



Second Quarter 2006

# Retirement PLAN WATCH

## LINKS and LINES

[www.advisoryservices.com](http://www.advisoryservices.com)  
[www.irs.gov](http://www.irs.gov)  
[www.legendgroup.com](http://www.legendgroup.com)  
The Legend Group:  
800-749-4221 (other than NY)  
800-749-4321 (NY only)  
561-694-0110 (local)

## Maximum Annual Contribution and Excess Contributions

### Salary Deferral Limits

The §402(g) limit governs all salary deferrals except the deferrals from §457 plans which has its very own limit. It is the same dollar amount as the §402(g) limit but it is not governed by the same section of the Code. All other employer-sponsored retirement plans that provide for salary deferrals, including §403(b)s, §401(k)s, SAR-SEPs and SIMPLE IRAs, are subject to §402(g). This limit is simply the lesser of 100% of compensation or the applicable dollar limit for the relevant year. In 2006, this limit is \$15,000 overall with a maximum for SIMPLE IRAs of \$10,000. After 2006, these limits will be subject to cost-of-living adjustments.

The Over-50 Catch-Up is governed by §414(v) and allows an individual who will attain age 50 or more in the relevant tax year to use the Catch-Up at the start of that year. In 2006, the Catch-Up is \$5,000 for §403(b)s, §401(k)s, §457s and SAR-SEPs. For SIMPLE IRAs, the Catch-Up is \$2,500. After 2006, these limits will be subject to cost-of-living adjustments.

### Annual Additions Limit

For the §457, the dollar limit is the Annual Additions limit. No more can be contributed to this type of plan, by either the employer or the employee. For all other plans, employers may make contributions over and above the salary deferrals, subject to the §415 limit. The §415 limit is the lesser of 100% of compensation or the applicable dollar limit for the relevant year. In 2006 the §415 dollar limit is \$44,000. We won't know the §415 limit for 2007 until the end of October or so when the IRS announces the cost-of-living adjustments or COLAs.

Please bear in mind that the Over-50 Catch-Up is not part of the §415 limit. Therefore, a retiring teacher receiving lump sum employer contributions in a §403(b) discriminatory plan could actually have \$49,000 deposited into his account this year if his salary was at least this much. \$15,000 would be the basic elective deferral, the employer contribution would be the difference between \$15,000 and \$44,000 or \$29,000 and the client could defer an extra \$5,000 for the Catch-up.

### Excess Contributions

Let's review excesses in the §403(b) context. One type of excess (called excess contributions) has been eliminated due to the repeal of the MEA limit. There are two types of excesses because there are now two limits for §403(b) contributions:

- 1) *excess deferrals* – contributions over the §402(g) limit for the relevant year, and
- 2) *excess annual additions* – contributions over the §415 limit of the lesser of 100% of includable compensation or \$44,000.

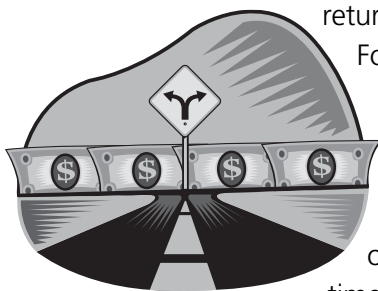
Back quite a few years ago, we used to be able to return excesses to employers but the IRS changed the rules and this is no longer possible.

For excess deferrals, the excess and the earnings thereon should be distributed to the account owner in a timely manner. If the distribution occurs before the end of the tax year in which the excess contribution was made, everything is straightforward. The taxpayer includes the amount of the excess and the earnings, if any, in that year's tax return as ordinary

income. In some markets, excesses will experience a loss – we are supposed to distribute the excess minus the loss to the participant. The participant must report the whole excess in his ordinary income. The custodian will issue one Form 1099R reporting the distribution as taxable. Under the §403(b) rules the excess and earnings are not treated as a premature distribution if the taxpayer is under the age of 59½ and are not subject to the premature penalty. Any earnings will be taxable income.

If distribution of an excess deferral (remember – these are excesses over the elective deferral limit) occurs after the end of the applicable tax year but before April 15th of the following year, it is still considered timely but *reporting the distribution* of the excess is a little different. If the taxpayer has already filed his tax return when he discovers the excess, an amended return using Form 1040X will be necessary to correctly report the excess amount as income in the preceding year. Any earnings on that excess are taxable in the year of receipt, i.e., the current year. The taxpayer will receive two Forms 1099R after the end of the current tax year if there were any earnings. One will report the excess amount with a code showing it was an excess for a prior year and the other will report the earnings as income for the year of distribution. Again, for §403(b) excesses, the distribution of earnings is not subject to the §72(t) premature penalty.

Some taxpayers think ADSERV should issue a Form 1099R in the current year for the excess amount in this scenario so the taxpayer can attach it to their return. This is not how the Form 1099R instructions tell us to report these distributions. But, in fact, the IRS themselves are not clear on their own instructions. Sometimes we have a taxpayer who properly reported the excess amount as income in the prior year – but the IRS *rejects* it because the taxpayer *didn't* have a Form 1099R reporting the excess. Don't panic – give us a shout and we will get



the IRS straightened out! It's actually best to attach a letter of explanation with the tax return to avoid any confusion – the bean counters are easily confused.

The corrections just discussed were timely corrections, i.e., before the taxpayer's tax filing deadline, *not* including extensions. But what happens if the excess isn't discovered until after that date? Excess deferrals (i.e., over the dollar limit) cannot be distributed unless the taxpayer is eligible for distributions! Of course, the taxpayer must still amend his return by filing Form 1040X for the year the excess was contributed, incurring penalties and interest on that excess. Then, when the taxpayer is eligible for and takes distribution, the excess will be taxed *again!*

For excess annual additions (i.e., over the 100% limit) the taxpayer has two years to take a corrective distribution (but he doesn't need to be eligible for a distribution this time!). The custodian, of course, must report the distribution of an excess on Form 1099R. Once again, if the excess is corrected in the year of excess, the excess and earnings are reported on one Form 1099R. If the excess is corrected in the next two years and the excess generated a gain, two Forms 1099R will be issued – one to report the excess and one to report the earnings. The codes on the Forms 1099R tell the IRS when the excess occurred in relation to the tax year of issuance, i.e., code 8 is used to denote amounts distributed in the tax year of issuance; code P denotes one year prior to the year of issuance; and code D denotes two years prior to the year of issuance.

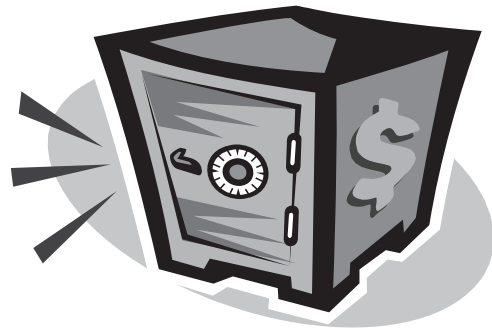
## Federal Bankruptcy Protection Extended to Qualified Retirement Accounts

Effective October 2005, Congress passed new legislation that extended federal bankruptcy protection to qualified plans, including:

- Keoghs and §401(k)s designed for sole proprietors
- §403(b)s
- IRAs (traditional, Roth SEP and SIMPLE)
- §457(b)s/§457(f)s

In traditional and Roth IRA accounts, protection is capped at \$1 million for amounts attributable to regular IRA contributions. There is no cap on amounts rolled over from employer plans, or assets that remain in a qualified employer plan as listed above.

Complete protection from creditors (outside of bankruptcy—i.e., civil suits) is still determined by state law.



ERISA plans are an exception as they are protected by ERISA law itself. Plans that are afforded this protection include:

- ERISA plans qualified under §401 of the IRS Code
- SEP IRAs if they benefit common law employees (i.e., the employee is not a relative of the owner)
- §403(b) employer-contributory plans

### Rollovers of Roth §403(b)s/ §401(k)s to Roth IRAs



The Proposed Roth Regulations make it possible for a participant to roll his/her Roth §403(b)s/§401(k)s to a Roth IRA after separation from service. This, in fact, is recommended since the required minimum distribution rules apply to the Roth §403(b)s/§401(k)s and the Roth IRA does not have this requirement.

However, there is one little catch to this rollover business. If you already have a Roth IRA set up and have satisfied the five year clock in that Roth IRA, the Roth §403(b)/§401(k) rollover assumes the Roth IRA clock and you may commence tax-free distributions if you are age 59½ or more. If you are establishing your first Roth IRA with the Roth §403(b)/§401(k) rollover, you must start a brand new five year clock for the Roth IRA and cannot take tax-free distributions until the Roth IRA five year clock has elapsed and you have attained age 59½.



## Access bills and make changes to participant contributions online!

Employers using ADSERV's Billing Services can now access their bills via the internet and make changes to participants' accounts online. It's convenient, and it improves processing time and accuracy.

When billing changes are submitted by an employer, the information is downloaded and stored in a "workfile" program on our AS/400 system. When the Employee Benefit Account Department receives the money relating to the employer's account, this bill will be pulled from the "workfile" program and processed.

Procedures on submitting checks remain the same.

A unique access code is required in order for each employer to use this system.

1. Call ADSERV at 1-800-749-4221 (other than NY) or 1-800-749-4321 (NY only) to receive your unique employer access code.
2. If you need technical help during the set-up process, or have any questions about using this process, call the appropriate phone number above and ask for Alejandra Salatino at ext. 718.



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ADVISORY SERVICES CORPORATION  
P.O. BOX 32427  
PALM BEACH GARDENS, FL 33410