



RETIREMENT PLAN NEWS

MAY/JUNE 2004

Recent Revenue Ruling Highlights

The IRS recently issued several Revenue Rulings affecting retirement plans. The subjects of these rulings are: allocating plan expenses to former employees (Rev. Ruling 2004-10); access to rollover contributions (Rev. Ruling 2004-12); and clarifying when a safe-harbor 401(k) plan is exempt from top-heavy rules (Rev. Ruling 2004-13). This article presents an overview of each of these rulings.

Revenue Ruling 2004-10

IRS Permits Plans to Allocate Plan Expenses to Former Employees on a *Pro Rata* Reasonable Basis, While Not Assessing Current Employees.

When the Department of Labor's (DOL's) Employee Benefit Security Administration (EBSA) issued Field Assistance Bulletin 2003-3 (FAB 2003-3) on May 19, 2003, the IRS representatives were surprised, and stated they needed time to address the allocation of expense provisions of the DOL's guidance. In particular, the IRS raised questions regarding the allocation of expenses to terminated participants and the need to consider the EBSA's QDRO expense allocation change. However, the IRS did not disagree with any of the other provisions of FAB 2003-3.

With the issuance of IRS Revenue Ruling 2004-10 on January 29, 2004, the IRS now concurs with FAB 2003-3 and permits the allocating of expenses to terminated participants, even if only to terminated participants, provided the allocation method is reasonable.

The IRS states that a plan may charge reasonable plan administrative expenses to the accounts of former employees

and their beneficiaries on a *pro rata* basis, or on another reasonable basis, that satisfies the requirements of ERISA Title I; even though the accounts of current employees are not charged.

Caveat: Not all allocation methods are acceptable. Following is an IRS example of an unacceptable allocation formula:

Allocating the expenses of the active employees on a *pro rata* basis to the accounts of active AND former employees, while allocating the expenses of the former employees who leave their assets in the plan only to the former employees' accounts. This is not reasonable because the former employees would be bearing the full portion of the plan's expense for their own accounts plus a portion of the active employee's plan expenses.

Keep in mind that EBSA regulations require that plan expenses allocated to participants must be disclosed in a Summary Plan Description or Summary of Material Modifications before they can be implemented.

FAB 2003-3 General Guidance

FAB 2003-3 indicates that plan sponsors and fiduciaries have considerable discretion under ERISA to determine, as a matter of plan provision or administrative policy, how expenses will be allocated among participants and beneficiaries. The FAB concludes that a method of allocating expenses as set forth in the plan document effectively becomes a part of

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the benefit entitlements under the plan and fiduciaries generally will be required to follow those provisions.

If plan documents are silent or ambiguous on the subject, *plan fiduciaries must act prudently and solely in the interests of participants in determining how to allocate expenses.* These general principles apply to methods of allocating expenses among participants in the plan as a whole, and of allocating specific expenses to individual participants, rather than to the plan as a whole.

The FAB focuses upon the allocation of expenses among participants and does not provide a list of permitted expenses that may be charged to a plan. However, those that are addressed (and now that the IRS is in agreement) are expenses that are clearly permitted. The FAB addresses expenses that may be allocated to a particular individual versus expenses that may be allocated among all participants. It further details expensing among all participants based on a *pro rata* versus *per capita* method.



Pro rata allocation: Allocation of expenses is made based on the value of the assets in the individual account. This is defined as a permissibly equitable method of allocating expenses among participants.

Per capita allocation: Expenses are allocated on an equal dollar or equal percentage basis to each participant's or beneficiary's account, regardless of the value of the individual's assets. This may be used for allocating certain fixed administrative expenses of the plan, such as: recordkeeping, legal, auditing, annual reporting, claims processing, and similar administrative expenses.

Under FAB 2003-3 guidelines, fees such as investment management fees that are based on account balances should be charged on a *pro rata* basis because a *per capita* charge appears to be arbitrary.

Services that provide investment advice to individual participants may be charged on either a *pro rata* or *per capita* basis regardless of the actual utilization by particular participants.

Revenue Ruling 2004-12

An eligible retirement plan that separately accounts for rollover contributions may permit the rollover contribution to be distributed at any time pursuant to the individual's request.

For an eligible retirement plan that separately accounts for amounts attributable to rollover contributions to the plan,

distributions of these rollover amounts will not be subject to the restrictions that apply to distributions of other sources of funds in the receiving plan.

Thus, *if the plan's design permits*, separately accounted for rollover contributions may be distributed at any time pursuant to the individual's request.

Examples of this rule's application:

If the receiving plan is a money purchase plan, and the plan separately accounts for rollover contributions, a plan provision permitting the in-service distribution of those amounts may be made without causing the money purchase plan to fail the rule that prohibits an in-service distribution on a money purchase plan.

Note, once rollovers are made into a money purchase plan or any plan subject to the joint and survivor (J&S) rules, spousal consent is needed to make the distribution from the J&S plan even if the rollover funds originated in an IRA or a plan that is not subject to J&S rules.

- Example 1: A participant receives a distribution from a profit sharing plan that is not subject to the J&S rules and rolls it over to the new employer's money purchase plan. Although participants are not permitted to receive an in-service distribution of money purchase plan contributions, the money rolled in from the profit sharing plan will be eligible for in-service distribution, if the terms of the plan document so provide. Keep in mind that since the money purchase plan is subject to the J&S distribution rules, the distribution of the amount rolled in from the profit sharing plan would now require spousal consent, even though spousal consent was not required on the profit sharing account.
- Example 2: If the receiving plan is a §457 eligible governmental plan or a tax-sheltered annuity as described in §§403(b)(7) or (11), and the plan separately accounts for rollover contributions, a plan provision can permit distribution of the rollover amounts at any time.

A distribution of a rollover contribution amount is subject to the rules of the receiving plan in regard to:

1. The survivor annuity requirements of §§401(a)(11) and 417 (J&S rules apply and spousal consent is needed for distributions, etc.).

To illustrate: A participant rolls a distribution from a profit sharing plan that is exempt from the J&S rules into a profit sharing plan that IS subject to them. The assets attributable to the rollover, as well as the assets that originate in the new profit sharing plan, WILL BE subject to the J&S rules.

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ERISA Protection For Sole Proprietor With Common-Law Employee

On March 2nd, 2004, the Supreme Court ruled unanimously that a sole proprietor who maintains a qualified retirement plan that also covers a common-law-employee participant (other than the sole proprietor's spouse) is deemed to be a plan participant. As such, the sole proprietor is equally entitled to ERISA Title I protection against bankruptcy creditors. The case is *Raymond B. Yates, M.D., P.C. Profit Sharing Plan v. Hendon*.

The Supreme Court decision reverses a contrary ruling by the United States Court of Appeals for the 6th Circuit that a business owner may be only an "employer" and not also an "employee" with regard to ERISA-sheltered plan participation.

According to Justice Ginsburg, who authored the opinion, as long as there are common-law employees participating in the plan in addition to the owner-employee and his or her spouse, the owner-employee may participate as an employee on equal terms with the other plan participants. Thus, such

an owner-employee qualifies for the ERISA protection afforded to any participant.

Justice Ginsburg further indicated that it is unnecessary to look outside ERISA to conclude that Congress intended owner-employees to qualify as plan participants.

The Yates decision leaves undisturbed the rule that Keogh (H.R. 10) plans which cover only the sole proprietor (or the sole proprietor and spouse) do not have ERISA Title I protections. However, a Keogh plan that has one or more common-law employees in addition to the self-employed individual will be covered under Title I of ERISA. ■



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2. The minimum distribution requirement of §401(a)(9).

For example: IRA funds rolled into a 401(k) plan would be subject to the required beginning date of the 401(k) plan. All IRA accountholders are required to begin distributions by April 1st of the year after 70½ is attained. The funds rolled over from the IRA into the 401(k) would not be subject to the IRA 70½ rule for the required beginning date and would be able to utilize the 401(k) rule which may provide the option for a non 5% owner to wait until retirement after age 70½ before being required to start distributions.

3. The additional income tax on premature distributions under 72(t).

For example: If a distribution from an IRA is rolled over into a 401(k) plan, any distribution from the §401(k) plan of amounts attributable to the rollover would be subject to the exceptions from the premature distribution excise tax that apply to the 401(k) plan and not to the exceptions that apply to IRAs, such as the first-time homebuyer exception.

Ruling Applies Only to Rollover Amounts

This ruling does not apply to amounts received by a plan as a result of a merger, consolidation or transfer of plan assets under §414(l), nor to plan-to-plan transfers otherwise permitted between §403(b) tax-sheltered annuities and between §457 eligible governmental plans.

Revenue Ruling 2004-13

Rules clarified for a 401(k) safe-harbor plan to be exempt from being top heavy.

This guidance makes it clear that the determination of whether a plan is exempt from the top-heavy rules is to be re-determined each year. In all the examples in the ruling, the safe-harbor matching contribution is used to illustrate satisfying the top-heavy exemption; note that the safe-harbor non-elective contribution may also be used.

This ruling clarifies through specific scenarios when a safe-harbor 401(k) plan is exempt from being top heavy and when it is not.

These situations are exempt from the top-heavy rules:

- If a safe-harbor 401(k) plan has only elective deferrals and the safe-harbor matching contribution, the plan is exempt from being top heavy.
- If a safe-harbor 401(k) plan provides for elective deferrals and the safe-harbor matching contribution and it has a plan provision to permit for a discretionary nonelective contribution, *but* the employer does not make a discretionary nonelective contribution, the plan is exempt from being top heavy. This clarification answers a question that was unclear in prior guidance.

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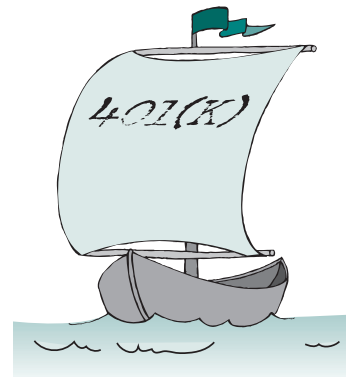
In the following situations, the safe-harbor 401(k) matching contribution plan will not be exempt from being top heavy:

- When the employer makes a discretionary nonelective contribution; and/or
- When forfeitures are allocated to participants' accounts in the same manner as nonelective contributions; and/or
- When employees are eligible to make elective deferrals upon hire but are not eligible for the match until after one year of service is completed. This is explained in detail below.

According to the ruling, a safe-harbor 401(k) plan will *not* be exempt from the top-heavy rules if it permits immediate or short eligibility for an employee to enter the plan for elective deferrals, but imposes a longer service requirement for the employee to enter the plan to receive safe-harbor matching contributions.

There is a seemingly new concept in this Revenue Ruling. It affects safe-harbor 401(k) plans that desire to be exempt from the top-heavy rules by only having the safe-harbor contribution and elective deferrals and no other contributions.

Specifically, in a safe-harbor 401(k) plan that permits employees to defer before meeting the statutory one-year-of-service requirement, but that requires a longer period of service before being eligible for the matching contribution, the plan is not eligible for the top-heavy exemption. Why not? Because newly-hired nonhighly compensated employees (NHCEs) will not be eligible to receive the same level of contributions as longer-term highly compensated employees (HCEs), and thus, the plan does not satisfy the requirements for the top-heavy exemption. This has a significant impact on the plan. For example, longer-term non-key employees who are eligible to defer but did not contribute any deferrals would now be eligible to receive the top-heavy minimum. Those who deferred 1 or 2 percent might also be eligible to receive the difference up to the 3% (and they would be, if the plan's top-heavy minimum is actually 3%). All this because the employer was trying to be more liberal than allowed and letting new hires defer early. Since staggered eligibility is a normal design method, employers may want to reconsider their plan's eligibility if they will be impacted by this change. ■



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