retirement
plan news

NOVEMBER/DECEMBER 2008

Safe Harbor 401(k) Plan Options for 2009

It's that time again — time to consider whether a safe harbor 401(k) plan design is right for you. 401(k) plans are subject to nondiscrimination tests that apply to employee deferrals (the actual deferral percentage or ADP test) and, if applicable, matching contributions (the actual contribution percentage or ACP test). Safe harbor designs allow plans to skip these nondiscrimination tests.

The new qualified automatic contribution arrangement (QACA) option means there are additional safe harbor choices for 2009. This article refers to an original safe harbor 401(k) as a *traditional* safe harbor plan.

In addition to avoiding the complex tax laws associated with nondiscrimination testing, safe harbor plans allow highly compensated employees (HCEs) to defer the maximum amount of compensation permitted by law. In 2008, the maximum elective deferral to a 401(k) plan is $15,500. If the plan document allows, participants who are age 50 or older in 2008 may make catch-up contributions of up to $5,000.

Traditional Safe Harbor Rules. Plan sponsors may satisfy traditional safe harbor contribution requirements by making either a nonelective contribution (NEC) or a contribution based on a matching formula. Contributions that satisfy the safe harbor must be 100% vested, and no conditions may be placed on allocations (such as requiring that participants be employed on the last day of the plan year or work a minimum number of hours — for example, 1,000 hours — during the plan year). In addition, all eligible employees must be provided with a safe harbor notice between 30 and 90 days before the beginning of the new plan year (or at the time of an employee's entry into the plan, if applicable).

Nonelective Contributions. If an employer elects to satisfy the safe harbor requirements by making a nonelective contribution, that contribution must be 3% (or more) of compensation, commonly known as the 3% NEC. Furthermore, the 3% NEC must generally be provided to all employees who are eligible to make elective deferrals to the plan, whether or not they do so.

The NEC may be either *guaranteed* or *flexible*. An employer who provides a guaranteed 3% NEC must make that contribution regardless of subsequent financial developments during the plan year. A flexible NEC permits the employer to decide each year whether to provide the NEC.

If a flexible NEC is chosen, the employer must provide participants with a second notice (no later than the first day of the twelfth month of the plan year) indicating that the safe harbor status has been elected and the NEC is being given. If the NEC is made, discrimination testing of elective deferrals is not required. If the NEC is not made, the second notice is technically not required and elective deferral contributions must be tested. Typically, when a safe harbor notice is provided stating that a NEC may be provided during the *upcoming* plan

(Continued on page 2)

CONTENTS

Safe Harbor 401(k) Plan Options for 2009
The HEART Act
Recent Developments

Kibble & Prentice
A USI Company

601 Union Street, Suite 1000
Seattle, Washington 98101-4064
206/441/6300 PH
206/441/6312 FX
www.kpcom.com

Safe Harbor 401(k) Plan Options for 2009 *(Continued from page 1)*

year, it also includes language addressing whether a NEC is being provided in the *current* year.

Matching Contributions. If a matching contribution is used to satisfy the safe harbor, the employer may elect either a *basic* or an *enhanced* match. The formula for a basic safe harbor matching contribution is a 100% match on the first 3% of compensation deferred and a 50% match on deferrals between 3% and 5%.

An enhanced matching contribution must be *at least* as much as the basic match at each tier of the match formula. It may not increase as the percentage of deferrals goes up. And the rate of match for the HCE group may not exceed the rate of match for the nonhighly compensated employee (NHCE) group.

Additional Matching Contributions. Within limits, a safe harbor plan may make additional, non-safe-harbor matching contributions. What are the limits? An allocation of discretionary matching contributions may not exceed 4% of compensation, matching contributions may not be made on deferrals that exceed 6% of compensation, and the rate of match for any HCE may not be more than that of any NHCE.

Allocation Restrictions. There cannot be any restrictions (such as the last-day rule or 1,000-hours-of-service requirement) on any matching contributions in a safe harbor plan unless *all* NHCEs satisfy the restrictions. For a plan to be exempt from nondiscrimination testing, all matching contributions must be allocated in a nondiscriminatory manner.

QACA Safe Harbor Rules. Under the new qualified automatic contribution arrangement, the traditional safe harbor rules apply with the following changes:

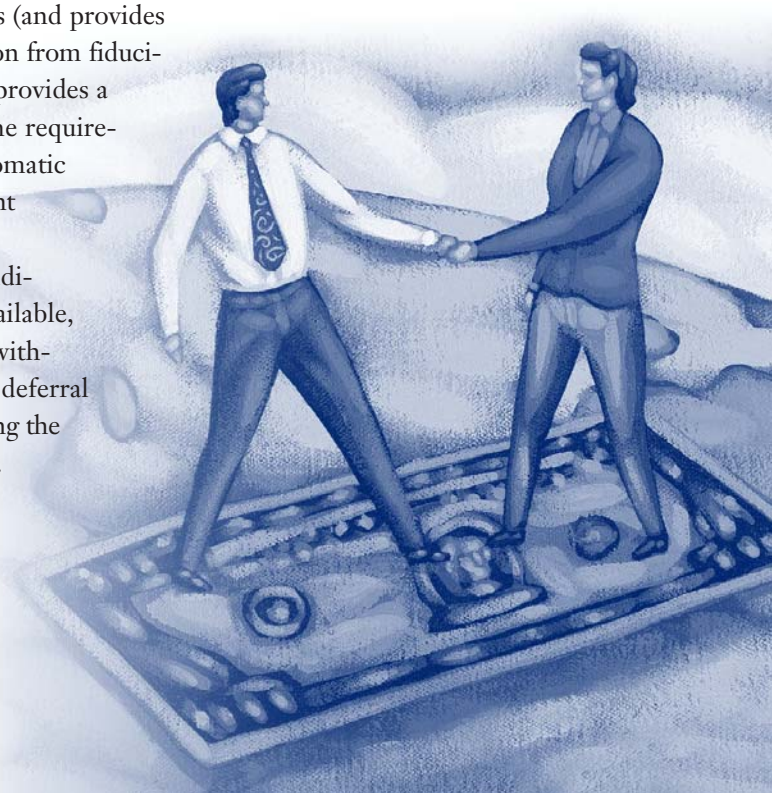
- The QACA safe harbor matching contribution formula is a 100% match on the first 1% of compensation deferred and a 50% match on deferrals between 1% and 6%,
- A two-year-cliff vesting schedule may be applied to QACA safe harbor contributions, and
- The minimum employee deferral percentage starts at no less than 3% and increases at least 1% annually to no less than 6% (with a maximum of 10%), unless the participant elects otherwise.

The Pension Protection Act of 2006 established a qualified default investment arrangement (QDIA), which allows for the investment of deferrals and employer contributions when employees fail to make investment choices (and provides employers with protection from fiduciary risk). A QACA that provides a QDIA must also meet the requirements of an eligible automatic contribution arrangement (EACA). When EACA requirements are met, additional options will be available, such as the permissible withdrawal of initial elective deferral contributions made during the first 90 days after deferral.

The Bottom Line. Safe harbor plan designs are very popular and, in many cases, provide valuable plan design options. However, employers should consider the *cost* of maximizing HCE deferrals as well as the advantages. When deciding between a QACA and a traditional safe harbor plan, an employer will need to consider at least these two issues:

1. Will turnover in the first two years save money with the two-year-cliff vesting schedule?
2. Will the maximum match of 3.5% provided in a QACA plan that uses automatic enrollment *cost more* than a maximum traditional safe harbor match of 4% provided only to those who elect to defer?

The question of whether to use a QDIA with a traditional safe harbor or add an automatic enrollment feature must also be addressed. Expectations, finances, fiduciary relief, and demographics should all be carefully weighed before committing to a traditional safe harbor 401(k) plan, a QACA, or a QDIA option with either one. ❖



The HEART Act

The Heroes Earnings Assistance and Relief Tax (HEART) Act was signed into law on June 17, 2008. It contains a number of changes to help those in the armed services and their families. Among other things, the HEART Act allows plans to treat individuals who die or become disabled while serving in the military as though they had returned to work the day before they died or became disabled.

Highlights Relevant to Retirement Plans. The HEART Act adds a new qualification requirement to the Internal Revenue Code (Section 401(a)(37)). Qualified plans must provide the survivors of a participant who dies or becomes disabled while performing qualified military service with any additional benefits (such as accelerated vesting, ancillary life insurance, and any other survivor benefits — other than benefit accruals — relating to the period of qualified military service) that would have been provided had the participant resumed work the day before death or disability and then terminated employment on account of death or disability the next day. In general, this provision of the HEART Act applies to deaths and disabilities occurring on or after January 1, 2007.

For benefit accrual purposes, an employer sponsoring a retirement plan *may* treat an individual who dies or becomes disabled (as defined under the terms of the plan) while performing qualified military service as if the individual resumed employment, in accordance with the individual's reemployment rights under USERRA, on the day preceding death or disability and terminated employment on the actual date of death or disability.

Any full or partial compliance by such plan with respect to the benefit accrual requirements applicable to such an individual shall be treated as required under USERRA and provided in a nondiscriminatory fashion.

Differential Military Wage Payments. Some employers compensate employees who are serving in the military by making differential wage payments (essentially, the difference between the amount of military pay the employee receives and the amount the employee was earning on the job). Effective January 1, 2009, such payments shall be treated as compensation for qualified plan contribution purposes (subject to nondiscrimination). Differential wage payments shall also be considered compensation for W-2 and IRA contribution purposes.

Distributions. An individual called into active duty in the uniformed services shall be treated as having been severed from employment and, thus, may take distributions from the plan, including deferrals. If deferrals are withdrawn, the individual may not make elective deferrals or employee contributions during the six-month period beginning on the date of the deferral distribution.

Qualified Reservist Distributions Made Permanent. An individual who is/was in the military reserves and is/was called into active duty for more than 179 days is entitled to withdraw certain retirement funds without incurring the 10% penalty that applies to individuals under age 59½. This applies to distributions from IRAs, qualified plans (such as 401(k) plans), and 403(b) plans, provided the distribution is made between the beginning date of the order/call to service and the date the active duty period ends. Furthermore, any or all amounts withdrawn may be repaid during the two-year period starting the day after active duty ends. This provision is effective January 1, 2008, and makes permanent a provision of the Pension Protection Act of 2006 that was in effect from September 11, 2001, to December 31, 2007.

Plan Amendments. Similar to the Pension Protection Act, the HEART Act calls for plans to operate in accordance with the new law's provisions (on the effective dates provided) before the actual plan amendment is required. The plan document amendment for the HEART Act is to be made on or before the last day of the first plan year beginning on or after January 1, 2010. The amendment deadline for governmental plans will generally be two years later. ❖

recent developments

EPCRS Update. The IRS's Employee Plans Compliance Resolution System (EPCRS) comprises three correction programs for employer retirement plans: the Self-Correction Program (SCP), the Voluntary Compliance Program (VCP), and the Audit Closing Agreement Program (Audit CAP). As it does every few years, the IRS has updated the EPCRS. One of the major goals of the current revision is to streamline, simplify, and expedite the VCP process for a number of common errors.

Previously, there was only one sample VCP submission schedule concerning interim good-faith non-amenders. The new procedure has added eight more sample compliance statements to Appendix F. The topics are non-amender failures (other than those on the first schedule), SEPs and SARSEPs, SIMPLE IRAs, plan loan failures, employer eligibility failure for a 401(k) or 403(b), failure to distribute excess deferrals, failure to pay required minimum distributions, and correction by plan amendment.

The new EPCRS is Revenue Procedure 2008-50 and is generally effective January 1, 2009. However, plan sponsors are permitted to use Rev. Proc. 2008-50 as of September 2, 2008. Rev. Proc. 2006-27 is modified and superseded by the new EPCRS. Section 3 of Rev. Proc. 2007-49 is also modified and superseded.

Fee and Expense Disclosure. The Department of Labor has issued proposed regulations regarding the investments available to 401(k) plan participants under the plan and the disclosure of fees and expenses involved with plan investments. Prior guidance released at the end of 2007 addressed disclosure to a plan fiduciary(ies). The DOL states that this will make it easier for an estimated 65 million 401(k) participants to make informed decisions about their retirement savings. The centerpiece of the proposed regulation is a requirement to provide investment related information in a comparative chart or similar format. The proposed regulations call for the new disclosure rules to apply to plan years beginning on or after January 1, 2009, though many industry practitioners question the ability of providers to meet that deadline. ❖

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.

Copyright © 2008 by NPI and McKay Hochman

ABOUT KIBBLE & PRENTICE

For more than 35 years, Kibble & Prentice has helped individuals and companies make decisions that create value and manage risk. We provide regionally-based services, world-class expertise and service in insurance and risk management consulting, employee benefits, retirement plan services, executive benefits and business continuation planning. Through our strategic partnerships and national platform, our clients have access to a full range of products and services. Our client-tested service model and personal focus enable us to provide our clients with objective advice — and the attention they deserve. By customizing each client's total risk management, investment and benefits strategy to meet their needs, we ensure a uniquely tailored and comprehensive approach to financial services. For more information, please visit www.kpcom.com.

Kibble & Prentice
A USI Company