

Newsletter

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Updated 2003 Employee Benefit Information

The 2003 dollar limits for Employee Benefit Plans have generally remained constant compared to their 2002 levels. A description of some of the important limits and the 2002 and 2003 figures are as follows:

2002	2003	
\$Value	\$Value	
11,000	12,000	Maximum 401(k) elective deferral. For Partners in a partnership, any matching contributions on elective deferrals are not included in this limit.
1,000	2,000	Maximum Acatch-up@ elective deferral for employees age 50 and over.
40,000	40,000	Maximum participant allocation under all defined contribution plans, including 401(k), matching, profit sharing, etc. Total allocation cannot exceed 100% of compensation.
200,000	200,000	Maximum compensation allowed for determining benefits, contributions and tax deductible contributions for all retirement programs.
160,000	160,000	Maximum annual lifetime benefit allowed to be paid in a defined benefit plan commencing anytime between ages 62 and 65.

84,900	87,000	Social Security Taxable Wage Base taxed at 6.2%.
NO	NO	Medicare Wage Base taxed at 1.45% on all wages.
LIMIT	LIMIT	
90,000	90,000	Salary in prior year to be considered Highly Compensated Employee (HCE) in current year. (More than 5% owners in prior or current year are automatically HCEs regardless of salary.)

The above limits are increased only when the Cost of Living Adjustment (COLA) reaches the next rounded threshold. Certain figures are rounded down rather than up, and the increments are not uniform for all figures. Thus, some figures may change for a given year, while others may not.

Year 2003

The year 2003 portends significant changes in the business environment, and the qualified retirement plan arena is no exception. Highlighted below are some of the more significant areas of interest which may also be viewed on our website.

- **New Defined Contribution Maximums**

As noted above, in 2003 the new 401(k) limit increases to \$12,000 and employees age 50 and older can make an additional "catch-up" contribution of up to \$2,000. The total maximum defined contribution limit remains the same at the lesser of \$40,000 or 100% of compensation. The 401(k) elective deferral is included in this limit, but the "catch-up" contribution is not.

- **New Defined Benefit/401(k) Planning Opportunity**

The increase in the maximum Defined Benefit (DB) Plan limits, starting at an earlier age, coupled with the new treatment of employee 401(k) deferrals as not included in an employer's tax deductible limit, offers small employers a unique opportunity to super-maximize their pre-tax savings. The enhanced employer tax deduction under the DB Plan can be augmented by pre-tax 401(k) contributions made out of compensation, up to \$11,000 in 2002 (\$12,000 for employees age 50 and over). Over the next four (4) years each limit will increase by \$1,000/year, reaching \$15,000 in 2006 (\$20,000 if age 50 or over in 2006).

- **New 401(k) Planning Opportunity**

The increase in the 401(k) elective deferral limit to 100% of compensation offers an opportunity for lower-paid employees to dramatically increase their 401(k) contributions. Under prior law, plans typically limited such contributions to no more than 25% of pay, or less if the plan also had matching and/or profit sharing contributions. Plan sponsors may wish to amend their plans to enable lower-paid employees to increase their deferrals at any time during the year.

CAUTION: It may be advisable to only permit Non-Highly Compensated Employees (NHCEs) to raise their rate of contribution to the higher limit. Allowing HCEs to do so could result in failed non-discrimination testing if an HCE accelerates his/her contribution early in the year, then terminates or has a dramatic decrease in their total pay for the year. Safe Harbor 401(k) plans (which allocate special fully vested contributions made by the employer) are not subject to such testing and, thus, could allow ALL employees to use this new limit.

- **401(k) Contributions**

Under U.S. Department of Labor regulations companies must transmit their employees' 401(k) contributions as of the earliest date on which such assets can be reasonably segregated from the employer's general assets, but no later than the fifteenth (15th) business day after the month of withholding. Loan repayments must be handled in a similar fashion, according to DOL Advisory Opinion 2002-02A.

The DOL has indicated that in simple situations (such as small businesses or larger ones with consolidated payrolls), segregation should take place in as little as three (3) business days within the date employee deferrals are withheld.

While we encourage employers to make deposits with each payroll, in some cases time and expense considerations mitigate against a three (3) day deposit deadline to the investment vehicle. In these situations a change from 12 deposits per year to 24, 26 or 52 deposits could be avoided by promptly transferring employee deferrals to a Trust holding account with the actual investment made monthly.

- **Plan Restatements**

As noted last year and on our website, all qualified retirement plans must be re-written to reflect pension law changes since 1993 (collectively called "GUST"). Under revised IRS guidance the process of redrafting of plans must now generally be completed by **September 30, 2003**.

- **New "Blackout Period" Notice Requirements**

When a defined contribution (so-called "individual account") plan such as a 401(k) Plan offers employees the ability to self-direct their investments, or changes the company providing employee statements, or changes the investment menu, participants are often precluded from making investment changes for a period of time, to allow conversion to the new recordkeeping platform. During this time period, called a "**blackout period**", it is also common to restrict participants' access to loans and distributions. Heretofore, such periods were not subject to any regulation. However, the experience involving ENRON (and other situations where participants' access was restricted) prompted a new law, the Sarbanes - Oxley Act of 2002. **The U.S. Department of Labor has now issued**

interim regulations that are effective for new blackout periods commencing January 26, 2003.

The new rules require detailed **advance notices** to affected participants to ensure they are aware of the pending restrictions and are given adequate time to take any appropriate action, such as changing their investment mix or requesting a loan or distribution. In general, the Notices must be provided to all affected participants at least 30 but not more than 60 days prior to the **earliest date a participant's access is limited.**

Failure to comply with the new rules can result in substantial penalties of up to \$100/day per participant.

There are certain limited exceptions to the advance notice requirement. For example, situations involving blackouts associated with certain corporate transactions (merger, acquisition, divestiture) or where unforeseeable events or circumstances beyond the control of the plan administrator prevent advance notice from being given. However, notices must still be given as soon as is reasonably possible.

For the large majority of situations, the new rules will require careful, advance planning to ensure the Notice requirements are satisfied. Please refer to our website, www.schlossco.com, for a detailed summary of the new rules, or call our office if you have any questions.

- **Final Participant Loan Rules**

Several important changes affecting loans made from qualified retirement plans to plan participant became effective in January 1, 2002. IRS has now finalized additional rules that become effective for new loans issued on and after January 1, 2004. A brief summary of the changes is shown on the next page.

Effective January 1, 2002

- i. Partners, sole proprietors and S-Corporation shareholders can take loans without incurring prohibited transaction penalty taxes. This rule applies to new loans taken on/after January 1, 2002, as well as pre-2002 (although the penalty taxes still apply for pre-2002 years).
- ii. Participants that miss a loan repayment must make up the payment by the end of the calendar quarter following the calendar quarter during which the payment was missed. Failure to make such repayment within this Acure period@ will result in a deemed distribution to the participant equal to the unpaid loan balance, subject to income tax plus a 10% penalty tax if the participant has not yet attained age 59.2. An exception is permitted if the participant is on a valid leave of absence, which allows suspension of

repayment for up to one year (but not to extend the loan term beyond the five year maximum from the date of the original loan).

- iii. Interest on the unpaid loan balance continues to accrue for purposes of calculating the maximum amount available for any subsequent loans.

Effective January 1, 2002

- iv. Partners, sole proprietors and S-Corporation shareholders can take loans without incurring prohibited transaction penalty taxes. This rule applies to new loans taken on/after January 1, 2002, as well as pre-2002 (although the penalty taxes still apply for pre-2002 years).
- v. Participants that miss a loan repayment must make up the payment by the end of the calendar quarter following the calendar quarter during which the payment was missed. Failure to make such repayment within this Acure period@ will result in a deemed distribution to the participant equal to the unpaid loan balance, subject to income tax plus a 10% penalty tax if the participant has not yet attained age 59.2. An exception is permitted if the participant is on a valid leave of absence, which allows suspension of repayment for up to one year (but not to extend the loan term beyond the five year maximum from the date of the original loan).
- vi. Interest on the unpaid loan balance continues to accrue for purposes of calculating the maximum amount available for any subsequent loans.

Effective January 1, 2004

- vii. **Multiple loans:** IRS has backed off its previously proposed limit of two loans per participant per year. Thus, each plan can continue to determine a limit on the number of loans a participant may have. IRS also acknowledged that, so long as all other requirements applicable to loans are met, so called "credit card" loans are not prohibited, as they likely would have been under a two loan per year limit.
- viii. **New loans after "Deemed Distributions":** A participant who fails to repay a loan as required is deemed to have received a taxable distribution. Failure to repay such outstanding loans will now result in new requirements for any subsequent loans, such that the participant must either:
 - a. agree to repayment of the subsequent loan via payroll withholding, or
 - b. post additional collateral in excess of the normal 50% of the participant's vested balance.
- ix. **Refinancing Loan:** A participant's ability to use a new loan to repay an existing loan will be limited by requiring repayment of the original loan by its original deadline, and restricting the amount of the new loan based on the unpaid balance of the existing loan. In effect a participant cannot reduce their current loan repayment amount via a new loan with a longer

repayment period which extends beyond the initial loan's maximum term (usually five (5) years).

- x. **Suspension of Loan Repayments for Leave of Absence/Military Service:** New rules will allow a participant to temporarily suspend loan repayments for up to 12 months on account of a bona fide leave of absence, or even longer for military service. However, loan repayments must commence upon the end of the applicable suspension period, interest must continue to accrue on the unpaid balance during the suspension period at the original loan interest rate (but maximum 6% per annum for military service period of suspension), and the loan must be paid in full by the end of the original loan's term (as extended by the period of military service).

- **Looming Deadlines for Staffing Firms**

Staffing firms that sponsor their own defined contribution plans (individual account plans such as 401(k)) have until May 3, 2003 (the "decision date") to make a key decision on the future of their plan. They will have until December 31, 2003, (the "compliance date") to implement these decisions.

The issue concerns the placement of employees of the staffing company (called a "Professional Employment Organization" or "PEO") in essentially full-time positions at the location of a Client Organization that contracted with the PEO. These so-called "work-site" employees are viewed by the IRS as employees of the Client Organization, **NOT** the PEO. As such they are not eligible to be in the PEO's defined contribution plan, since only **bona fide** employees of the PEO may be in such a plan.

By the Compliance Date, the PEO must (i) terminate the Plan and distribute all benefits, or (ii) convert it into much more complex **Multiple Employer Plan**, or (iii) create a **spinoff** plan, then transfer the work-site employees' balances into it, terminate it and distribute all accounts. The termination of the spinoff plan must be submitted for an IRS determination letter.

Regardless of which approach is taken, the assets of the work-site employees must be out of the PEO Plan by December 31, 2003, or the Plan could be disqualified.

Year-End Reminder

The deadline for adopting a new plan for the 2002 calendar year is December 31, 2002. You must have a signed document in place at that time, even if your first contribution is not actually made until some time in 2003. ***In addition, if you have an age-weighted or cross-tested plan, and have experienced a big change in the relative-age composition of your work force that will affect the 2002 plan year, please contact us immediately.***

Changes to the allocation method that may be appropriate must be adopted before December 31, 2002 (for calendar year plans).

Deadline Reminders

Date	Action Required
1/31/2003	Distribute Form 1099-R to all recipients of 2002 distributions, including direct rollovers of lump sum payments to IRAs or other qualified plans, minimum required distributions and monthly pensions.
2/28/2003	File Form 945 to report any income tax withheld from 2002 distributions. File Forms 1099-R using transmittal Form 1096.
3/15/2003	Distribute 401(k) contributions plus imputed earnings to the Highly Compensated Employees from 401(k) Plans that fail ADP/ACP Test for 2002 calendar Plan year. Amount distributed is taxable 2002 income. (For non-calendar plans, distribute within 22 months of plan year end). Employer subject to 10% penalty tax on distributions after this date, but then amount is taxable to participants in 2003.
4/01/2003	Pay out first minimum distribution to participants who reach 702 in 2002 and did not take the first payout by 12/31/2002. Second minimum payout due by 12/31/2003, with annual payouts thereafter. Participants with a valid TEFRA 242(b) election and non-owner employees born prior to July 1, 1917 may continue deferral of distributions until actual retirement. Non-owners attaining age 702 in 1997 and beyond may also elect to defer if the Plan document is properly amended and a valid deferral form (with spousal consent) is timely signed.
4/15/2003	Distribute any 2002 salary deferrals in excess of \$11,000 , except valid Acatch-up@ deferrals for employees age 50 and over, (plus imputed earnings) made to 401(k) Plans. Excess deferrals taxable as 2002 income. Imputed earnings taxable as 2003 income.
	First Quarterly Contribution for 2003 due for calendar year defined benefit plans, unless notice is given to participants by 6/15/2003 or Plan is exempt.

Calculation of 2002 Keogh Contribution

The calculation of contributions for self-employed individuals must reflect the deduction of 2 of the Social Security taxes on self-employment earnings ("SEE"). The procedure is complicated by the two-tiered Social Security tax (i.e., 12.4% of the first \$84,900 of SEE, plus 2.9% of all SEE). The \$200,000 compensation limit further complicates the calculation, depending on the Plan type - Profit Sharing ("PS") or Money Purchase ("MP").

The 2002 Keogh contribution may be determined as follows*:

1. Enter Net Schedule C profit - but not more than \$248,592.45 for a PS or MP Plan. \$ _____
- (a) If item #1 is greater than or equal to \$91,928.05 multiply item #1 by .98661
2. \$ _____
- (b) Subtract from item #2(a) \$5,263.80
3. If item #1 is less than \$91,928.05 multiply item #1 by .92935 \$ _____
4. If PS enter .25 (maximum) or if MP enter rate specified in plan but not to exceed .25 \$ _____
5. Multiply item #4 by item #2(b) or item #3 whichever is applicable \$ _____
6. Add one "1" to item #4 \$ _____
7. Divide item #5 by item #6 equals the 2002 Keogh Contribution (maximum \$40,000) \$ _____

***Note:** If the plan provides for contributions or allocations that are **not** pro rata on compensation (e.g., the plan provides for permitted disparity, or is age-weighted or otherwise cross-tested), or the self-employed individual also has regular W-2 wages subject to FICA taxes from any employer, then the above method **requires modification**.

Effective January 1, 2002, the maximum tax deduction (25% of eligible pay) is now available in a discretionary Profit Sharing Plan. Thus, employers no longer need a Money Purchase Plan, and its required contribution, to achieve the highest available contribution. Please contact your Schloss & Co. consultant for further information.

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