

REPTECH

Customized Employee Benefits Administration

NEW BENEFIT PLAN LIMITS ANNOUNCED FOR 2004

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**FROM the
STAFF AT
REPTECH!!**

Each year the U.S. government adjusts the limits for private pension plans, Social Security, Medicare, and other benefit programs to reflect price and wage inflation, and changes in the law.

Many of the pension plan limitations changed for 2004 as noted below.

	2003	2004
Annual Compensation Limit	\$200,000	\$205,000
Elective deferral limit for 401(k), 403(b), and 457(b) plans	\$ 12,000	\$ 13,000
Catch-up contribution limit for 401(k), 403(b) and governmental 457(b) plans	\$ 2,000	\$ 3,000
SIMPLE Plans		
Elective deferral limit	\$ 8,000	\$ 9,000
Catch-up contribution limit	\$ 1,000	\$ 1,500
Annual additions limit for defined contribution plans The maximum annual addition is the lesser of 100% of compensation or \$41,000.	\$ 40,000	\$ 41,000
Annual benefit limit for defined benefit plans The maximum annual benefit allowed between ages 62—65 is the lesser of 100% of compensation or \$165,000.	\$160,000	\$165,000
Highly compensated employee compensation threshold A highly compensated employee is any person who either owns more than 5% of the employer or earned more than \$90,000 in the prior plan year. (No change)	\$ 90,000	\$ 90,000
Key employee compensation threshold A key employee for top-heavy plan purposes is any person who is a more than 5% owner, a 1% owner earning more than \$150,000, or an officer who earned more than \$130,000 in the current plan year. (No change)	\$130,000	\$130,000
Social Security taxable wage base	\$ 87,000	\$ 87,900

DOL Addresses Plan Expenses

The Department of Labor (“DOL”) has issued long awaited guidance regarding: (1) the allocation of plan expenses in a defined contribution plan; and (2) the propriety of charging participants for the cost of plan distributions (Field Assistance Bulletin 2003-3). The guidance is significant because it rescinds prior DOL guidance that many practitioners used as the basis to advise plans not to charge participant accounts for certain expenses, such as distributions.

ERISA provides little guidance on the allocation of plan expenses in a defined contribution plan. ERISA only requires that the plan expenses must be both reasonable and proper plan expenses. ERISA does not provide specific guidance with respect to the allocation of expenses, but grants to the plan administrator broad discretion in determining the method of expense allocation. If the plan document specifies a method for allocating expenses, the plan administrator generally should follow the plan terms unless the terms are discriminatory. When the plan document is silent or ambiguous with respect to expense allocation, the plan administrator must prudently select a method consistent with the duty to act “solely in the interest of the participants and beneficiaries.” A plan administrator who also is a plan participant must be careful to avoid self-dealing.

Pro-rata vs. per capita. The DOL guidance indicates that the allocation of expenses on a pro rata basis (*i.e.*, proportionate to account balances) probably is the most equitable method. However, the allocation of certain fixed administrative expenses (*e.g.*, recordkeeping, legal, auditing, Form 5500 preparation, and claims processing) on a per capita basis (*i.e.*, dividing the expenses by the number of accounts) also might be reasonable. Re-

gardless of the type of expense, the DOL is careful to point out that the method of allocating expenses must comply with IRS qualification requirements (*i.e.*, the nondiscrimination requirements). Since a plan that allocates expenses on a per capita basis has the potential for discrimination, the plan that chooses to use such a method may need to take additional precautions. For example, the plan may want to: (1) include specific plan language describing the method for allocating expenses; and (2) obtain an IRS determination letter. Furthermore, a plan that uses the per capita method should make certain that such expense allocation does not result in unreasonable allocations. For example, if a plan with 10 participants incurs an administrative expense of \$3,000 and allocates the expense on a per capita basis, the plan might charge \$300 of expense to a participant with a relatively small account balance (*e.g.*, \$500). Although the guidance does not discuss such a scenario, the DOL and the IRS likely would have concerns with such an allocation of expenses.

Types of Expenses. The DOL guidance expressly permits the allocation of five common expenses directly to an individual participant’s account. These expenses include the costs to:

- Determine if domestic relations orders meet the requirements to be considered qualified domestic relations orders (QDRO) or qualified medical child support orders.
- Process benefit distributions. This includes hardship and QDRO distributions.
- Calculate benefits payable under different plan distribution options.
- Maintain accounts for terminated vested participants.

Summary plan description (SPD). A plan that allocates certain expenses to a participant’s account needs to include a provision in the SPD describing the

circumstances under which the plan may charge a participant’s account. The SPD does not need to reflect the method the plan uses for allocating general plan expenses. Rather, the SPD only needs to indicate specific fees or charges that the plan will impose on a participant as a condition of receiving plan benefits. For example, if the plan allocates QDRO expenses as a general plan expense, then the employer does not need to specify the expense allocation method in the SPD. However, if the plan allocates the QDRO expense only to the participant subject to the QDRO, then the SPD must reflect this expense allocation.

DOL vs. IRS. The DOL specifically notes that it is not giving an opinion on how the views expressed in FAB 2003-3 relate to the Internal Revenue Code (“the Code”).

Allocating expenses to particular participants or groups of participants could raise other issues under the Code. IRS regulations do not permit a plan to impose a “significant detriment” on participants who elect not to receive an immediate distribution of their plan accounts (above the minimum cash-out amount). It is unclear whether imposing expenses on terminated vested participants that are not imposed on active participants may violate this provision. Moreover, it is unclear whether imposing expenses in a non-uniform manner would create a separate benefit structure or benefit, right, or feature requiring separate nondiscrimination testing.

To charge or not to charge? Because the guidance is new, many investment vendors do not have a mechanism in place to take specific fees from individual participant accounts. Some vendors are beginning to put in place procedures to accommodate portions of the guidance, for example, taking fees from

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The Basics of Cash Balance Plans

Recently cash balance plans have emerged as an extremely popular solution to creating additional retirement benefits for key employees. These “hybrid” plans can be used stand-alone, or combined with a 401(k) profit sharing plan to achieve annual contributions well above the \$40,000 IRS limit.

We are currently installing a cash balance plan that will allow additional contributions of \$45,000 each for five key employees (over and above the \$40,000 they are receiving in their profit sharing plan--\$85,000 each) while limiting the additional cost of contributions for staff to 3% of compensation. Result: \$225,000 of additional contributions for the key employees at an additional cost of \$27,800 for the staff.

Here is how a cash balance plan works. The employer contributes a set percentage of pay (e.g., 20% or \$40,000) for the key employees, and a different percentage for the staff (e.g., 2%). This is possible because of cross-testing—the same methodology used in the ever-popular “new comparability” plans—only this time instead of testing the profit sharing contributions, you test the cash balance contributions. Each contribution creates an account that earns a guaranteed interest rate which

floats with the 30-year Treasury rate. If the accounts earn more than the guaranteed interest rate, the employer contribution is reduced for future years. Conversely, if the accounts earn less than the guaranteed rate, the employer contribution is increased for future years. Contributions to the accounts are fully income tax deductible to the employer, the earnings are tax-deferred, and the participants do not pay income tax on the amounts until they take a distribution. The benefits are fully portable, and when eligible for a distribution the amounts can be rolled over into another retirement plan or an IRA.

Cash balance plans provide visible, portable benefits that are easy to understand by both key employees and younger staff. Though the plan is a defined benefit plan, the accrued benefit is expressed in terms of a present-day accumulation account rather than as a future monthly life income at some distant retirement age. If the employer contribution credit for a staff member is \$1,000, and the guaranteed interest credit 5%, the following year the account will be worth \$1,050. These cash balance plans make participants smile as their account increases each year at the guaranteed rate. The accounts are not self-directed investment accounts controlled by participants, but a pooled

fund supporting the promised benefits. Professional money management of the fund is very important, as is a solid Investment Policy Statement providing for appropriate liquidity for distributions to participants who terminate employment.

There has been some recent controversy surrounding cash balance plans; however, the issues are not related to the existence or design of the plans, but with the conversion of traditional defined benefit plans to cash balance plans by some very large public companies. These issues do not arise when employers expand their employee benefits by offering an additional retirement plan. When a cash balance plan is established to augment the retirement accumulation of the workforce, the acceptance has been overwhelming. Having watched the stock market erode the value of their 401(k) accounts, many employees are thrilled to see their employer creating a retirement plan that has guarantees. This enthusiasm is magnified for key employees who are nearing the age when they want to slow down. The benefit of substantial additional tax-favored accumulations through a cash balance plan is certainly worth investigating.

DOL Addresses Plan Expenses

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individual participant accounts for distributions.

The new guidance is a welcome change on the part of the DOL. However, investment vendors must have appropriate procedures in place before the allocation of specific plan expenses to individual participants will become common practice.



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To Borrow or Not To Borrow

Have you been getting an unusual amount of requests for participant loans from your 401(k) Plan? Research indicates that you are not alone. Many employers are faced with the same dilemma as employees use their 401(k) funds to pay down debts, purchase a home, or cover medical expenses. While it can be very tempting to use a plan loan in a cash crunch, participants should consider the advantages and disadvantages, as it can seriously impact their future retirement income. Plan loans are not “easy money” as some people think.

By providing some additional information to employees before processing loan requests, they may rethink their original decision. If you have employees requesting 401(k) loans, consider providing a summary of the advantages and disadvantages of taking those loans.

Some of the advantages to the participant are:

- No credit check because the loan is secured by the retirement plan balance.
- Low interest rate compared to other loans available in the marketplace.
- No taxes to pay since the loan is not considered a taxable withdrawal.
- Loan interest is paid to the participant, not to someone else.
- The loan could enable paying off higher interest debt.

Disadvantages to the participant are:

- The amount of interest paid back may be much less than the account might have earned.
- Interest is paid with after-tax dollars, and taxed again when a distribution is made.
- At retirement or termination of employment, the loan balance becomes due and pay-

able, usually in a short period of time. If the loan is not repaid, the amount of the outstanding loan will be treated as a taxable withdrawal—subject to income taxes and a 10 percent penalty for those under 59 1/2.

- If the loan is used to pay off debt, don't forget that an additional after-tax payroll deduction will be taken. Additionally, if more debt is assumed during the loan period, the participant could end up with twice as much debt.
- A loan fee is often charged when application is made for the loan and some plans charge an annual fee as well.

Be sure to indicate on your summary that in no way should the information provided be construed as advice. Recommend they consult with a tax or financial professional if they have specific questions about their particular situation.

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