws apply. Remember, Roth contributions are not in addition to regular 401(k) contributions, but are in lieu of regular 401(k) contributions.

Pros:

- (A) Opportunity for Higher-Paid Employees - The Roth option offers an opportunity for tax-free earnings on deferrals to higher-paid employees who are not eligible to make Roth IRA contributions (due to the income cap on Roth IRA eligibility).
- (B) Higher Limit Than Roth IRA Contributions - Designated Roth contributions are subject to a higher overall limit than Roth IRA contributions. For example, the 2006 limits are \$15,000 for designated Roth contributions and elective deferrals combined versus \$4,000 for Roth IRA contributions. In addition, for catch-up eligible participants, the catch-up limit in 2006 for designated Roth contributions and elective deferrals combined is \$5,000 versus \$1,000 for Roth IRA contributions.
- (C) Tax Diversification - Designated Roth contributions serve the dual purpose of tax diversification and enhancing overall retirement savings.
- (D) Easier to Make Designated Roth Contributions - The Roth option offers employees the ease of making Roth contributions through payroll deduction and without having to set up a separate Roth IRA.

Cons:

- (A) Participant Communication - Communicating the relative tax effects to employees during plan enrollment will unnecessarily complicate the enrollment process. Employees are already making choices about contribution rates and investment funds. The choice between Roth and traditional 401(k) is complicated, involving current and future marginal rates. Studies show that the more complex the enrollment process is, the fewer employees who will actually sign up to contribute.
- (B) Administrative Complexity. With so much record keeping to be done, it is more than likely that allowing this design option will result in higher plan costs and increased risk of plan operational errors. For instance:
 - (a) Plan Documents and new Summary Plan Descriptions must be amended to add these provisions, which will result in additional fees by the plan sponsor.
 - (b) This additional option will double an employer’s record-keeping because employees will be permitted to elect what portion of their 401(k) deferral should be treated as a Roth Contribution and what amount is for the traditional 401(k).
 - (c) These separate elections will have to be set up in the employer’s payroll system and are treated differently. Roth contributions will have to be taxed, while traditional 401(k) are not taxed.
 - (d) The Roth and 401(k) contributions will have to be identified separately when plan contribution data and contributions are submitted to the plan’s record-keeper.
 - (e) The IRS requires plan record-keepers to track the Roth accounts separately from other plan accounts. Record-keepers will have to track Roth contribution “basis”. These requirements mean record-keepers must add additional plan account records, resulting in higher record-keeping costs, which will be passed on to participants.
 - (f) When plan distributions are made, if participants want to roll over their accounts to an IRA, they will have to establish two IRAs, traditional and Roth, and see that the distribution is properly allocated between two accounts.
 - (g) If a plan with Roth contributions fails the ADP test and issues refunds to high paid employees, the Roth rules permit the affected participant to elect what portion of the refund should be from Roth vs. 401(k). This will add significant delay to processing refunds, which are already difficult to accomplish by March 15th each year. For refunds made after March 15th, a 10% IRS penalty is assessed on the employer. In addition to slowing down the refund process, the complexity of directing from which account to pay the refund will result in higher plan administration fees.

So, if you are considering adopting a 401(k) Roth account for your retirement plan, we encourage you to carefully assess the advantages and disadvantages of this type of account. ♦

*This summary is intended for information and educational purposes only and does not constitute financial, tax, or legal advice. Further, this information is general in nature and is not intended to address the particular needs of any specific plan. Please contact your financial, tax, or legal advisor for information about your specific situation.