

# retirement

## plan news

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### Final 401(k) Regulations Effective in 2006

The long-awaited final 401(k) regulations, effective for plan years beginning after December 31, 2005, were issued by the IRS in December 2004. Although IRS guidance on how to integrate the final regulations into plan documents is still pending, the changes are firm and plan sponsors should be prepared to address them.

This article is an overview of several of the most notable changes to 401(k) plans contained in the final regulations, including rule changes, clarifications, and new options for plan sponsors.

Plan sponsors have the option of applying the final regulations to any plan year ending after December 29, 2004, and before their 2006 plan year. However, any plan adopting the final regs before its 2006 plan year must apply *all* of the final regulations for that entire plan year.

#### Discretionary Matching

##### Contributions in a Safe Harbor Plan.

Within limits, a safe harbor plan may make discretionary matching contributions without triggering the actual contribution percentage (ACP) test if:

- The contributions do not exceed 4% of compensation,
- The contributions are not made on deferrals that exceed 6% of a participant's compensation, and
- The rate of match for any highly compensated employee (HCE) is not more than that of any nonhighly compensated employee (NHCE).

Failure to comply with these restrictions

will require the plan to run an ACP test. The final regulations clarify another restriction: To remain exempt from ACP testing, *all* matching contributions must be allocated on a nondiscriminatory basis.

*Example:* A safe harbor 401(k) plan with a 3% qualified nonelective contribution (QNEC) and a discretionary match of 50 cents on a dollar on up to 6% of deferred compensation satisfies the actual deferral percentage (ADP) safe harbor test. If the plan has a last-day rule and/or a 1,000-hours-of-service requirement on the discretionary match, however, this plan will not satisfy the ACP safe harbor test unless *all* the NHCEs meet all the allocation requirements. If even one of the NHCEs does not, then the plan will have to run the ACP test. The surest way to avoid the ACP test is to eliminate allocation requirements on the discretionary match.

**Hardship Withdrawals.** Prototype plan documents currently provide four safe harbor reasons for hardship withdrawals:



1. To pay medical expenses described under IRC Section 213(d) for the employee or the employee's spouse or dependent. (*All* deductible medical expenses are includable, not just amounts that exceed 7.5% of adjusted gross income.)

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2. To purchase the employee's principal residence. (Mortgage payments do not qualify.)
3. To pay tuition and related educational fees for the next 12 months of post-secondary education for the employee or the employee's spouse, children, or dependents.
4. To prevent eviction from, or mortgage foreclosure on, the employee's primary residence.

The final 401(k) regs expand the list of expenses that qualify as safe harbor reasons for hardship withdrawals. The additions are:

5. Funeral expenses of the employee's parents, spouse, children, or dependents.
6. Certain expenses to repair damage to the employee's principal residence that would qualify for the casualty deduction, such as damage from hurricanes or floods. (This is for all casualty expenses, not just the losses that exceed 10% of AGI.)

Participants are no longer required to take a plan loan *before* taking a hardship distribution if taking the loan makes the hardship worse.

**Prefunding Prohibited.** Employers may not make contributions on behalf of their employees until the employees have worked the requisite amount of time to earn the money supporting the contributions. An exception is allowed for a "bona fide administrative consideration" (a circumstance that might require contributions to be deposited prematurely, such as a pay period when the company bookkeeper is going to be absent).

**Irrevocable Elections.** The deadline for employees to "opt out" of an employer's plan has been pushed back from the indi-

vidual's initial date of employment to the date the individual first becomes eligible to participate in the plan.

### "Successor Plan Rule" Options

**Expanded.** In general, an employer must wait 12 months after terminating a 401(k) plan and distributing elective plan deferrals before establishing a new defined contribution plan. The employer may, however, establish or maintain certain "alternative plans" without waiting 12 months. Currently, defined benefit plans, employee stock ownership plans (ESOPs), and simplified employee pension (SEP) plans are considered permissible alternative plans. Under the final regulations, the list of permissible alternatives is expanded to include 403(b) and 457(b) plans and SIMPLE (Savings Incentive Match Plan for Employees) IRAs.

### Restrictions on Transferred Assets.

If an employer directs a plan-to-plan transfer of assets, the final regs reinforce the requirement that the receiving plan must maintain the transferring plan's restrictions on withdrawals of elective deferrals and qualified contributions. ❖

## IRS and Social Security Cost-of-Living Adjustments

IRS LIMITS	2006	2005
Defined Contribution Plan Limit on Annual Additions	\$44,000	\$42,000
Defined Benefit Plan Limit on Annual Benefits	\$175,000	\$170,000
Maximum Includable Compensation	\$220,000	\$210,000
401(k), SARSEP, 403(b), and 457 Plan Deferrals/Catch-up	\$15,000/\$5,000	\$14,000/\$4,000
SIMPLE Deferrals/Catch-up	\$10,000/\$2,500	\$10,000/\$2,000
IRA Contributions/Catch-up	\$4,000/\$1,000	\$4,000/\$500
Compensation Defining Highly Compensated Employee (for use in 2007 plan year tests)	\$100,000	\$95,000
Compensation Defining Key Employee/Officer	\$140,000	\$135,000
Social Security Taxable Wage Base (SSTWB)	\$94,200	\$90,000

# Roth 401(k) Basics

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) created the Roth 401(k) deferral option for plan years beginning after December 31, 2005. With the final Roth 401(k) regulations still pending at press time, the following analysis is based on the proposed regulations released by the IRS in March 2005. Note that plan sponsors are not required to adopt the Roth 401(k) — it is an optional plan design.

**An Overview.** In a traditional pretax 401(k), salary deferrals and account earnings are tax deferred when held in the plan and taxable when withdrawn. With a Roth 401(k), salary deferrals are made with after-tax dollars and are withdrawn tax free. The earnings on Roth deferrals are tax free when withdrawn *if* contributions remain in the plan for at least five years after the first Roth deferral *and* the participant is age 59½, becomes disabled, or dies.

**Maximum Deferrals.** A participant may choose to make both traditional pretax and after-tax Roth deferrals. In 2006, the maximum amount a participant may defer is \$15,000. Participants age 50 or older may make additional catch-up contributions of up to \$5,000. Thus, the total of a participant's pretax *and* Roth deferrals may not exceed \$15,000 (\$20,000 for those eligible to make catch-up contributions). These limits are adjusted annually for inflation.

**Participant Decisions.** The decision to characterize a deferral as a Roth contribution is made at the time the participant signs a deferral agreement (i.e., before contributions are made). The decision is *irrevocable*. A change may be made for future deferrals only.

**Five-year Rule.** To withdraw earnings tax free, Roth contributions must remain in the plan for at least five years. The five-year period starts with the plan year of the first Roth contribution. Subsequent Roth contributions do not start new five-year periods. If a participant withdraws Roth funds before five years have elapsed and before reaching

age 59½, becoming disabled, or dying, the earnings are generally subject to income tax and a 10% premature withdrawal tax.

**Separate Recordkeeping.** Roth and pretax deferrals must be sourced separately and records must be kept separately. Records of Roth contribution earnings also must be kept separately.

**Matching a Roth.** Employer matching contributions on Roth 401(k) deferrals are tax deferred. The matching funds plus any earnings they generate will be taxable when withdrawn. Employer matches are also subject to the ACP test.

**Roth IRA versus Roth 401(k).** One of the drawbacks of Roth IRAs is that they are not available to people whose adjusted gross income (AGI) exceeds certain limits. There are no such restrictions with Roth 401(k)s. All participants in a qualified plan may make Roth 401(k) contributions, regardless of AGI.

**Other Differences.** The required minimum distribution (RMD) rules do not apply to Roth IRAs but they *do* apply to Roth 401(k)s. And Roth IRA contributions may be recharacterized up until tax-filing deadlines, while Roth 401(k) contributions are irrevocable. An individual may have a Roth IRA and participate in a Roth 401(k) plan during the same year.

**Possible Sunset.** EGTRRA provisions, including the Roth 401(k), expire or “sunset” in 2011. To become permanent, Congress will need to pass legislation before then. ❖



# recent developments

■ **Remedial Amendment Procedure Finalized.** After a comprehensive review, the IRS finalized a new determination letter process. It introduces the concept of updating retirement plans for legal and regulatory changes on a recurring basis. Preapproved plans, such as master and prototype documents and volume submitter plans, will be updated on a six-year cycle, and individually designed plans on a five-year cycle based on the last digit of the employer's taxpayer identification number (TIN). Employers with TINs ending in 1 and 6 are in cycle A, those with 2 and 7 are in cycle B, and so on. The IRS has extended the EGTRRA Remedial Amendment period for all *preapproved* plans until the end of the first cycle: January 31,

2011, for defined contribution plans, January 31, 2013, for defined benefit plans. Individually designed plans have until the last day of their first cycle.

■ **Hurricane Relief for Qualified Plans.** Various provisions, including increased loan amounts and a waiver of the 10% tax on premature distributions for hardship withdrawals, have been enacted to provide relief for individuals affected by Hurricane Katrina. IRS Announcement 2005-70, Notice 2005-73, and the law entitled Katrina Emergency Tax Relief Act (KETRA) provide the details. In addition, the Department of Labor (DOL) has extended the Form 5500 filing deadline and added information about locating employers' plans to the DOL's website at [www.dol.gov/ebsa/contactinfo.html](http://www.dol.gov/ebsa/contactinfo.html).

■ **IRS Priority Guidance.** What's on the drawing board at the IRS for 2006? The Service has big plans, including the long awaited Roth 401(k) guidance. Other plans include:

- Final regulations on the electronic transmission of notices and participant consents.
- Guidance on abusive arrangements under IRC Section 401(a)(4).
- Updated regulations regarding the definition of "highly compensated employee."
- Comprehensive final regulations regarding the limits on benefits and contributions under IRC Section 415.
- Employee Plans Compliance Resolutions System (EPCRS) program update. ❖

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.

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