THE EMPLOYEE BENEFIT
Forum
current issues in retirement benefit planning

AGH
Allen, Gibbs & Houlik, L.C.
CPAs and Advisors

Handling Breaks in Service

SITUATION: We recently rehired a former employee who was 20% vested in the employer matching contributions in her 401(k) plan account when she cashed out the vested portion of her account shortly after leaving our company three years ago. Our plan uses a six-year graded vesting schedule for matching contributions.

QUESTION: Do we have to give her credit for her prior two years of service with us for purposes of vesting in our 401(k) plan?

ANSWER: Yes, you will have to credit the employee's two prior years of service for vesting purposes.

DISCUSSION: When you rehire a former employee before he or she has accrued five consecutive one-year breaks in service, you generally must credit the rehired employee's prior service. Generally, a one-year break in service occurs for any year in which a participant doesn't complete the minimum hours of service required by the plan (for example, 501 hours).

Since the employee you mention accrued only three consecutive one-year breaks in service during her absence, you must credit (for vesting purposes) her two years of service before the employment break. However, if your plan has a waiting period for receiving vesting credit for pre-break years, you don't have to credit the employee's prior service until that waiting period is completed. After the employee completes the waiting period, you'll have to credit both the employee's pre-break and post-break service.

If your plan has a cash-out/buyback provision, you also will have to give her an opportunity to have forfeited matching contributions restored. Basically, a cash-out/buyback provision gives rehired employees the option of repaying the plan the total amount distributed to them after they terminated their original employment. Once the distributed amount is repaid, the plan must restore the forfeited nonvested portion of the account and vest the participant in the reinstated amount based on both pre- and post-break years of service. To qualify for this treatment, a rehired employee must have had fewer than five consecutive one-year breaks in service. So your rehire would qualify.

If a plan doesn't have a cash-out/buyback rule, the nonvested portion of a participant's account balance generally won't be forfeited until the participant incurs five consecutive one-year breaks in service.

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RMD Reminder

Fall is a good time to review your plan in preparation for making required minimum distributions (RMDs) to retired employees and beneficiaries.

Generally, retirement plans must make RMDs to retired employees who have reached age 70½ *and* to any current employees who own 5% or more of the company and are age 70½ or older. RMDs also must be paid to beneficiaries of a deceased employee's qualified plan account. Your plan may provide that employees (other than a 5%-or-more owner) who continue to work for your company after age 70½ can wait until April 1 of the year after the year they retire to start taking RMDs.

Retirees and more-than-5% owners must take their first RMD by April 1 of the year following the year they turn age 70½. Your plan must make subsequent RMDs by December 31 of each year. Other rules apply to beneficiaries. Please call if you have questions about making your plan's 2012 RMDs.

Americans' Investing and Saving Habits

Each year, the Employee Benefit Research Institute (EBRI) reports on how Americans are saving and investing for retirement. So how are Americans doing? Here are some of the findings from the latest report.

Account Balances

The average 401(k) plan account balance was $60,329 at year-end 2010. But employee account balances varied widely. About three quarters of participants had account balances lower than $60,329. Approximately 39% of participants had account balances of less than $10,000. Of those participants, 51% were in their 20s or 30s. And of the 17.1% of participants who had balances greater than $100,000, 59% were in their 50s or 60s. Along with age, EBRI attributes the variation to other factors, including tenure and salary.

Asset Allocation

As the stock market rose in 2010, so too did the percentage of assets invested in stocks. Sixty-two percent of employee account balances were invested in equity securities — stock funds, the stock portion of balanced funds, and company stock. Fixed income securities, such as stable value investments and bond and money funds, made up 33% of account balances.

Average Asset Allocations of 401(k) Accounts

Selected Years	Stock Funds	Company Stock	Balanced Funds	Bond Funds	Stable Value Funds	Money Funds
1999	53%	19%	7%	5%	11%	4%
2002	40%	16%	9%	11%	16%	6%
2007	48%	11%	15%	8%	11%	4%
2008	37%	10%	15%	12%	15%	7%
2009	41%	9%	17%	11%	13%	5%
2010	42%	8%	18%	12%	10%	4%

Source: "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2010," EBRI, *Issue Brief*, No. 366

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Be Aware of the Top-heavy Rules

As part of a Learn, Educate, Self-Correct, and Enforce (LESE) project, the IRS examined 401(k) plans for compliance with the tax law's top-heavy plan requirements. All the examined plans were potentially subject to the top-heavy rules. The project found several common reasons for top-heavy compliance failure. The questions and answers below may help you avoid similar compliance errors.

What types of failures did the LESE project uncover? Some plans did not conduct top-heavy plan testing and, consequently, the plan sponsors did not make required minimum contributions. Plans also failed to use the proper definition of compensation as stated in the plan documents, causing minimum contribution allocation errors. In addition, eligible employees were excluded from plans, and top-heavy allocations weren't made to some eligible employees.

When is a plan top heavy? Defined contribution plans, such as 401(k) plans, generally are considered top heavy when the value of accounts of "key employees" represents more than 60% of the total value of all employee accounts. A plan that tests as top heavy on the last day of the 2012 plan year will be subject to the top-heavy rules for the 2013 plan year.

Who are key employees? For purposes of the top-heavy rules, key employees include: (1) owners of more than 5% of the business, (2) company officers with compensation greater than $165,000 in 2012, and (3) individuals who own more than 1% of the business and earn more than $150,000 a year. In determining the 1% and 5% ownership, an individual is considered to own stock owned by certain family members.

What happens when a plan becomes top heavy? Under the top-heavy rules, the employer sponsoring the plan generally must contribute at least 3% of compensation on behalf of nonkey employees. This minimum contribution may be required even for a top-heavy plan that provides for elective contributions only, unless no key employee makes elective contributions to the plan. Not making required minimum top-heavy contributions can jeopardize a plan's tax-exempt status.

Who must receive top-heavy contributions? All nonkey employees who are plan participants at the plan's year-end must receive the minimum contribution. No additional contributions are required for employees who leave the company before the end of the year.

Can we do anything before year-end to avoid being subject to the top-heavy rules for 2012? If your plan permits, consider making additional profit sharing contributions on behalf of a designated group of nonkey employees before year-end.

How might we avoid top-heavy status in the future? Adopt a safe harbor plan design. 401(k) plans that meet certain safe harbor contribution requirements — basically, a nonelective employer contribution of at least 3% of compensation or a qualifying matching formula — avoid annual nondiscrimination testing *and* the top-heavy rules, assuming no non-safe harbor employer contributions are made. Adopting a qualified automatic contribution arrangement (QACA) also avoids top-heavy treatment.

Is there anything else we should know? Only plans that consist solely of elective deferrals and safe harbor employer contributions qualify for the top-heavy exemption. Your plan should provide for forfeitures to be allocated to pay plan expenses or reduce the employer's safe harbor (nonelective or matching) contribution or as a permitted safe harbor discretionary match.

RECENT DEVELOPMENTS
In Benefit Plans

Fee Disclosure Reminder. With the initial annual fee disclosures to participants out of the way for many plan sponsors, you should have your eye on the due date for the first required quarterly fee disclosures. The initial annual fee disclosures were due to plan participants and beneficiaries by August 30, 2012, for calendar-year plans. The first quarterly disclosures for these plans are due by November 14. To help plan sponsors meet their disclosure obligations, the U.S. Department of Labor has issued guidance in the form of 38 frequently asked questions (*www.dol.gov/ebsa/regs/fab2012-2.html*).

The Importance of 401(k) Plan Participation. According to the Employee Benefit Research Institute (EBRI), being able to participate in a 401(k) plan at work is one of the single most important factors in closing the retirement savings gap for Generation X (those born between 1965 and 1974). EBRI gap modeling estimates that Gen Xers with at least 20 years of future eligibility to participate in a 401(k) or other defined contribution plan will have an average financial shortfall at retirement of approximately $23,000 per individual. For those with no future years of eligibility, the projection of the average retirement savings shortfall widens to $78,000.

AGH

Allen, Gibbs & Houlik, L.C.
CPAs and Advisors
301 N. Main, Suite 1700
Wichita, KS 67202-4868
www.aghlc.com
(316) 267-7231