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# Freedman Benefits news

## The importance of plan compliance

To preserve its tax-exempt status, a qualified retirement plan must comply with legal and regulatory requirements, both in form (the plan documentation) and in operation (how the plan is operated in accordance with the plan document). Plan sponsors must work with their service providers to ensure that plans are properly maintained and to limit plan defects.

### Plan disqualification

When the IRS discovers that a plan is not in compliance with qualified plan requirements, disqualification (originally the IRS's only course of action) is a possible outcome. When a retirement plan is disqualified, the plan's trust loses its tax-exempt status and becomes nonexempt. As a result, employees, the employer, and the plan's trust are all negatively impacted. A retirement plan's trust is a separate legal entity that is tax exempt. If a plan is disqualified, the trust loses its tax-exempt status and must pay income taxes on trust earnings.

### Participants lose out

When a plan is disqualified, it means participants must include as taxable income any vested contributions the employer makes to the plan on their behalf in any calendar year for which the plan is deemed disqualified.

**IRS example:** Pat is a participant in the XYZ Profit Sharing Plan. The plan has immediate vesting of all employer contributions.

- In calendar year one, the employer makes a $3,000 contribution to the trust under the plan for Pat's benefit.
- In calendar year two, the employer contributes $4,000 to the trust for Pat's benefit.
- In calendar year two, the IRS disqualifies the plan retroactively to the beginning of calendar year one. Pat would have to include $3,000 in her income in calendar year one and $4,000 in her income in calendar year two to reflect the employer contributions paid to the trust for her benefit in each of those calendar years.

**Note:** If the plan has a five-year graded vesting schedule and Pat is only 20% vested in her employer contributions in calendar year one, then she would include $600 (20% x $3,000) in her income for the year.

### Sponsors lose out, too

Disqualification also impacts the plan sponsor. The sponsor's tax deduction for amounts it contributed to the trust may be delayed or restricted as a result of a plan disqualification based on the deduction rules that apply when the plan is

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# Buyback rules

When a participant who is partially vested in his/her retirement plan account terminates employment, he/she may receive* or choose to receive a distribution of the vested portion of the account. The nonvested portion of the account is forfeited. What happens if the participant receives a payment and is subsequently rehired?

### What is a buyback?

If the rehire occurs before the participant has had five consecutive one-year breaks in service, he/she has the option of repaying the plan the amount of the distribution received. Once the distributed amount is repaid, the nonvested portion of the account that had been forfeited is restored. This is called a "buyback." If there isn't enough money in the plan's forfeiture account to restore the proper amount to the participant, the employer must contribute the difference.

A rehired participant has five years from the date of rehire to repay the amount distributed and have his/her forfeited amount restored. Should the participant fail to repay the distributed amount, the nonvested portion of the account balance will be treated as permanently forfeited.

> **Example:** Art has a profit sharing plan account balance of $10,000 and is 40% vested when he terminates employment. If Art decides to take a distribution of his vested balance, he'll receive $4,000 (40% x $10,000). The nonvested portion ($6,000) is forfeited at that time.
>
> Three years later, Art is rehired. Since he was rehired before incurring five consecutive one-year breaks in service, he has the right to repay the plan for the $4,000 distribution he received. In order for the $6,000 nonvested portion to be restored, he must repay the entire $4,000 within five years of being rehired. His vested percentage will increase based on his additional years of vesting service.

**Note:** If a plan allows elective deferrals and the participant's deferrals were also distributed, he or she must repay the total amounts distributed, including the elective deferral amount. The participant cannot repay just the vested employer contribution amount.

### Not yet vested

When a participant who is 0% vested in employer contributions terminates service and is then rehired prior to having five consecutive one-year breaks in service, the employer must automatically repay the participant's previously forfeited account balance. This is considered a "deemed" cash out since the participant did not actually receive a payment before the account was forfeited (because he/she was 0% vested).

* When a participant terminates with a vested account balance of $5,000 or less, the plan may cash out the participant's account. A participant with a vested account balance of over $5,000 cannot be forced to take a distribution until reaching age 70½.

## The importance of plan compliance

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deemed nonqualified. Generally, sponsors of qualified plans cannot deduct contributions as of the point at which the plan is considered to be disqualified.

### Fallout for rollovers

Plan disqualification has an impact on rollovers, too. Plan distributions that were rolled over to other eligible retirement plans or individual retirement accounts (IRAs) are no longer considered eligible rollover distributions. As a result, all eligible rollover distributions that were rolled into an IRA or other qualified plan after the point the plan was considered to be disqualified would not be eligible for rollover and would be subject to taxation at that point.

### Correction programs

Because the consequences for innocent, nonhighly compensated plan participants can be extremely negative, the IRS established a program to assist plan sponsors in correcting the most common operational and plan document errors and retaining the plan's tax-exempt status. The IRS Employee Plans Compliance Resolution System (EPCRS) encompasses three programs for correcting operational and plan document errors: the Self-Correction Program (SCP), the Voluntary Compliance Program (VCP), and the Closing Agreement Program (CAP). Through EPCRS, a plan sponsor can correct plan errors, pay a preset fee to regain its compliant status, and avoid the negative consequences of disqualification.

More details on the tax consequences of plan disqualification may be found in a recent IRS publication: *Employee Plans News*, Issue 2012-1, March 20, 2012 (*www.irs.gov/pub/irs-tege/epn_2012_1.pdf*).

### Make compliance a focus

Maintaining compliance is key to avoiding disqualification. A strong partnership between employer and service provider can help ensure that all the necessary steps are taken to make certain the plan is in compliance with the vast number of regulatory requirements that need to be satisfied. One of the best ways to assure proper compliance is to keep your service providers informed of any major changes in business circumstances that could impact the operation of your plan.

# Roth 401(k): The five-year clock

What's the big attraction with Roth accounts? Tax-free earnings. To qualify for tax-free earnings on Roth 401(k) contributions, two criteria must be satisfied. Once they are met, both Roth 401(k) deferrals and their earnings are "qualified distribution" funds, which means they are tax free.

The first criterion is the completion of a five-year period (the five-year clock). The second is that one of three events must occur: reaching age 59½, death, or permanent disability (as defined in Code Section 72(m)(7)).

### Five-year clock

The five-year period is measured on a calendar-year basis. The first year of the five-year period begins the first day of the employee's tax year (January 1 for almost all taxpayers) that the employee first contributes to a plan's designated Roth account. The period ends when the fifth consecutive tax year is completed.

So, for example, if a participant's first designated Roth contribution is made on December 23, 2012, the clock starts January 1, 2012, and the five-year period would be satisfied on January 1, 2017. Participants are not required to make a contribution every year; the five-year period merely starts when the first contribution is made.

### More than one account

Every Roth 401(k) account has its own five-year clock. Here's an example: An employee makes Roth 401(k) contributions to his employer's plan from 2009 to 2012. He changes jobs in 2012 to an unrelated employer whose plan also offers designated Roth contributions, and the employee starts making Roth contributions to the new employer's plan. Each account has its own five-year clock. The clock on the new plan starts in 2012, while the clock on the original employer's plan continues to be counted from 2009. So it is possible, over the course of an individual's career, to have numerous five-year Roth 401(k) clocks ticking.

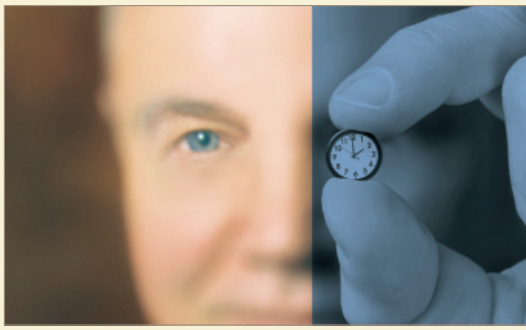
There is an exception for participants who directly roll over designated Roth amounts from one employer's plan to another. If the new employer's plan also offers designated Roth contributions and accepts rollovers of designated Roth amounts, and the participant directly rolls his/her designated Roth funds from the old employer's plan to the new employer's plan, then the five-year clock that applies to his/her prior plan applies to the amount rolled over — *and* to the designated Roth contributions to the new employer's plan. Thus, if that had been the case in the example above, all amounts would be tracked from 2009 for purposes of the five-year clock.

### Direct rollover to Roth IRA

A Roth individual retirement account (IRA) has a separate five-year clock from a designated Roth 401(k) account. So, when a participant rolls over amounts from a Roth 401(k) to a Roth IRA, the five-year rules apply differently. The number of years the money was in the Roth 401(k) will not apply to the Roth IRA.

For example, if a participant makes designated Roth contributions to a 401(k) plan for three years, leaves the employer, and rolls his/her money into a brand new Roth IRA, the Roth IRA five-year clock starts the year of the rollover. The prior three years in the designated Roth account are lost, since the Roth IRA only recognizes years the money is in the Roth IRA and not the years the money was in a designated Roth account.

If, however, the Roth IRA has already existed for more than five years, the amount directly rolled from the designated Roth 401(k) into the Roth IRA would satisfy the five-year clock because the Roth IRA has already met the time requirement. (If the Roth IRA had been in existence less than five years, the 401(k) Roth would still pick up the Roth IRA clock.)



**Note:** The Roth IRA five-year clock starts with the individual's first Roth IRA. If the individual has several Roth IRAs and at least one of them has satisfied the five-year clock, then all of the individual's Roth IRAs have satisfied the five-year clock. Thus, if the employee rolls the funds to a new Roth IRA but has another Roth IRA that has already satisfied the five-year clock, the five-year requirement on the designated Roth rollover would be satisfied.

### Rollovers after five years

If an individual has a designated Roth account that has satisfied the requirements for tax-free earnings and he/she decides to roll over this "qualified distribution" from the designated Roth into a Roth IRA, then the entire amount is treated as an after-tax contribution. If the individual subsequently decides to take a distribution of the designated Roth rollover amount, the entire amount would be considered tax free.

If the rollover went into a new Roth IRA and the individual had never had a Roth IRA, then the Roth IRA would have to satisfy the five-year clock before earnings on the qualified distribution would be tax free. However, the entire amount that is rolled from the designated Roth into the Roth IRA, including earnings, remains tax free. Only the earnings that accrue in the Roth IRA *above* the qualified distribution amount must wait five years to attain tax-free status.

# RECENT developments

## Disclosure guidance

In May 2012, the Department of Labor (DOL) issued Field Assistance Bulletin (FAB) 2012-02 to provide plan administrators and service providers with guidance about complying with the new fee disclosure rules. The 38 frequently asked questions (FAQs) in the FAB focus chiefly on participant-level fee disclosures under ERISA Section 404(a)(5). There are some, however, that clarify certain service provider disclosure rules under ERISA Section 408(b)(2). The FAB also explains how plans that provide self-directed brokerage accounts can satisfy the new disclosure obligations.

The participant disclosure rules apply to defined contribution plans that allow participants to direct their own investments. Initial annual disclosures were due by August 30 for calendar-year plans. Quarterly participant fee disclosures for calendar-year plans are due by November 14, 2012. The DOL is offering transitional relief to plans that issued fee disclosures prior to the release of FAB 2012-02 but failed to comply with its requirements. The DOL does not anticipate pursuing enforcement actions against a plan administrator who made a good faith effort to comply with the final fee disclosure regulations. The DOL will be issuing additional FAQs regarding fee disclosure.

## Miss the EGTRRA restatement deadline?

The IRS has created a kit for plan sponsors who failed to restate their preapproved defined contribution (DC) or defined benefit (DB) plan documents for EGTRRA. Sponsors who wish to continue having their plans treated as qualified plans for tax benefit purposes must correct this error through the IRS's Voluntary Compliance Program (VCP).

The submission kit is designed to guide sponsors through the VCP process. The DC plan restatement deadline was April 30, 2010; the DB plan restatement deadline was April 30, 2012. Keep in mind that DB plans that missed the deadline are eligible for a 50% discount on the IRS's nonamender fee if the employer adopts a preapproved EGTRRA DB plan and submits it through the VCP by April 30, 2013. The kit provides detailed information about completing the VCP application and includes line-by-line instructions, a fee schedule, and an explanation of what to expect after the application is filed. Kits are available at *www.irs.gov/pub/irs-tege/0430_dcnonamender_submission_ kit.pdf* for DC plans and *www.irs.gov/pub/irs-tege/0430_dbnonamender_submission_kit.pdf* for DB plans.

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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