NRS
NATIONAL RETIREMENT SERVICES, INC.
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REMINDER: MARCH 15 IS DUE DATE FOR 401(K) REFUNDS

Employers who sponsor 401(k) retirement plans that use the calendar year as their plan's fiscal year should be aware that March 15 (June 30 for "Eligible Automatic Contribution Arrangements") represents the last day that discriminatory employee deferrals may be refunded to Highly Compensated Employees and avoid a 10% excise tax. This deadline is important for plans that do not use one of several "safe harbor" employer contribution rates that automatically satisfy non-discrimination concerns and thus avoid the need for both the discrimination tests and the associated refunds. Similarly, employee deferrals to 403(b) plans do not need to meet non-discrimination rules and so employers of these plans need not be concerned with this deadline.

TEMPORARY CHANGE IN SELF EMPLOYMENT TAXES FOR 2010

Self-employed individuals can deduct their self-employed health insurance in computing adjusted gross income on Form 1040. Normally, they cannot take the health insurance deduction into account when computing self-employment tax on Form 1040 Schedule C. So the health insurance deduction reduces income, but not the self-employment tax. The Small Business Jobs Act of 2010 ("SBJA") contains a provision that allows self employed individuals to reduce their net self-employment income by the amount of their self-employed health insurance deduction when computing 2010 self employment tax. However, the change (effective only for the 2010 tax year) has retirement plan practitioners puzzled as to how this relates to the calculation of "earned income" for purposes of determining benefits under tax qualified retirement plans that base benefits and deductible contributions on earned income. The provision in the SBJA was designed to reduce the amount of self employment tax that self employed individuals pay. For example, a self employed individual earning $100,000 Schedule C income and paying $8,000 health insurance for both years 2009 and 2010 will pay $1,131 less self employment tax in 2010 than was paid in 2009.

How Does This Relate to Retirement Plan Benefits?

While SBJA is successful in providing an immediate tax reduction for the 2010 tax year, the question remains as to whether this temporary rule will also apply to the computation of earned income for retirement plan purposes. Before SBJA was passed, "earned income" for pension benefit purposes was calculated by reducing net income calculated on the federal tax Schedule C by half the self employment tax paid that year. It follows that, absent a special provision in the law, a lower payroll tax results in a higher earned income amount because the reduction for half the self employment tax is lower. In our example above, the $100,000 Schedule C income is reduced to $92,935 if the 2010 change is ignored and becomes $93,500 if the 2010 health deduction reduction to self employment tax is recognized.

Is There an Answer?

Not exactly. According to the Joint Committee on Taxation report on the SBJA, "It is intended that earned income be computed without regard to this deduction for the cost of health insurance." It goes on to conclude that earned income is computed "without regard to this deduction." This would seem to answer the pension community's question concerning earned income. However, the Committee report has a disquieting footnote that states "A technical correction may be needed to achieve this result." So the pension practitioner and accountants are left with the question of interpreting the *intent* of the law or the actual

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provisions of the law. Ignoring the change simplifies life for those with existing software programs that do not follow the one time change. Recognizing the change may result in slightly higher contributions/tax deductions. Since tax season is already in full swing, and since the Joint Committee report was published last September, additional guidance for this one time anomaly is unlikely.

KEY FACTORS TO CONSIDER BEFORE SPONSORING A "412(E) (3) FULLY INSURED" DEFINED BENEFIT PLAN

Defined Benefit Pension Plans are important to the retirement security of business owners and their employees. They provide a promise to employees of a valuable income after retirement, and they provide an opportunity for business owners to defer large amounts of taxable income until later years. Fully insured defined benefit plans pay benefits from insurance company contracts that provide guaranteed investment results and benefits. But these plans need to be properly managed. Here are some issues to consider if your plan is to be funded exclusively by guaranteed insurance contracts.

- *Plan Design* - The Plan's provisions dictate the size and timing of participants' benefits, and therefore the cost to the employer. The size of the benefit is determined by the plan's mathematical formula (e.g. 1% of Average Monthly Compensation per year of plan participation). The richer the benefit formula, the greater the required (and maximum deductible) contribution. Plans can retroactively increase benefits as late as 2.5 months after the plan year, while reductions in benefits are also permitted, but only on a prospective basis.

- *Limits on Benefits* - Plan benefit design should take into consideration limits placed on the amount of single sum benefits that a plan is permitted to pay to a participant and set benefits low enough to avoid insurance cash values that exceed these limits. Otherwise, excess amounts may revert to the employer with associated excise tax penalties.

- *Age and compensation of employees* - Generally, the older a given employee and the higher the employee's compensation, the greater the employer's required contribution. This is because the pension plan's benefit is generally described as a lifetime income starting at a specified "Normal Retirement Date". The closer an employee is to his / her Normal Retirement Date, the greater the cost of the future retirement benefit. Changes in the workforce, like replacing a younger employee with an older one, also impacts plan contribution requirements.

- *Required Annual Contributions* - Federal regulations exempt fully insured plans from hiring an Enrolled Actuary to determine contributions, but only if -

  - The plan is funded exclusively (other than top heavy minimum benefits) by the purchase of guaranteed individual insurance contracts that provide for level annual premium payments from the date an individual becomes a participant or earns a benefit increase until Normal Retirement Age.
  - All current and prior premium payments have been made before the policy lapses or the policy is reinstated during the plan year of the lapse.
  - No policy loans (other than automatic premium loans repaid in the same year granted) may be outstanding at any time.
  - No insured benefits have been subject to a security interest at any time.

Employers with fully insured plans must be aware of these requirements and take all steps necessary to be sure that they comply with these rules. Third Party Administrators such as NRS are not in a position to adequately monitor, much less enforce, these important rules. If an employer finds it impossible to meet these requirements, he/she must advise the Third Party Administrator immediately so that suitable alternate actuarial valuations may be arranged.

- *Employer Financial Stability* –A pension plan is designed to be a permanent retirement benefit program with certain required employer contributions. Factors discussed above can result in unintended contribution requirements. In general, if an employer's business lacks the stability to make unexpected pension contributions, a defined contribution plan, such as a profit sharing plan, is probably a better choice.

APRIL 30, 2011 IS LAST DAY TO FILE FOR LOW COST RELIEF ON TARDY EGTRRA RESTATEMENTS

Employers who use pre-approved plan documents to set out the provisions of their defined contribution retirement plans were required to amend and restate those documents (commonly called "EGTRRA Restatements" after the 2001 tax law) no later than April 30, 2010 or else risk plan disqualification. If an employer missed that deadline for any reason, the IRS offers a relatively painless method of correction. As long as the employer files with the IRS under their Employee Plans Compliance Resolution System ("EPCRS") by April 30, 2011, the filing fee is a modest $375, regardless of plan size. However, reporting the late amendment under EPCRS after April 30, 2011 will result the imposition of the normal filing fees. These fees vary depending upon the number of plan participants. The fee equals $750 for plans covering under 21 participants, but escalates rapidly, amounting to $2,500 for plans covering between 51 and 100 participants and $5,000 for plans covering between 101 and 500 participants.

Employers that were delinquent in adopting the required amendment, or those who assist and advise them, would do well to address this issue by the April 30 deadline.

Corrections: Our February 2011 Newsletter article titled IRS Reverses Position on Preparer Application System contained an incorrect reference to the form number for filing federal excise taxes. The correct form for this purpose is Form 5330. Also, preliminary releases of this March Newsletter contained an incorrect date (April 15, 2011) in the title of the final article dealing with EGTRRA restatements.

For more information or to request a proposal, please visit our website at www.NRServices.com, or for sales support, please contact:

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