

Worker, Retiree, and Employer Recovery Act of 2008

On December 23, 2008, President Bush signed the *Worker, Retiree, and Employer Recovery Act of 2008* (the "*Act*") into law. The *Act* contains beneficial changes to both defined contribution and defined benefit plans and also includes technical corrections to certain provisions of the Pension Protection Act of 2006. This Summary provides an overview of the provisions of the *Act* relating to 401(k) and other defined contribution plans we believe are most relevant to plan administration. For information on other provisions of the *Act* including those provisions that impact defined benefit plans, please call.

Temporary Suspension of Required Minimum Distribution Rules

Background

Retirees are generally required to begin distributions from their retirement accounts in the calendar year in which they attain age 70½, although the first such distribution can be postponed until April 1st of the following year. The required minimum distribution amount is calculated based on the participant's (and sometimes, spouse's) age and the balance of the account at the end of the immediately preceding calendar year.

New Law

Due to the significant downturn in the financial markets, Congress was concerned that requiring retired participants to take required minimum distributions in 2009 might force participants to sell assets in their retirement accounts at market lows. As a result, the *Act* provides a one-year waiver to participants otherwise subject to the minimum distribution rules as follows:

1. No minimum distributions are required for calendar year 2009. This applies to minimum distributions that would otherwise be payable to either participants or beneficiaries. However, if a participant is required to take her first distribution (for 2008) by April 1, 2009, that distribution must still be made.
2. For beneficiaries who are subject to the "five-year rule" under the terms of the plan, the five-year period does not "count" or otherwise include the 2009 calendar year. The five-year rule generally refers to the ability of beneficiaries of participants who died before their attainment of age 70½ to defer distributions until the end of the fifth year following the year of death. A beneficiary of a death benefit related to a participant who died in 2007, for example, would normally have to receive the entire death benefit no later than the end of 2012. Due to the changes to the required minimum distribution rules under the *Act*, the same beneficiary would not be required to receive the entire benefit before the end of 2013.
3. Because there is no requirement to receive a minimum distribution in 2009, any distribution that a participant may take that represents a payment that otherwise would have been made to satisfy the required minimum distribution requirements will be eligible to be rolled over (a rollover eligible distribution). The *Act* also specifies that if the

distribution is made under these circumstances during the 2009 calendar year, it will *not* be subject to the 20% mandatory federal tax withholding that ordinarily applies to rollover eligible distributions. The plan sponsor does not have to provide a rollover option for this type of distribution. However, if the plan sponsor does provide this option, the participant must receive a notice to inform her of the rollover options for the distribution proceeds (the notice is required under Internal Revenue Code Section 402(f) and is sometimes referred to as the 402(f) or Special Tax Notice).

Gap Period Income

Background

Gap period income refers to a portion of the earnings on corrective distributions paid to a plan participant when a plan fails certain nondiscrimination tests required by law. For example, if a plan fails the Actual Deferral Percentage (ADP) test, “excess contributions” and related earnings need to be distributed to certain higher-paid participants determined under the test. Similarly, if a plan fails the “excess deferral” test because a participant has made contributions which exceed the applicable dollar amount prescribed by the IRS during the calendar year (\$16,500 for 2009), that participant must receive a refund of the excess deferrals, including earnings. Gap period income is simply the earnings that accrue between the end of the year in which the excess occurred and the date of the corrective refund of the excess contribution. Beginning with the 2008 plan year, the Pension Protection Act of 2006 (“PPA”) eliminated the requirement to calculate and include gap period income for distributions to participants on account of excess contributions which result from a failed Actual Deferral Percentage (ADP) or Actual Contribution Percentage (ACP) test. However, the PPA did not affect the requirement to calculate and include gap period earnings for corrective distributions to participants on account of “excess deferrals” contributed to the plan over the applicable dollar limit prescribed by the IRS.

New Law

It was widely expected that Congress would pass a technical corrections bill for the PPA eliminating the requirement to calculate and include gap period earnings for corrective distributions of excess deferrals. For plan years beginning in 2008, the *Act* has eliminated the requirement to include gap period income in “excess deferral” corrective distributions. This means that earnings on corrective distributions to participants for both “excess contributions” and “excess deferral” refunds need only be calculated *through the end of the year*, rather than through the date of the corrective distribution. This change should make administration of “excess deferral” and “excess contribution” corrective distributions more uniform and streamlined.

Rollover Option for Non-spouse Beneficiaries

Background

The PPA provided a means for non-spouse beneficiaries to roll over their death benefit from an employer sponsored plan to an “inherited IRA,” by which the IRA is generally established in the name of the deceased participant and the beneficiary of the retirement

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account is designated as the beneficiary of the IRA account. Although the PPA provided the option for non-spouse beneficiaries to rollover death distributions beginning in 2007, the option was not available unless adopted by the plan. The PPA **did not require** plan sponsors to provide a rollover option to non-spouse beneficiaries.

New Law

The *Act* **requires** defined contribution retirement plans to provide for non-spouse beneficiary rollovers for plan years beginning after December 31, 2009. Any non-conforming calendar year plans should provide for these distributions no later than January 1, 2010. The non-spouse beneficiary should receive notification of her ability to rollover a retirement plan distribution to an "inherited IRA" via a 402(f) notice.

Direct Rollovers of Designated Roth Accounts from Retirement Plans to Roth IRAs

Background

Effective January 1, 2008, a participant is allowed to receive a distribution from the pre-tax portion of his retirement account and directly roll it over to a Roth IRA, in effect "converting" non-Roth money from his employer-sponsored plan into "Roth" money in his IRA. This is a taxable rollover, however, unlike the "usual" rollovers of pre-tax, non-Roth money. The availability of these "pre-tax plan account to Roth IRA conversions" is limited in 2008 and 2009 to situations in which the participant has a modified adjusted gross income that is less than \$100,000. However, these income restrictions have been removed beginning in 2010.

New Law

The *Act* has made a technical correction which clarifies that a participant's ability to elect a rollover distribution from a designated Roth account in a defined contribution plan is not subject to the adjusted gross income limitation (\$100,000) that otherwise applies where the distributing plan is not a Roth IRA. The *Act* has made this change retroactive for distributions made beginning January 1, 2008 (as if originally provided under the terms of the PPA).

EACA Definition Is Changed and Permissible Withdrawals Are Expanded

Background

An Eligible Automatic Contribution Arrangement ("EACA") generally requires that in the absence of an election to defer plan contributions (or to decline to make such contributions) all eligible employees will be enrolled in the plan at a certain contribution percentage, which the employer will withhold from the employee's wages unless or until the participant provides contribution instructions. An EACA is also required to direct all plan contributions withheld from an employee's wages into a plan default investment fund which meets the definition of a Qualified Default Investment Alternative ("QDIA"), unless the employee provides other investment instructions. A QDIA is a default investment fund that is described in final regulations issued by the Department of Labor on October 24, 2007. A QDIA must conform to several requirements (including specific notice requirements) as described in the final regulations, and often takes the

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form of an age-based or targeted retirement date or life expectancy investment option, or a balanced fund or portfolio. In the absence of investment instructions provided by the eligible employee, all plan contributions made on the employee's behalf are directed into the default fund. Under the PPA, a plan adopting an EACA is allowed to provide participants with the option to receive a distribution of amounts contributed to the plan under the EACA within 90 days of the date of the initial contribution date.

New Law

Under the *Act*, plans implementing an EACA are no longer required to have a QDIA as the default investment. This means that many plans which would have previously met the requirements of an EACA (except that a QDIA was not used as the default investment option) may now provide for permissible withdrawals. Furthermore, besides qualified retirement plans maintained by an eligible employer (such as 401(a), 403(b), and 457(b)), many other retirement arrangements may now offer a permissible withdrawal option, including a SEP (simplified employee pension plan) that has a salary deferral arrangement (SARSEP) and a Simple IRA. These changes are effective for plan years beginning after December 31, 2007. In addition, the *Act* clarified that permissible withdrawals are not taken into account for purposes of the annual limit on elective deferrals prescribed by the IRS (\$16,500 for 2009). This clarification is effective for plan years beginning after December 31, 2007.

Contribution Deduction Limit to Plan Combinations (Defined Contribution and Defined Benefit) Modified

Background

There is a limit on an employer's ability to deduct contributions made to defined contribution and defined benefit plans. Generally, the overall deduction limit is the greater of the following amounts:

- 1) 25% of participant compensation during the tax year, or
- 2) the amount of employer contributions made to the defined benefit plan to satisfy minimum funding standards. The PPA provided that when an employer contributes to one or more defined contribution plans, the overall deduction limit applied to the extent that the defined contribution plan contributions exceeded 6% of participants' compensation (excluding elective deferrals). In such cases, the overall deduction limit was calculated as follows:

- Total employer contributions (to all plans) – 6% of the compensation of participants in the defined contribution plans. The IRS determined that in cases where employer contributions to defined contribution plans do not exceed 6% of participants' compensation, the overall deduction limit did not apply to the defined contribution plans. However, employer contributions made to the defined benefit plans remained subject to the overall deduction limit.

New Law

The *Act* clarified that for contributions to plans for tax years beginning after December 31, 2005, the following set of rules apply:

- If the contributions to the defined contribution plans do not exceed 6% of participants' compensation, the overall deduction limits do not apply to the employer contributions to the defined benefit plans; and
- If the contributions do exceed 6% of participants' compensation to the defined contribution plans, the overall deduction limit is applied by taking into account only those defined contribution plan contributions in excess of the 6% threshold.

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