



LAW OFFICES OF
PEEPLS & HILBURN, P.C.
 5580 Peterson Lane, Suite 145
 Dallas, Texas 75240



Richard H. Peeples
Allison M. Kohler

TEL: (972) 503-9441
 FAX: (972) 503-9442

WEB PAGE: www.peepleshilburn.com

Winter 2010-2011

RETIREMENT PLAN NEWSLETTER

INTRA-PLAN ROTH CONVERSIONS

The Small Business Jobs Act of 2010 was signed into law on September 27, 2010. This legislation permits a 401k plan *which has Roth provisions* to allow a participant to transfer "distributable account balances" into the participant's designated Roth contribution account within the same plan. Perhaps a way of referring to this is an "intra-plan Roth conversion". Only amounts which are eligible for in-service distribution can be converted. Thus, for example, 401k and safe harbor account balances cannot be converted until the participant has attained age 59½ (since by law such balances cannot be distributed prior to that age).

The plan's terms will dictate whether amounts are eligible for in-service distribution. For example, the plan may permit the in-service distribution of discretionary matching and profit sharing contribution account balances before age 59½. A plan's in-service provisions can be amended to facilitate these conversions. Any amended provision can apply universally or be limited to only those participants who request an intra-plan Roth conversion.

No actual distribution will occur for these intra-plan Roth conversions. Instead, a participant would request an in-service "distribution" of all or a portion of the participant's account and designate that such amount be "transferred" into the participant's Roth account in the 401k plan. This "distribution" amount will be transferred *on a bookkeeping basis* from the non Roth account (e.g., a discretionary profit sharing account) into an intra-plan Roth rollover account. *It should be noted that unlike conversions to Roth IRAs, a participant does not have the ability to change her/his mind and reverse the conversion at a later time.*

Generally, a participant must pay taxes on the amount of any intra-plan Roth conversion in the year of the conversion. However, *for 2010 conversions only*, a

participant will be able to recognize the income on any 2010 intra-plan Roth conversion in 2011 and 2012 unless the participant elects to recognize the entire amount in 2010.

This legislation is effective for distributions made after the date of enactment. However, if the sponsor/ employer wishes to permit intra-plan Roth conversions, the plan document must be amended. The IRS has issued guidance providing that such amendments are required by the later of the last day of the year in which the amendment is effective or December 31, 2011. *However, notice to participants must be provided before any conversion is processed. Please contact us if you are interested in amending your plan to allow intra-plan Roth conversions.*

FEE DISCLOSURES

In 2010, the Department of Labor has launched a three-step disclosure initiative focused on fees paid by and on behalf of qualified retirement plans. The first step involves reporting requirements on Schedule C of the annual Form 5500. The second step involves regulations issued under Section 408(b)(2) of ERISA. These regulations require disclosures from "covered service providers" to the plan sponsor. Under ERISA, there are rules that allow a plan to pay "reasonable" compensation to certain service providers. The prior 408(b)(2) regulations addressed what is "reasonable" compensation. These new regulations add an additional layer requiring certain disclosures about the services performed and the fees charged for those services.

The third step involves regulations issued under Section 404(a) of ERISA. *These regulations only apply to defined contribution plans that allow participants to direct the investment of their individual accounts.* These regulations require the plan administrator to provide to each participant or beneficiary certain plan-related information and certain investment-related information.

If you have questions about how these rules may impact your plan, we recommend you contact your financial advisor, plan administrative firm or us for assistance.

EGTRRA PLAN RESTATEMENT

Since 2005 our newsletters have included updates about the required restatement of all qualified retirement plans to incorporate the 2001 EGTRRA legislation and various post-EGTRRA laws and regulations. The deadline for restating all 401k and other defined contribution plans was April 30, 2010.

The IRS has now announced a two-year "window" during which all defined benefit plans (including frozen plans) will have to be restated to incorporate these EGTRRA and post-EGTRRA changes. The window began on May 1, 2010 and will end on April 30, 2012. This restatement will consolidate the "good faith" amendments to your existing plan and also add additional, legal language required by the IRS.

We began restating client plans in August of 2010, and are continuing our review of all defined benefit plans. We will be sending out individual correspondence describing the restatement process and the related fees. *As always, we remain committed to providing high-quality, cost-effective service.*

DEFINED BENEFIT FUNDING AND DEDUCTIONS

As a result of the Pension Protection Act of 2006 (PPA), the rules governing defined benefit plans have changed dramatically. First, the employer/sponsor of a defined benefit plan is required to fund *at a minimum* an amount equal to the cost of the benefits earned by participants during the year (called the "target normal cost"). Whether there are additional funding requirements now depends on the plan's "funded status".

A plan's funded status is determined annually by calculating plan liabilities and comparing that to the value of the plan assets. If the total present value of benefits earned by participants exceeds the plan assets, the plan has what is called an "asset shortfall". Under the PPA rules, if there is an asset shortfall, the sponsor must make a contribution to pay off the shortfall, normally over a seven-year period. This shortfall funding amount is in addition to the target normal cost *and is required even if the plan benefits have been frozen.*

The law requires that the plan actuary must formally "certify" the funded status of the plan by the 1st day of the fourth month of the plan year (i.e., April 1 for a calendar year plan). If the plan's funded status falls below certain thresholds, various restrictions relating to distributions and benefit levels are triggered.

On the flip side, another PPA funding rule may result in a plan's assets actually exceeding the present value of benefits earned by participants. Under PPA, the sponsor may be able to contribute and deduct certain amounts in advance of the benefits actually being earned (this is referred to as a "cushion amount"). If cushion amounts are funded, those amounts may be applied in subsequent years toward satisfaction of any required contributions. In a sense, funding the cushion is like setting up a savings fund inside of the defined benefit plan trust account.

Contributions made by the employer/sponsor to defined benefit plans within the funding range (as determined by the administrative firm) are deductible. However, where an employer sponsors and contributes *both to defined benefit and 401k/profit sharing plans*, special deduction rules apply. In those cases, the deduction is *generally* the greater of (1) 31% of considered compensation of participants covered under the plans or (2) the deductible defined benefit funding amount plus an amount contributed to the 401k/profit sharing plan up to 6% of considered compensation. Salary deferral amounts made to a 401k plan are deductible in addition to this limit. Where multiple affiliated employers have adopted the plans, these limits generally apply separately to each of these business entities.

As you can see, these funding rules are complicated and the plan's funded status can have significant ramifications. **Therefore, it is very important to keep in touch with your financial advisor, us and your administrative firm if your financial situation changes.**

CASH BALANCE PLANS

In addition to the many changes that PPA made for traditional defined benefit plans, PPA also formally sanctioned cash balance defined benefit pension plans (also called "hybrid plans") and imposed a number of requirements on those plans. For purposes of this article, a cash balance plan is a pension plan which defines the benefit as a lump sum amount (often called a "hypothetical account balance") instead of a fixed monthly benefit. For example, a cash balance benefit formula may provide for an annual benefit equal to 3% of compensation (often called a "hypothetical allocation") for each active participant plus an annual interest earnings credit, whereas the traditional defined benefit formula might provide a benefit equal to 0.5% of the participant's average compensation for each year of plan participation. Many employers and participants alike favor this type of plan design because it is easier for the participant to appreciate the value of the plan when she can see a hypothetical account balance (which closely resembles an account balance under a 401k/profit sharing plan) as compared to a monthly benefit payable at normal retirement age over the participant's lifetime.

Cash balance plans are still considered defined benefit pension plans and are subject to the same funding and accrual rules that govern traditional defined benefit plans. Thus, a cash balance plan is subject to the "target normal cost" and "funded status" calculations described above. Generally, the *funding level* of the cash balance plan is determined by multiplying the hypothetical allocations in the plan by the compensation of the plan participants and by comparing the actual rate of return to the annual interest earnings credit provided under the plan formula. In a traditional defined benefit plan, the funding level is more dependent on the ages of the participants and is highly sensitive to changes in interest rates. Consequently, cash balance plans often provide more stable funding levels from year to year.

New plans can be established as cash balance plans. In addition, existing traditional defined benefit plans can be converted into cash balance plans on a prospective basis. With the release of recent IRS regulations, the rules and protections for participants that apply in the case of a conversion are more clearly defined. **If you or your financial advisor have questions about cash balance plans or cash balance conversions, please contact us.**

DOCUMENTATION OF FAMILY ON PAYROLL

Because we feel it is an important issue for your plan, we continue to include information about family members on payroll in our annual newsletter. In many small businesses family members provide personal services to the business. Like other employees, they can be compensated for their services and contributions to the business' retirement plans can be made on their behalf. That compensation and any plan contributions are legitimate deductions for the business, *but only so long as the services are ordinary and necessary to the business and the total compensation is reasonable for the personal services provided.*

It is important to document that the rate of compensation for any family member on the payroll is comparable to the rates paid to other employees performing similar functions. We also believe it is important to maintain a personnel file for any family members/employees and keep track of the hours they spend performing services related to the business by maintaining an accurate time log. **If you have questions about this, we recommend that you contact your tax and/or financial advisor.**

REHIRED EMPLOYEES

Another year has passed, and again we have observed that rehired employees continue to provide challenges for our clients and their plans. In virtually all plans, if you rehire an employee who previously worked for your business (or a predecessor or related business, such as a

prior sole proprietorship), her prior employment is counted in determining her eligibility for the plan. *This applies even if the prior employment occurred before the plan existed.* This also applies even if the employee is only rehired on a "fill-in", temporary or part-time basis. Normally, a rehired employee who had previously met the eligibility requirements is eligible *immediately* as of her date of re-employment and would enter the plan on that date. She does not have to wait until the next regular entry date.

If a rehired employee is eligible and you have a 401k plan, you must give her the Salary Reduction Agreement form on her date of rehire (safe harbor plans must also provide the Safe Harbor Notice for the current year on the same date). You will also need to give her a copy of the current Summary Plan Description. *If you fail to do so, you will be required to make corrective contributions for the rehired employee in accordance with the IRS program known as Employee Plans Compliance Resolution System (EPCRS). These contributions will be immediately 100% vested.*

For any rehired employees, we recommend that you contact your plan administrative firm or us immediately upon rehire to determine exactly when they will be eligible to participate.

SAFE HARBOR NOTICE FOR 401k PLANS

The Safe Harbor Notice is the key document in the annual operation of a safe harbor 401k plan. The notice describes in simple terms the major provisions of the plan. Generally, your plan administrative firm will assist you in providing this notice.

If you do not timely distribute the annual Safe Harbor Notice to all participants, *including each newly eligible employee and rehired employees*, and allow salary deferrals to be made, you have caused, at the very least, an operational error which must be corrected. The IRS program known as the Employee Plans Compliance Resolution System (EPCRS) sets out an appropriate correction method and involves making corrective contributions for the affected employee(s). This will result in increased funding costs and administrative and legal expenses to you. **If you have questions about which employees are eligible to participate in the plan, we recommend you contact your financial advisor, plan administrative firm or us for assistance.**

401k SALARY DEFERRAL (AND OTHER) LIMITS

The IRS establishes annual limits on amounts that can be contributed to retirement plans. For the second year in a row, most of these limits did not increase for 2011. For 2010 and 2011, the dollar limits for making salary deferrals to 401k plans (called the 402(g) limit), including "catch-up" contributions, are \$16,500 and \$5,500, respectively. *These limits apply to a participant's*

combined pre-tax deferrals and Roth deferrals, if applicable. "Catch-up" contributions are additional deferrals that participants who are age 50 or older at any time during the year can make to a 401k plan.

Several other 2011 dollar limits as published by the IRS are below. These limits are indexed for inflation after 2011.

| | |
|--|-----------|
| Annual compensation limit | \$245,000 |
| Defined contribution plan dollar limit | \$49,000 |
| Defined benefit plan dollar limit | \$195,000 |

DEPOSITING 401k DEFERRALS

The assets of your 401k plan include participants' salary deferrals (including Roth deferrals, if applicable). Department of Labor (DOL) regulations state that *such deferrals must be separated from the assets of the employer (i.e., transmitted to the plan trust account) as of the earliest date on which it is reasonably possible to do so.*

As discussed in our last couple of newsletters, the DOL issued guidance in 2008 establishing a safe harbor to meet the "earliest date" standard. Under that guidance, the DOL considers participant salary deferrals to be timely separated if transmitted to an account of the plan no later than 7 business days after the pay date. This safe harbor also applies to loan payments withheld from a participant's pay. It is important to remember that this DOL guidance establishes a "safe harbor" for timeliness; it does not override the general rule. Thus, while we recommend you meet the 7 business day standard whenever possible, just because an amount is deposited outside of the safe harbor time period does not necessarily make the deposit late. As is always the case with the DOL, it is a facts and circumstances determination.

This is an issue of great importance to the DOL. Thus, in all cases, when late deposits of salary deferrals are identified, you must correct them by funding any missing deferral amounts and in addition, making a contribution to the plan for lost earnings. The late deferrals will be reported as late on the plan's annual Form 5500 return. The DOL does offer a voluntary correction program for reporting late deposits of deferrals; however, we have found that for most of our clients, the amount involved is minimal. Thus in most cases the administrative and legal costs involved in submitting an application under the program would greatly outweigh any benefit from participating in the program.

Please be aware that the DOL continues to actively police the late deposit of salary deferral (and loan payment) amounts. Thus, you may receive a letter from the DOL regarding salary deferral amounts that have been reported as late on the plan's Form 5500. Generally, the DOL letter will invite you to participate in

their voluntary correction program. However, in some cases, plan sponsors are being notified that their plan has been selected for an audit. **If you are contacted by the DOL, we recommend that you contact your plan administrative firm or us immediately.**

NON-TRADITIONAL INVESTMENTS

We continue to have clients ask about investment of plan assets in "non-traditional" investments. Several legal issues can arise where "non-traditional" investments are made by qualified plans. Basically, this includes any investment that is not in publicly traded stocks, bonds, mutual funds or qualified group pooled trusts. Examples include real estate investments, partnership interests, non-publicly traded stocks or loans. With respect to the investment decision, we have identified three broad *legal* issues that often require analysis - fiduciary duties, prohibited transaction rules and plan asset regulations. In addition, non-traditional investments raise administrative issues concerning valuation and reporting of the non-traditional asset and the required coverage amount under the plan's ERISA bond.

If you are considering investing plan assets in a "non-traditional" investment, please contact your financial advisor or us for a general review of the legal issues.

CHANGES IN YOUR BUSINESS OPERATION AND/OR CONTACT INFORMATION

Any change in your business structure (incorporation, new partner, split in partnership, etc.) or establishment or purchase of an interest in another business may impact your qualified retirement plan. **Please let us know about any purchase of a business interest or change in your business structure as soon as possible. Also, please notify us of any changes regarding your office, mailing or email address, your telephone or fax number (including area code), or your plan advisors so that we may keep our records up to date.**

CHANGES IN OUR BUSINESS

As highlighted in the immediately preceding article, we routinely ask you to notify us of any changes in your business structure. We would now like to notify you of a change in ours! Allison M. Kohler, who has been an attorney with the firm since 2004, has become an owner in the firm. Richard H. Peebles will continue to be in the office and involved in the practice, though he will be reducing his hours in order to spend more time enjoying other pursuits. **Feel free to contact us if you have any questions about this transition.**

This newsletter contains general information and should not be used to resolve legal questions regarding specific fact situations.