

2007

Plan Compliance Update for

In this issue:

- [Introduction](#)
- [New Annual Limits](#)
- [Reporting Distributions](#)
- [Nondiscrimination Testing](#)
- [Top Heavy Testing](#)
- [Census Information](#)
- [Benefit Statements](#)
- [Annual Reports](#)
- [Bonding Requirement](#)
- [Plan Notices](#)
- [Plan Distributions](#)
- [Conclusion](#)

It's that time of year again... when retirement plan sponsors need to give their plans the administrative equivalent of an annual physical exam. There are new limitations to consider as well as recurring compliance deadlines and fiduciary responsibilities. All of these matters have become a bit more complicated by the passage of the Pension Protection Act of 2006.

This newsletter will review the 2007 administrative compliance requirements and deadlines for qualified plans as well as some of the newly enacted Pension Protection Act provisions.

New Annual Limits

Participants in 401(k), 403(b) and 457 salary deferral plans should be notified that the annual deferral dollar limit for 2007 increased to \$15,500, while the additional catch-up contribution, for those age 50 and over as of the end of the year, remains unchanged at \$5,000. The maximum compensation for plan purposes increased to \$225,000. The prior year compensation level used for determining highly compensated employees remains at \$100,000 while the key employee compensation threshold for officers increased to \$145,000. In defined contribution plans the maximum annual additions (total contribution allocations) increased to \$45,000 per participant, and the defined benefit plan maximum annual benefit increased to \$180,000.

Reporting of Distributions

Participants who received plan distributions during 2006 must be furnished with Form 1099-R by January 31, 2007 showing the amount of the distribution, the taxable portion, any taxes withheld and the appropriate distribution code. Defaulted loans must also be reported on Form 1099-R. Copy A of these forms must be submitted to the IRS along with transmittal

Form 1096 by February 28.

Nondiscrimination Testing

Qualified plans must perform annual testing to make sure they don't unfairly discriminate in favor of "highly compensated employees" (HCEs). An employee is an HCE if he owns more than 5% of the company (including family attribution rules) or has compensation in the prior plan year exceeding a specified level (\$100,000 in 2006).

Plans that don't cover all employee divisions, classifications or the employees of a related company, or require participants to work a minimum number of hours or be employed on the last day of the plan year to share in allocations, may have to test annually for coverage discrimination.

Salary deferral plans, other than safe harbor plans that meet the employer contribution and notice requirements, must test at the end of each plan year to insure that employee deferrals and employer matching contributions aren't discriminatory. Generally speaking, if the ADP (average deferral percentage) and the ACP (average contribution percentage) for the HCEs are within 2% of the ADP and ACP for the non-HCEs, the plan is not discriminatory.

The most common method for correcting a failed ADP or ACP test is to make corrective distributions of the excess contributions plus earnings. These corrections must be done within 2½ months of the plan year end in order to avoid a 10% penalty. The final deadline for making corrective distributions with the penalty is the last day of the following plan year.

If an employee makes excess deferrals in a calendar year above the annual dollar limit, such excess is not deductible on the employee's tax return and should be distributed to the employee by the following April 15. If not, the amount will be subject to double taxation: once in the year deferred and again when distributed.

Top Heavy Testing

A plan is considered top heavy if more than 60% of the benefits belong to "key employees," who are defined as more than 5% owners (including family attribution rules), more than 1% owners earning above \$150,000 and officers earning over a specified amount (\$145,000 in 2007). An annual test must be performed to determine if the key employees have more than 60% of the benefits, after certain adjustments. If so, the plan must meet the top heavy minimum contribution and vesting requirements.

Census Information

In order for the nondiscrimination and top heavy tests to be performed, the employer must compile census information for all employees of the company. The census should include dates of birth, hire and termination, total compensation, hours worked, whether the employee is an officer or owner (or a family member of an owner) and contributions made on behalf of each employee.

Benefit Statements

Under the new law, all plans are required to provide benefit statements to participants as of the 2007 plan year. Most plans have already been doing so. The statements must indicate the total accrued benefits and the vested benefits, if any, or the earliest date on which benefits will become vested. They must also include an explanation of any permitted disparity or other offset arrangements used in calculating accrued benefits.

Individual account plans must provide the statements at least annually. Where participants direct their own investments, statements must be provided at least quarterly, although the vesting information need only be provided once a year. The quarterly statements must also contain an explanation of any limitations or restrictions on investment direction, an explanation of the importance of a well-balanced and diversified portfolio, including a statement that holding more than 20% of a portfolio in one security may not be adequately diversified, and a notice directing participants to the Department of Labor (DOL) website for more information.

Defined benefit plans must provide benefit statements at least once every three years to active participants with a vested accrued benefit, or to any participant upon written request (not more often than once a year). Alternatively, the three-year requirement will be met if at least once a year participants are provided with a notice of the availability of a pension benefit statement and the ways in which one may be obtained.

In Field Assistance Bulletin 2006-03, issued in December, the DOL clarified that benefit statements can be delivered electronically (as can other employee notices). It also provided a 45-day safe harbor after the end of the period during which the statements will be considered timely provided.

While this deadline may be reasonable for the information required on quarterly statements, it may not be for annual statements. More time may be needed to update vesting percentages and allocate employer contributions, which are sometimes not deposited until 8½ months after the plan year ends. Hopefully, additional guidance from the DOL will be forthcoming before the end of the year regarding the deadline for issuing annual benefit statements.

Annual Reports

Almost all retirement plans, except one-participant plans with assets of \$100,000 or less (increased to \$250,000 as of the 2007 plan year), are required to file an annual report, Form 5500, with the DOL. The due date is the last day of the seventh month after the end of the plan year (July 31 for calendar year plans). The deadline can be extended 2½ months by filing Form 5558 by the original due date.

Plans that covered 100 or more participants at the beginning of the year (large plans) must have the plan audited by an independent accountant and attach the audit report to Form 5500. In a salary deferral plan, all eligible participants are counted, whether or not they contribute to the plan.

A summary annual report, which is a brief summary of Form 5500, must be provided to each participant or beneficiary within nine months of the plan year end. This deadline is extended

2½ months if an extension was filed for the 5500.

Bonding Requirement

All fiduciaries who handle plan assets are required to be bonded for at least 10% of the market value, up to a maximum of \$500,000. Small plans (up to 100 participants) with certain types of investments (such as limited partnerships) may need additional bonding to avoid being subject to the audit requirement for large plans discussed above. Fiduciaries should review the plan asset values at least once a year to determine if the bond coverage needs to be increased. The amount of the bond in force is reported on Form 5500.

Plan Notices

Various notices are required to be provided to plan participants including the following:

- Plans with automatic enrollment provisions must notify participants at least 30 days before they become eligible and 30 days before each subsequent plan year of the default participation and investment options.
- Summary plan descriptions (SPDs) must be distributed to each participant within 120 days of the adoption of a new plan (or 120 days of the effective date, if later). Ongoing plans must give an employee the SPD within 90 days of becoming a participant.
- Safe harbor 401(k) plans must provide a notice between 30 and 90 days before the next plan year begins informing participants that the plan intends to satisfy one of the safe harbor contribution requirements in the following year, thereby becoming exempt from ADP/ACP testing. Alternatively, employers may issue a "maybe" notice stating that the plan may become safe harbor by making a 3% nonelective contribution next year. An additional notice must be given out 30 days before the end of the plan year if the employer decides to actually make the contribution.

Plan Distributions

The new law made numerous changes affecting plan distributions:

- New vesting rules are effective in 2007 for defined contribution plans. They must now meet one of the top heavy schedules: a six-year graded or three-year cliff schedule. Plan distributions should be calculated taking into account the new vesting requirements.
- Hardship distributions were expanded to allow plans to consider the financial needs of a participant's primary beneficiary, even if such beneficiary is not a spouse or dependent.
- Distribution notices containing tax and joint and survivor annuity information can now be given out from 30-180 days before the distribution begins. The contents of the notices must be revised to include additional information.
- Effective in 2007, plans may allow nonspouse beneficiaries to roll over death benefit distributions to an IRA. But while a spouse can delay distributions until age 70½, the nonspouse beneficiary must begin distributions from the IRA immediately.

Conclusion

The Pension Protection Act made numerous changes impacting plan administration effective in 2007. Plan administrators need to take a careful look at the changes and make

the necessary preparations. New annual limits should be communicated to participants in salary deferral plans so they can make educated decisions about their deferral elections. Census information including all employees should be compiled as soon as possible after the plan year ends so that discrimination testing can be performed and any corrective distributions can be made in a timely manner.

[\[top of page\]](#)

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