October 26, 2007 v 07-01

Benefits Observer

President's Message

Hello again! It's been a while since our last newsletter but a lot has happened with retirement plans and employee benefits. For instance, the Pension Protection Act of 2006 introduced several new requirements and made permanent many of the changes from the Economic Growth and Tax Relief Reconciliation Act of 2001. The recent changes include guidance on such issues as automatic enrollment, default investment selection, investment advice and diversification. Employers can now have a general comfort level in taking a more active role in their employees' retirement planning. As a result, this may be a good time to think about changes to your retirement plan or other employee benefits for the upcoming year. As you know, offering great employee benefits is an excellent way of attracting and retaining employees. Improving the benefits of your retirement plan can often be accomplished with a simple plan amendment. For example, you may already offer a good 401(k) plan but adding the Roth 401(k) option (featured in our last newsletter) may make it more attractive to those employees who like the idea of being taxed now on contributions instead of later upon withdrawals. So take some time to think about what your retirement plan provides and determine if it meets the needs of all your employees.

Also, I would like to announce the newest addition to our staff. Phil Glackin joined us this summer as a Pension Analyst. Phil has an MBA and is a Certified Financial Planner™ with over 15 years experience in the pension area. Phil will be involved in research, plan installation and amendment processes and, of course, the Benefits Observer. Please contact Phil at (518) 374-5726 or pjg@lawrence-pearson.com with any questions you have about your plan document and the laws and regulations that pertain to your plan.

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2008 Retirement Plan Limits

On October 18, 2007, the Internal Revenue Service announced cost of living adjustments applicable to dollar limitations for pension plans and other items for Tax Year 2008.

	2008	**2007**	**2006**	**2005**	**2004**
Annual Benefit Limit - DB Plans	**$185,000**	$180,000	$175,000	$170,000	$165,000
Annual Addition Limit - DC Plans	**$46,000**	$45,000	$44,000	$42,000	$41,000
401(k)/403(b)/457 Deferral Limit	**$15,500**	$15,500	$15,000	$14,000	$13,000
401(k)/403(b)/457 Age 50 Catch-Up Limit	**$5,000**	$5,000	$5,000	$4,000	$3,000
SIMPLE Employee Deferrals	**$10,500**	$10,500	$10,000	$10,000	$9,000
SIMPLE Age 50 Catch-Up Limit	**$2,500**	$2,500	$2,500	$2,000	$1,500
IRA Contribution Limit (Traditional & Roth)	**$5,000**	$4,000	$4,000	$4,000	$3,000
IRA Age 50 Catch-Up Limit	**$1,000**	$1,000	$1,000	$500	$500
Annual Compensation Limit	**$230,000**	$225,000	$220,000	$210,000	$205,000
Highly Compensated Employees	**$105,000**	$100,000	$100,000	$95,000	$90,000
Key Employee	**$150,000**	$145,000	$140,000	$135,000	$130,000
Social Security Wage Base	**$102,000**	$97,500	$94,200	$90,000	$87,900
Social Security Cost of Living Increase	**2.3%**	3.3%	4.1%	2.7%	2.1%

ABCs of 401(k) Compliance

No matter what business you are in, you most likely have your own language when speaking to fellow employees, colleagues and competitors in your industry. As part of your language, you probably use acronyms as an easy and effective way to communicate. So it may come as no surprise that with your involvement in your company's 401(k) plan, you may already be exposed to the language and acronyms of the 401(k) industry.

Let's review the 401(k) basics and annual compliance requirements as an example:

401(k) is the reference to the section of the Internal Revenue Code (**IRC**) that allows an individual to contribute into their employer's defined contribution **(DC)** plan through a cash or deferred arrangement **(CODA)**. The amount of salary deferrals that can be contributed to the 401(k) plan depends on whether the individual is a highly compensated employee **(HCE)** or a non-highly compensated employee **(NHCE)**. For 2008, a HCE is generally any employee who earns $105,000 or more or is greater than a 5% owner of the company and a NHCE is generally anyone who earns less than $105,000 and is less than a 5% owner of the company.

The general rule of thumb is that the average deferral percentage **(ADP)** of the HCE's can be no more than 2% of the ADP of the NHCE's. If the employer decides to make a matching contribution, the average contribution percentage **(ACP)** for the HCE's can be no more than 2% of the ACP for the NHCE's. If a plan fails the ADP test, the employer has an opportunity to make an additional qualified non-elective contribution **(QNEC)** to the NHCE's to satisfy the discrepancies in lieu of contribution refunds for the HCE's. Likewise, if a plan fails the ACP test, the employer has an opportunity to make an additional qualified matching contributions **(QMAC)** to NHCE's satisfy the discrepancies in lieu of contribution refunds for the HCE's.

If this sounds a little complicated, you may be relieved to know that the employer can eliminate the ADP and/or ACP test requirements altogether by offering a Safe Harbor 401(k) plan. If the employer adopts a Safe Harbor 401(k) plan, they agree to:

1. make fully vested safe harbor non-elective contributions for all eligible employees based on 3% of compensation; or
2. make fully vested safe harbor matching contributions up to 4% of compensation for eligible employees making salary deferrals.

A safe harbor notice is also required to be provided to all eligible participants 30 days prior to the beginning of each plan year.

Although Safe Harbor 401(k) exempts the plan from the ADP and ACP tests, 401(k) plans are subject to these nondiscrimination tests:

- general nondiscrimination test under IRC Section 401(a)(4)
- maximum deferral limit test under IRC Section 402(g)
- coverage test under IRC Section 410(b)
- annual additions limitations test under IRC Section 415
- top-heavy test under IRC Section 416

All these nondiscrimination tests are fairly complex and need to be performed annually. These nondiscrimination tests should be handled by an experienced and reliable practitioner. This is why it is so important to have a trustworthy third-party administrator **(TPA)**, like Lawrence & Pearson Associates **(LPA)**, working for you.

New Statement Requirements

Prior to the Pension Protection Act of 2006 (PPA), plan administrators of defined benefit and contribution plans were generally required to provide plan participants and beneficiaries with benefit statements only once a year. PPA amended the applicable section of the Employee Retirement Income Security Act of 1974 (ERISA) that set forth the requirements applicable to furnishing benefit statements. As a result, there are a significant number of updated requirements for benefit statements of individual account plans (such as 401(k) plans) and defined benefit plans starting in 2007.

One significant change is that plan administrators are now required to provide benefit statements at least:

- Quarterly - in the case of individual account plans that permit participants to direct their investments
- Annually - in the case of individual account plans that do not permit participants to direct their investments
- Every 3 Years - in the case of defined benefit plans

Benefit statements must also be provided within a period of 45 days after the end of each applicable period.

PPA also increased the amount of information that must now be provided on benefit statements. Benefit statements are now required to include the participant's:

- total account balance (accrued benefit)
- vested account balance
- vesting date in the case of non-vested benefits
- value in each investment allocated to the account

For plans that permit participants to direct their investment, benefit statements are also required to include:

1. An explanation of any limits under the plan on the participant's right to direct investments
2. An explanation of the importance of a well-balanced and a diversified portfolio plus the risk of holding more than 20 percent of the account's value in any single investment
3. A notice directing the participant to the Department of Labor (DOL) website for information on investing and diversification at http://www.dol.gov/ebsa/investing.html

Benefit statements are also no longer required to be in written paper form only. Other forms, such as electronic, are now acceptable to the extent such form is reasonably accessible to plan participants or beneficiaries. However, the benefit statement must be written in a manner that is understood by the average plan participant. Benefit statements can be provided on a continuous basis through a secure web site with clear instructions. Participants must also be informed that a paper copy of their benefit statement is available at no charge upon request.

In order to comply with the requirements, the DOL issued Field Assistance Bulletin (FAB) 2006-03, which provides a method of good faith compliance. Until the final regulations are issued, the DOL is permitting plan administrators to use multiple documents or sources to provide the required information. Pending final regulations, the DOL also indicated that it will not bring enforcement actions against plan administrators acting in good faith compliance with a reasonable interpretation of the statute.

New Proposed Cafeteria Regulations

On August 6, 2007, the Internal Revenue Service issued new proposed cafeteria plan regulations under section 125 of the Internal Revenue Code. The proposed regulations replace existing regulations dating back to 1984. The proposed regulations incorporate and restate prior proposed regulations and add much needed clarification. The new proposed regulations are expected to be effective for a plan's year starting on or after January 1, 2009, but can be relied upon immediately.

Background

A cafeteria plan allows an employer to offer certain benefits to employees on a pre-tax basis. To qualify, an employee agrees to reduce compensation in exchange for benefits chosen prior to the start of the plan year. The proposed regulations reaffirm that a cafeteria plan must offer employees a choice between at least one permitted taxable benefit (typically cash) and at least one qualified nontaxable benefit.

Nonqualified Benefits

A plan offering any nonqualified benefit is not a cafeteria plan. A cafeteria plan can not offer any of the following benefits:

- scholarships
- employer-provided meals and lodging
- educational assistance
- fringe benefits
- contributions to Archer Medical Savings Accounts
- group-term life insurance for spouse, child or dependent
- elective deferrals to tax-sheltered annuity plans or
- long-term care insurance

A plan offering only elections among nontaxable benefits or a plan offering only elections among taxable benefits is not a cafeteria plan. In order to keep the qualified benefits from being taxable to employees and ensure the plan is valid, employers will need to comply with the new proposed regulations.

Below are some cafeteria plan requirements that reflect several of the general changes of the new proposed cafeteria regulations.

Written Plan

A cafeteria plan must be in writing and be operated in accordance with the written plan terms and must:

1. specifically describe all benefits
2. set forth eligibility rules, enrollment and election procedures
3. provide that all elections are irrevocable
4. state how employer contributions may be made
5. state the maximum amount of elective contributions
6. state the plan year
7. specify that only employees may participate
8. specify that the cafeteria plan year be for a 12-month period

If the cafeteria plan provides a flexible spending arrangement (FSA), it must also include provisions complying with the uniform coverage rule and the "use-it-or-lose-it" rule.

Qualified Benefits

A cafeteria plan can only offer qualified benefits. Qualified benefits are generally benefits attributable to employer contributions that are not currently taxable to the employee by reason of an express provision of the Code and do not defer compensation. Qualified benefits include health and insurance benefits, such as medical, dental, vision, life insurance and disability plan. The new proposed regulations also recognize adoption assistance plans, certain deferred compensation benefits and health savings accounts (HSAs) as qualified benefits.

Elections

A cafeteria plan must require irrevocable elections annually, which must be made before the first day of the coverage period. Certain mid-year elections are permitted if they are included in the written cafeteria plan document. There is also a special rule that applies if the plan offers HSA contributions through salary reduction. Automatic elections are also permitted. Elections, revocations or changes in elections can be made electronically.

Flexible Spending Arrangements (FSAs)

FSAs are designed to reimburse employees for incurred expenses of certain qualified benefits up to a designated amount. All benefits and contributions must be used by the end of the plan year ("use-or-lose-it" rule) or they must be forfeited. The required period of coverage for all FSAs is twelve months. The period of coverage and the plan year need not be the same. Non-elective employer contributions (or so-called "flex-credits") can be used at the employee's election for qualified benefits.

The new proposed regulations recognizes three types of FSAs:

1. dependent care assistance
2. adoption assistance
3. medical care reimbursements

Experience Gains (Forfeitures)

Unused amounts are now referred as "experience gains." The new rules retain the forfeiture allocation rules of prior guidance under which the employer sponsoring the cafeteria plan may:

- retain forfeitures
- use forfeitures to defray expenses of administering the plan
- allocate forfeitures among participating employees

Substantiation of Claims

A cafeteria plan may only pay or reimburse an expense that is:

- properly substantiated
- incurred on or after enrolled in a particular qualified benefit
- incurred while covered under the particular qualified benefit

Nondiscrimination

The cafeteria plan must not discriminate in favor of highly compensated individuals with respect to eligibility, contributions and benefits. Also, several key terms are now defined, including dependent, highly compensated individual or participant, officer, five percent shareholder, key employee and compensation. Testing under the new rules must be performed as of the last day of the plan year. The proposed regulations establish two safe harbors, under which a plan is deemed to be nondiscriminatory.

Conclusion

Cafeteria Plans will soon be more formal, particularly in terms of documentation, substantiation and nondiscrimination. Specific information regarding the proposed regulations can be found at: www.ustreas.gov/press/releases/reports/section125.pdf.

Qualified Default Investment Alternatives (QDIA) Final Regulations

On October 23, 2007, the Department of Labor (DOL) issued final regulations relating to Qualified Default Investment Alternatives (QDIA) under Participant Directed Individual Account Plans. QDIA was created out of a provision from the Pension Protection Act of 2006 (PPA). The final QDIA regulations are effective December 24, 2007. Plan sponsors who elect QDIA and comply with the guidelines in the final regulations will not be liable for investment outcomes for participants who are subject to QDIA as a result of not selecting their investments. Plan sponsors will still be responsible for prudently selecting and monitoring the particular funds that make up the QDIA and the managers of those funds.

Overview of Final Regulation

The final regulations provide the following conditions that must be satisfied in order to obtain safe harbor relief from fiduciary liability for investment outcomes:

- Assets must be invested in a "qualified default investment alternative" (QDIA) as defined in the regulation.
- Participants and beneficiaries must have been given an opportunity to provide investment direction, but have not done so.
- A notice generally must be furnished to participants and beneficiaries in advance of the first investment in the QDIA and annually thereafter. The rule describes the information that must be included in the notice.
- Material, such as prospectuses, provided to the plan for the QDIA must be furnished to participants and beneficiaries.
- Participants and beneficiaries must have the opportunity to direct investments out of a QDIA as frequently as from other plan investments, but at least quarterly.
- The rule limits the fees that can be imposed on a participant who opts out of participation in the plan or who decides to direct their investments.
- The plan must offer a "broad range of investment alternatives" as defined in the Department's regulation under section 404(c) of the Employee Retirement Income Security Act of 1974 (ERISA).

Qualified Default Investment Alternatives (QDIA)

The final QDIA regulations did not specify particular investment products, but provided mechanisms with which to ensure participants are invested appropriately. The final regulations provides for four types of QDIAs:

1. A product with an investment mix that factors the participant's age or retirement date (i.e. lifecycle or target fund);
2. An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the participant's age or retirement date (i.e. a professionally managed account);
3. A product with an investment mix that factors the characteristics all employees of the employer, rather than each participant (i.e. a balanced fund); and
4. A capital preservation product for only the first 120 days of participation. This may be suitable for plans with automatic enrollment where employees can opt-out within 90 days. Unless the participant opted-out or redirected investments within 90 days, the participant's investment must be redirected into another QDIA after 120 days

Other Significant Provisions

- Recognizing that some plan sponsors adopted stable value products as their default investment prior to passage of PPA and this final regulation, the regulation provides a transition rule. The regulation "grandfathers" these arrangements by providing relief for contributions invested in stable value products prior to the effective date of the final rule. The transition rule does not provide relief for future contributions to stable value products.
- The final regulation clarifies that a QDIA may be offered through variable annuity contracts or other pooled investment funds.
- The rule provides that ERISA supersedes any State law that would prohibit or restrict automatic contribution arrangements, regardless of whether such automatic contribution arrangements qualify for the safe harbor.

A copy of the final regulations and fact sheet summarizing the final regulations can be found at www.dol.gov/ebsa.

Please contact us to discuss any of the information mentioned in this newsletter or any other employee benefits or retirement plan issues .

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