

# Pension ANALYST

Important Information

Plan Administration and Operation

2007 Plan Year



## 2007 Plan Year: Year-End Compliance Reminders

### For Defined Contribution Plans subject to ERISA

This information applies to qualified defined contribution plans and 403(b) plans that are subject to Title I of ERISA.

Every year, plan sponsors must make sure their plans meet certain compliance requirements, including those listed below. This publication identifies the materials you need to review and will help you prepare for year-end.

If any of these compliance tests or services are included in your Services Agreement, you will receive the *Compliance Testing Data Submission Guidelines* package under separate cover at a later date. This package will contain additional information you will need to know to initiate the testing process.

- **2007 Compensation Limit is \$225,000.** When determining 2007 contributions and tax-deductible contribution limits and performing most of the 2007 plan year nondiscrimination tests (e.g., Actual Deferral Percentage Test, Actual Contribution Percentage Test), plan sponsors may only take into account each participant's compensation up to \$225,000.
- **Minimum Coverage Test.** The percentage of Non-Highly Compensated Employees (NHCEs) benefiting under the plan must be at least 70% of the percentage of Highly Compensated Employees (HCEs) who benefit under the plan. This is called the Ratio Percentage Test. If a plan does not pass this test, it must pass the more complex Average Benefit Test. The plan must pass one of these tests on either a daily basis, a quarterly basis, or on an annual basis as of the last day of the plan year. The 401(k) and 401(m) portions of a plan each must meet the minimum coverage requirement on an annual basis as of the last day of the plan year.

Minimum coverage testing may be performed every third year if the employer reasonably concludes that there are no significant changes in the following two plan years. Significant changes may include changes in plan provisions, the employer's workforce, or compensation practices. The determination of whether a change is significant depends upon the relative margin by which the plan passed the coverage requirement in the last year in which the plan was tested and the likelihood that the change would cause the plan to fail coverage testing.

A special transition rule allows plans involved in company level merger and acquisition situations to be treated as satisfying the minimum coverage requirements during a transition period following the transaction. The transition period begins on the date of the transaction and ends on the last day of the following plan year. This special transition rule can be used if a plan has satisfied the minimum coverage

requirements immediately before the transaction, and if there have been no specific changes in the plan's coverage aside from the transaction.

- **Annual Deferral Limit and Correction Deadline.** For the 2007 calendar year, a participant's deferral contributions to a 401(k) plan, 403(b) program or section 457 plan could generally not exceed \$15,500. A single \$15,500 limit applies to deferral contributions made to any combination of 401(k) plans or 403(b) programs. However, deferrals made to 401(k) plans or 403(b) programs do not reduce the limit on deferrals that may be made to a section 457 plan. As a result, an individual could contribute \$15,500 to a combination of 401(k) plans or 403(b) programs and contribute an additional \$15,500 to a section 457 plan.

Some 401(k), 403(b), or governmental section 457 plans also may have allowed participants age 50 or older in 2007, to contribute an additional \$5,000 of "catch-up" deferrals during the 2007 calendar year. Additional catch-ups (i.e., 15 year catch-up, last three year catch-up) are available under some 403(b) programs and section 457 plans.

*Excess deferrals made in 2007 to a single plan, or to multiple plans sponsored by the same employer (determined on a controlled-group basis), must be distributed to the participant, with related earnings, by April 15, 2008.* Failure to make these corrective distributions by April 15, 2008, may result in plan disqualification or loss of the tax deferred status of plan assets. In addition, the amount of excess elective deferral contributions must be included in the participant's income in both the year contributed and in the year eventually distributed.

If your plan needs to distribute 2007 excess deferrals to any participants, complete and return to your Client Consultant a [Request for Distribution of Excess Elective Deferrals](#) form for each affected participant.

- **Annual Additions Limit.** Employer contributions, employee post-tax and pre-tax contributions, and forfeitures reallocated to a participant during a limitation year (collectively referred to as "annual additions") are limited to the lesser of \$45,000 or 100% of the participant's compensation. We have included an [Annual Additions Limit Worksheet](#) that you may photocopy and use to calculate each participant's limit and actual annual additions. For each participant who has excess annual additions, complete and return to your Client Consultant a [Request for Distribution of Excess Annual Additions](#) form. The sample form provides additional information about acceptable correction methods.
- **Actual Deferral Percentage (ADP) Test.** A 401(k) plan must perform an Actual Deferral Percentage (ADP) Test as of the last day of each plan year to prove that HCEs do not contribute disproportionately more to the plan than NHCEs. If the plan fails this test, it must correct the resulting excess contributions. If your plan allows employees age 50 and older to contribute catch-up deferrals, the catch-up deferrals made during the plan year (due to the application of the annual deferral limit, annual additions limit, or a plan-imposed limit) are not included in the ADP test.
- **Actual Contribution Percentage (ACP) Test.** Plans, including 403(b) plans, that accept employee post-tax contributions or employer matching contributions must perform an Actual Contribution Percentage (ACP) Test as of the last day of each plan year. If the plan fails this test, it must correct the resulting excess aggregate contributions.

If your plan uses the prior year testing method and your document provides for a discretionary matching contribution, the NHCE ACP will equal 0% in any year you do not fund a match. This 0% will be the limit for the HCEs in the following year. Therefore, if you have a discretionary match and it is likely that you will not fund an employer match in any given year, you may want to consider amending the plan to use the current year testing method. The change from the prior year method to the current year method may be made at any time. However, in general, a plan must use the current year method for five years before changing to the prior year method.

If your plan used an ADP/ACP safe harbor design for the 2007 plan year, you may not have to perform the ADP and ACP tests. If your plan will be using an ADP/ACP safe harbor design for the 2008 plan year, you will need to give notice to employees within a reasonable period before the beginning of that plan year. A plan satisfies the timing requirement if the notice is given at least 30 days and no more than 90 days before the beginning of the plan year. The ADP/ACP safe harbor requirements are described in detail in our April 2000 publication titled "[Improved ADP and ACP Safe Harbor Plan Designs](#)."

- **Correcting ADP Test and ACP Test Excesses.** In general, plans must correct all 2007 plan year excess contributions and excess aggregate contributions *by the last day of the 12th month after the end of the 2007 plan year* (by December 31, 2008, for a calendar plan year). If your plan allows for catch-up deferrals, a portion, or all, of the excess contributions may be reclassified as catch-up deferrals. Any HCE who is age 50 or older and is due a corrective distribution as a result of a failed ADP test will have a portion reclassified as a catch-up deferral to the extent that HCE has not already contributed the maximum catch-up deferral allowed for the year. This will help reduce or eliminate the amount of Corrective Distributions or Corrective Contributions needed.

### **Corrective Distributions**

A plan may correct these excesses by making corrective distributions of the excesses and related earnings. *If this is done within 2½ months after the end of the 2007 plan year (on or before March 15, 2008, for a calendar plan year)*, the plan sponsor will avoid paying a 10% excise tax (if applicable) to the IRS on the amount of the excesses and the corrective distribution is generally taxable to the participant in the year of contribution.

However, if corrective distributions are made within 2½ months of the plan year-end and the total amount of the excess contributions and excess aggregate contributions distributed to a participant are less than \$100, those excesses (and income) will be taxable income in the year distributed.

In some cases, plan sponsors may want to wait until more than 2½ months after the end of the 2007 plan year to make these corrective distributions. While certain plan sponsors will have to pay a 10% excise tax on these excesses, the corrective distribution amounts will be taxable to all affected participants in 2008 instead of 2007. This means participants receiving these distributions will not have to amend their 2007 tax returns if they have already filed.

As mentioned in our March 2005 *Pension Analyst* titled "[IRS Issues Final 401\(k\) and 401\(m\) Regulations](#)," gap period income is required to be included in corrective distributions of excess contributions and excess aggregate contributions for the 2006 and 2007 plan year.

**If Prudential Retirement Provides ADP or ACP Testing services for your plan**, along with the test results for your plan, you will receive a letter explaining the ADP and/or ACP corrective distributions process.

**If Prudential Retirement Does Not Provide ADP or ACP Testing services for your plan**, you should complete and return to your Client Consultant the following forms to request ADP and/or ACP corrective distributions:

To request participant distributions of \$100 or more within 2½ months of the plan year end, use the [Request for Distribution of ADP/ACP Excess Within 2½ Months Following Plan Year End](#) form for each affected participant.

To request distributions of less than \$100 per participant within 2½ months of the plan year end, complete a [Request for Distribution of ADP/ACP Excess More Than 2½ Months Following Plan Year End Or De Minimis Distribution \(<\\$100\) Within 2½ Months of Plan Year End](#) form for each affected participant.

To request distributions more than 2½ months after the end of the plan year, complete a [Request for Distribution of ADP/ACP Excess More Than 2½ Months Following Plan Year End Or De Minimis Distribution \(<\\$100\) Within 2½ Months of Plan Year End](#) form for each affected participant.

### Corrective Contributions

Alternatively, in some situations, a plan may correct a 2007 plan year excess by making Qualified Nonelective Contributions (QNECs) or Qualified Matching Contributions (QMACs) to some or all NHCEs if the plan provides for these types of contributions. The employer must make the QNECs or QMACs by the last day of the 12th month after the end of the 2007 plan year (by December 31, 2008, for a calendar plan year). The 10% excise tax on ADP and ACP excesses does not apply, even if the QNECs or QMACs are made more than 2½ months after the end of the plan year. These types of corrective contributions are not available to correct failed ACP tests for 403(b) plans.

If you make QNECs or QMACs, you must notify us at the time you make the contributions that they are QNECs or QMACs. These contributions must be 100% vested, are subject to special withdrawal restrictions, and cannot be combined with other employer contributions for recordkeeping purposes.

Keep in mind if you have elected to use the prior year testing method, a QNEC or QMAC contribution is not available as a corrective measure.

- **2007 Forfeitures.** In general, defined contribution plans may not carry unallocated suspense accounts from one plan year to the next. The IRS makes specific exceptions to this rule for suspense accounts arising from the correction of excess annual additions, assets transferred from a terminated defined benefit plan to be allocated over a seven-year period, and leveraged ESOPs. Otherwise, the IRS expects all plan assets to be allocated among participant accounts at year-end. Generally, whether your plan reallocates forfeitures, applies them as a credit toward employer contributions, or applies them as a credit toward plan expenses, there should be no unallocated forfeitures remaining at year-end. Your plan document may contain language specifically addressing the timeframe by which forfeitures must be applied.
- **Form 5500 Annual Reporting.** Each year, most plan sponsors must file a Form 5500 series report with the IRS and DOL. This filing is due by the last day of the seventh month after the end of the plan year. Plan sponsors may request a 2½-month filing extension by completing and submitting to the IRS a Form 5558. Prudential Retirement provides a Form 5500 Preparation Service.

In general, an independent qualified public accountant must conduct an audit of a qualified plan's financial statements, including review of the plan's Form 5500, Schedules, internal control practices, and other information. This audit requirement currently does not apply to 403(b) plans or to qualified plans that are eligible for the "Small Plan" exception. However, the DOL has proposed substantial revisions to Form 5500 reporting effective for plan years beginning in 2008, that would require fuller reporting and audits by 403(b) plans, and revamp reporting by small plans. For information regarding the "Small Plan" exception, refer to our January 2002 publication titled "[New Year Brings New Rules for Small Plans.](#)"

- **Keep Records of All Nondiscrimination Testing.** Plan sponsors must keep records to prove that their plans passed the appropriate nondiscrimination tests. If an IRS auditor requests these records and the plan sponsor cannot produce them, the IRS could disqualify the plan.
- **Plan Amendments.** Plan sponsors that have decided to implement optional provisions in 2007, such as catch-up contributions, designated Roth contributions, or any of the optional provisions regarding [post-severance compensation](#), must adopt the appropriate plan amendments by the last day of the 2007 plan year. In addition, plan sponsors that allowed certain transactions (e.g., distributions, loans, loan repayment suspensions, or recontributions of certain distributions) due to the [Katrina Emergency Tax Relief Act of 2005 \(KETRA\)](#) or the [Gulf Opportunity Zone Act of 2005 \(GOZA\)](#) must amend their plans to include these provisions by the last day of the 2007 plan year.

To ensure that Prudential's recordkeeping system accurately reflects the provisions of your plan, it is important that you send Prudential copies of all plan amendments that you've adopted, or those that you plan to adopt, during the 2007 plan year.

The following items apply to defined contribution plans other than 403(b) plans:

- **Stock Attribution.** Stock attribution rules for family members apply when determining ownership for purposes of identifying HCE 5% owners and Key Employee 1% and 5% owners.
- **2008 Top-Heavy Determination.** To determine if your plan is top-heavy for the 2008 plan year, you must first identify your "Key Employees." An employee is a Key Employee only if he is:
  - A 5% owner in 2007, or
  - A 1% owner who received more than \$150,000 compensation from the company in 2007, or
  - An officer of the company who received more than \$145,000 compensation in 2007.

Employees who performed no services for your company during the one-year period ending on the last day of the 2007 plan year are disregarded in determining top-heavy status.

Also, the lookback period for adding back distributions to account balances depends on the type of distribution made. A five-year lookback applies to in-service withdrawals, including hardship withdrawals. However, other distributions (e.g., due to retirement, disability, death or termination of employment) are added back only if they were made during the one-year period ending on the last day of the 2007 plan year.

If Prudential Retirement does not provide top-heavy testing services for your plan, you may use the [Top-Heavy Test Worksheet](#) we have provided to perform this test or make other arrangements to do this testing.

- **2007 Top-Heavy Contributions.** If your plan was Top Heavy for 2007, based on 2006 plan year-end data, you must make a minimum contribution to satisfy the Top-Heavy requirements. This contribution is subject to the same timing requirements as any other 2007 employer contribution.

If you have questions about plan amendments, testing requirements, Prudential's testing services, ADP/ACP safe harbor plan design, or other compliance requirements, please contact your Prudential Retirement representative.

**Pension Analyst by Prudential Retirement**

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