TRISTAR PENSION CONSULTING

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Keeping Plans in Compliance

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A qualified retirement plan can provide many benefits to employees as well as the sponsoring employer. Employees are ultimately provided with income to help sustain their lifestyle in their post-retirement years. Employers are given a tax deduction for contributions made to the plan, which helps them provide a valuable fringe benefit and boost employee morale.

In 1974 Congress passed the Employee Retirement Income Security Act (ERISA), which provided much needed protection for workers' retirement benefits. That law, as well as applicable sections of the Internal Revenue Code (IRC), established a host of administrative rules which must be followed in order for a plan to maintain its qualified status and avoid excise taxes and fiduciary penalties. Following is a summary of the ongoing compliance requirements for qualified plans.

NONDISCRIMINATION TESTING

One of the basic requirements of a qualified plan is that it not discriminate in favor of employees who are considered "highly compensated employees" (HCEs). HCEs are employees who own more than 5% of the employer in the current year or the previous year (including family attribution rules) or who earned more than $90,000 in the previous year.

COVERAGE REQUIREMENTS

The first area of possible discrimination involves the coverage requirements of IRC section 410(b). This comes into play where a plan is established for only a portion of the employer's staff and not the entire company. Testing is done on an annual basis to insure that the percentage of the company's non-HCEs covered under the plan is at least 70% of the percentage of the company's HCEs that are covered. Alternatively, the plan can pass a more complicated "average benefits test" which illustrates that the benefits provided do not discriminate in favor of the HCEs.

EMPLOYER CONTRIBUTIONS

Money purchase pension plans and profit sharing plans contain a formula for allocating employer contributions, although in profit sharing plans contributions are often discretionary (optional) from year to year. Such contribution allocations must not violate nondiscrimination rules. While the formula established under the plan generally must prohibit discrimination, certain facts and circumstances need to be considered each year. For example, a plan may require employment on the last day of the plan year to be eligible to share in the contribution, as well as completion of up to 1,000 hours of service. But if a significant number of employees who worked over 500 hours are eliminated from the allocation because of these rules, the plan may be considered discriminatory. This could result in having to include some of the otherwise ineligible participants in the allocation.

401(K) PLANS

Plans that allow salary deferrals, matching contributions and/or other employee contributions must test these contributions for discrimination at the end of each plan year (except safe-harbor 401(k) plans). The ADP (actual deferral percentage) and ACP (actual contribution percentage) tests compare contributions made on behalf of the HCEs with contributions made on behalf of the non-

HCEs. Generally, the HCEs are allowed an average percentage that is somewhat larger than the average for the non-HCEs. The differential varies depending upon the non-HCE contribution level.

Plans that don't pass the ADP and/or ACP test usually satisfy the test(s) through corrective distributions, although other methods are available such as making additional employer contributions. A failed test must be corrected within 12 months of the end of the plan year. However, corrective distributions made more than 2½ months after the plan year-end will be subject to a 10% excise tax.

CONTRIBUTION AND BENEFIT LIMITATIONS

IRC section 415 provides the maximum benefit and annual additions limitations for each participant. For plan years beginning in 2004, the maximum annual retirement benefit that can be provided in a defined benefit pension plan is $165,000. In defined contribution plans, the maximum annual additions (i.e., total contribution and forfeiture allocations) is the lesser of 100% of a participant's compensation or $41,000. For benefit and contribution calculation purposes, the maximum compensation that can be utilized is $205,000.

The maximum salary deferral for 2004 is $13,000. If permitted by the plan, those age 50 and older can defer an additional $3,000 as a catch-up contribution (even if it causes the annual additions to exceed $41,000). In Simple 401(k) plans, the maximum deferral is $9,000, and the catch-up limit is $1,500.

The plan administrator must make sure that these limits are not exceeded. Excess annual additions must be distributed to the participant, reallocated or transferred to a suspense account, in accordance with the plan provisions. Excess deferrals must be distributed by April 15th following the calendar year of the excess. Since the deferral limit includes all plans in which an employee participated during the calendar year, it is the employee's responsibility, if he participated in salary deferral plans of more than one employer, to notify such employers of any excess.

TOP HEAVY TESTING

Each retirement plan must perform an annual test to determine if it is "top heavy." A plan is considered top heavy if key employees (generally owners and highly paid officers) have more than 60% of the total account balances (defined contribution plans) or present value of accrued benefits (defined benefit plans) of all plan participants. The determination date for the calculation of top heavy status is the last day of the previous plan year.

If a plan is determined to be top heavy, the employer must provide certain minimum contributions or benefits, and meet one of the enhanced vesting schedules.

REPORTING REQUIREMENTS

FORM 5500 ANNUAL REPORT

Most plan sponsors must file an annual report, Form 5500, with the Department of Labor by the end of the 7th month following the plan year-end. The deadline may be extended an additional 2½

months by filing an extension. Where the owner of the company is the only participant, the plan is exempt from filing a Form 5500 until total assets of all plans of the employer exceed $100,000.

Plans with 100 or more participants at the beginning of the year ("large plans") are required to attach an accountant's audit report to the Form 5500. An exception applies for plans with no more than 120 participants that were able to file as a small plan the previous year. Small plans are only exempt from the audit requirement if 95% of the assets are "qualifying plan assets" or if a fidelity bond is purchased for non-qualifying assets and a notice requirement is satisfied in the summary annual report (see below). Qualifying plan assets include assets held or issued by a registered investment company or financial institution, qualifying employer securities, participant loans and participant-directed investments.

ERISA requires plan fiduciaries to obtain a surety bond for at least 10% of the value of plan assets. The amount of the bond in force must be reported on Form 5500.

FORM 1099-R

Distributions from qualified plans are required to be reported to the IRS on Form 1099-R with a copy furnished to the participant. This is true even if the distribution is nontaxable, as in the case of a direct rollover to an IRA or other qualified plan. Form 1099-R must also be filed for a defaulted loan treated as a distribution. The deadline for furnishing the participant's copy is January 31st following the calendar year of distribution.

PBGC PREMIUMS

Defined benefit plans that are subject to the federal government's PBGC (Pension Benefit Guaranty Corporation) insurance program must pay the required annual premium accompanied by the appropriate PBGC forms. The deadline varies depending upon the size of the plan and its funding status.

PARTICIPANT NOTIFICATIONS

Certain information must be provided to participants throughout the year. Here is a list of the necessary notifications:

Summary Annual Report: A summary of Form 5500 must be provided to each participant within two months of the 5500 filing deadline (including extensions).

Summary Plan Description (SPD): This document which summarizes the plan provisions should be provided to new participants within 90 days of their plan entry date. The SPD should be updated every five years if the plan has been amended, or every ten years if no amendments have been adopted.

Summary of Material Modifications: When a plan amendment results in a material modification of one or more plan provisions, an explanation of the amendment must be provided to participants within 210 days of the end of the plan year in which the amendment was adopted.

Benefit Statements: Most plans provide benefit statements to participants at least once a year and, if not, are required to do so upon request. Pension plans must automatically provide a benefit statement when a participant terminates employment or has experienced a one-year break in service within 180 days of the close of the plan year in which such termination or service break occurred.

Safe-Harbor Notice: 401(k) plan sponsors who elected to make safe-harbor contributions to avoid ADP and ACP testing must give out a safe-harbor notice within a reasonable time before the start of the plan year. A notice distributed between 30 and 90 days before the first day of the plan year will automatically be considered timely.

Distribution Forms: Participants who are entitled to a distribution of their benefits should be provided with appropriate distribution forms as well as tax and rollover information. Plans that contain annuity distribution options must also furnish a notice explaining spousal rights and comparing equivalent values of optional forms of benefits.

Qualified Pre-Retirement Survivor Annuity (QPSA) Forms: Plans that offer annuity distribution options must provide a written explanation of the QPSA and a waiver form to each participant between the ages of 32 and 35. Where the QPSA first becomes available after age 35 (as with participants hired after that age), the materials must be provided within one year of applicability. Participants who terminate employment before age 35 should be notified within one year of separation.

Investment Information: Many plans today, particularly 401(k) plans, allow participants to direct the investments in their accounts. In order for plan fiduciaries to limit their liability for poor investment results in such accounts, ERISA section 404(c) requires that participants be given the opportunity to exercise control over their accounts. Consequently, they must be furnished with sufficient information about the investments available to them under the plan. Prospectuses and other reports about available investments must be provided on a regular basis (and upon request), and statements showing account balances and activity should be provided at least once every three months.

Blackout Notice: When investment direction, loans or distributions will be unavailable to participants, as in the case of the transfer of plan assets from one custodian to another, a blackout notice must be provided between 30 and 60 days before the blackout period begins.

CONCLUSION

There are numerous administrative procedures and reporting requirements that must be followed throughout the year to keep a qualified retirement plan in compliance with ERISA and the Internal Revenue Code. Failure to comply can result in fines, excise taxes and even plan disqualification. A properly administered plan can be a valuable fringe benefit for employers and employees.

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