

# Retirement PLAN

## news

## All in the family: Attribution rules

To preserve favorable tax treatment, qualified retirement plans must not discriminate in favor of highly compensated employees (HCEs) with respect to contributions and benefits. Family members who participate in the plan are often HCEs.

They may also be “key” employees, which raises another concern: If the accounts of key employees make up 60% or more of plan benefits, the plan becomes “top heavy.” For a top-heavy defined contribution plan, if a contribution is made on behalf of or a deferral is made by any key employee (or a benefit accrues in a top-heavy defined benefit plan), then minimum contributions must be made to participants who are not key employees. The attribution of ownership rules also play a role.

### Who is an HCE?

A plan participant becomes an HCE in one of two ways: through ownership or compensation. According to the definition, a highly compensated employee is either:

- An owner, at any time during the current plan year or the immediately preceding plan year, of a more than 5% interest in the business sponsoring the retirement plan (a 5% owner) or

- An employee who earned at least \$110,000 in the immediately preceding plan year from this employer. (This figure is adjusted for inflation.)

Any employee who does not meet either standard is a nonhighly compensated employee (NHCE).

### Who is a key employee?

A key employee is a plan participant who, at any time during the immediately preceding plan year, was:

- An officer of the business sponsoring the retirement plan earning more than \$160,000 (adjusted for inflation),
- A 5% owner (owns more than 5%), or
- A 1% owner (owns more than 1%) who earns more than \$150,000.

Any employee who does not meet one of these standards is a nonkey employee. Note that these definitions do not overlap. An individual may be an HCE but not a key employee and vice versa. However, it is possible to be both, e.g., an individual who was a 5% owner in the prior plan year.

### What is attribution of ownership?

Attribution is a legal concept that treats two or more people as owning the same interest in a business entity that is directly owned by one of them or by a third party. Under pension law, indirect ownership through attribution



from a family member has the same status as direct ownership. This is to prevent discrimination against rank-and-file participants when testing for nondiscrimination (regarding the allocation of contributions and benefits) and may cause a determination that the top-heavy minimum contribution requirements apply to the plan. However, family attribution never applies when the determination of HCE or key employee status is based solely on the employee's earnings.

Generally, the attribution of ownership rules apply only to a spouse (as defined under federal tax law) and “lineal ascendants and descendants” of the direct owner. (See table on page 2.) In

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# All in the family: A closeup

The Internal Revenue Code defines family relationships for the purpose of ownership in most retirement plan applications. According to Section 318(a)(1):

- A. An individual shall be considered as owning the stock owned, directly or indirectly, by or for
  - (i) His or her spouse (as determined under federal tax law, not state, and other than a spouse who is legally separated from the individual under a decree of divorce or a separate maintenance) and
  - (ii) His or her children, grandchildren, and parents.
- B. Effect of adoption: A legally adopted child of an individual shall be treated as a child of such individual by blood.

Consider a hypothetical family:

Spouses/parents: John and Mary

Children: Hank (age 27), Jim (age 24), and Sarah (age 17)

Attribution type*	Section 318 rules	Example:
Spouse	Deemed to own the stock**	John would be considered to own the stock of his wife Mary. Mary would be considered to own the stock of her husband John.
Parent to child younger than age 21	Deemed to own the stock	Hank, Jim, and Sarah would each be considered to own the stock of their parents.
Parent to child older than age 20	Deemed to own the stock	
Child to parent	Deemed to own the stock	John and Mary would each be considered to own the stock of their three children.
Grandchild to grandparent	Deemed to own the stock	John and Mary would also be considered to own the stock of their grandchildren.
Grandparent to grandchild	No attribution	John and Mary's grandchildren would <i>not</i> be considered to own the stock of John and Mary.
Other lineal ancestors and descendants	No attribution	The parents of John and Mary do not attribute to John and Mary's grandchildren.
Brothers, sisters, and half-siblings	No attribution	Neither Hank, nor Jim, nor Sarah is considered to own each other's stock. Sisters and brothers are not part of the family attribution rules.
Spouses of lineal descendants	No attribution	The spouses of Hank, Jim, and Sarah would not own the stock of Mary and John. In-laws are not part of the family attribution rules.

\* There are also attribution rules for partnerships, estates, trusts, and corporations.

\*\* Unless divorced (final decree only) or separated.

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the case of a spouse, attribution continues until the individuals are either formally divorced or legally separated under relevant state law.

## What is the impact of attribution?

Although the principal intent of the attribution rules is to prevent the manipulation of the qualified plan rules, attribution can be a double-edged sword. For example, attribution may increase the number of individuals included in the HCE class for nondiscrimination testing. Depending on how much the additional HCEs defer to a 401(k) plan, the resulting average deferral percentage (ADP) for the whole HCE class may be higher or lower. With careful planning, this may present an opportunity to maximize allowable deferrals for HCEs and key employees.

On the other hand, attribution may be a significant impediment. As an example, a cross-tested plan design is used and the owner's son or daughter is hired to work for the firm. In a cross-tested plan, both age and compensation are taken into account for discrimination testing purposes. Family attribution gives the owner's children the same ownership percentage as the parent/owner. Thus, the child would be brought into the HCE class when testing the allocation of contributions. This will likely cause the cross test to fail. As a result, additional contributions would have to be made on behalf of NHCEs.

It is also important to identify HCEs (e.g., the married daughter of an owner who has a different last name) when submitting a census for ADP or ACP testing. Since family members without their own direct ownership are HCEs under the family attribution rules, understanding the rules helps the employer and plan administrator determine the correct test results.

## Important issues

Attribution has a significant impact on plan design and administration. The ownership attribution rules also play a significant role in determining whether controlled and affiliated groups exist. It is prudent to discuss these concepts with your retirement plan advisor.



# Beneficiary distribution options in 2011

Qualified retirement plan documents, such as 401(k) plans, have default provisions to cover various beneficiary scenarios, including the possibility that a participant failed to designate a beneficiary prior to death or that a deceased participant's beneficiary form may be invalid or missing.

Other thorny issues can arise, such as a beneficiary predeceasing the participant or a life changing event (e.g., a divorce and/or remarriage) occurring *after* a beneficiary designation form was filed.

Administrators are encouraged to review the plan's beneficiary designation forms on a regular basis (at least once every five years) to confirm that each participant has a current form on file. Also, participants should be educated about the importance of reviewing their beneficiary forms every five years (or sooner, if there is a reason). Failure to do so could result in distributions that do not conform to participants' wishes or fulfill their estate plans.

## Marital status

Marital status should be addressed as part of the participant's beneficiary designation since there are laws that protect a spouse as the primary beneficiary of a married participant. Detailed procedures must be followed to permit a bona fide waiver, i.e., consent must be in writing and be witnessed by a notary public or plan representative. Note that some states currently allow same-sex marriages. However, federal laws, protections, and requirements do not apply to such marriages.

## Spouse beneficiary

A spouse beneficiary may generally roll over qualified plan funds into his or her own IRA or qualified plan (if the receiving qualified plan accepts rollovers). Alternatively, the spouse may leave the funds in the participant's plan until the end of the year in which the decedent would

have attained age 70½. If the decedent was under age 70½ and the beneficiary is over age 70½, this could be advantageous.

A spouse may establish a life expectancy payout based on his or her own life expectancy. The spouse's age is used to determine the distribution factor from the IRS single life expectancy table in the year distributions begin and each subsequent year. A spouse may name a beneficiary and, when the spouse dies, payments can continue over the spouse's remaining life expectancy at that point (reduced by one each year). The spouse's beneficiary may not use his or her own life expectancy.

Some surviving spouses prefer to roll over the funds to their own IRAs so that *their* beneficiaries can use their own life expectancies to "stretch" out payments when the IRA owner dies.

## Nonspouse beneficiary

A nonspouse beneficiary may directly roll over qualified plan funds into an "inherited IRA." If a life expectancy payout is elected, the age of the nonspouse beneficiary is used to determine the distribution factor from the IRS single life expectancy table. (The distribution factor is then reduced by one in years following the initial distribution year.)

## Conversion to an inherited Roth IRA

Effective in 2008, a spouse or nonspouse beneficiary may now convert qualified plan funds to an inherited Roth IRA, provided the individual can pay the taxes in the year of conversion. An in-plan rollover to a designated Roth may only be made by a spouse beneficiary.

## RMDs in the year of death

If the participant was receiving required minimum distributions (RMDs), the decedent's RMD for the year of death must still be paid. The beneficiary may then begin receiving life expectancy distributions based on his or her life expectancy the following year. A nonspouse beneficiary who is a person (as opposed to a charity or similar entity without a life expectancy)



may use his or her life expectancy to calculate the minimum payout using the IRS single life expectancy table. (The life expectancy factor is reduced by one for each year thereafter when calculating subsequent payments.)

## Decision deadline

A beneficiary generally must decide how to take a distribution by September 30 of the year after the year of the participant's death. The options are to:

- Take the entire benefit in a lump sum,
- Establish a life expectancy payout arrangement commencing no later than the last day of the calendar year following the participant's death,
- Disclaim his or her beneficiary rights, or
- Receive payment (either periodically or in a lump sum) of the entire benefit by the last day of the fifth year following the year of the participant's death.

**Note:** This option is usually only applicable if the decedent died before reaching their required beginning date for taking required minimum distributions (RMDs). Also note that because RMDs were waived for 2009, the five-year rule is extended by one year for the beneficiaries of participants who died between 2004 and 2009.

## Other considerations

While these rules are the norm, plans can be drafted to provide that distributions to beneficiaries, including spouses, must be made by the end of the calendar year containing the fifth anniversary of the participant's death.



# RECENT developments

## ▶ Form 8955-SSA

Before the requirement that Form 5500 be filed electronically and displayed online, Schedule SSA was filed with the Form. However, due to the confidential nature of specific participant information on Schedule SSA, it has been replaced by the new Form 8955-SSA. The new form is also used to notify the Social Security Administration about participants' benefits when they apply for Social Security. For 2009 and 2010 plan year filings, a transition rule applies: The electronic filing deadline is the *later of* the due date that applies for filing Form 8955-SSA for the 2010 plan year or August 1, 2011.

## ▶ Definition of fiduciary

Phyllis C. Borzi, the assistant secretary of labor for the Employee Benefits Security Administration (EBSA), recently issued comments on the proposed

rules that would amend ERISA's definition of "fiduciary." Borzi explained that the 36-year-old fiduciary definition is in need of updating to ensure that the investment advice that today's financial advisors render is in the best interest of the plan. Borzi stressed the fact that the current rule was adopted when most retirement plans were defined benefit plans. Today, participant-directed investments in 401(k) plans and IRAs represent the majority of retirement plan assets. The new rule would remove the requirement that investment advice be made on a "regular basis" and "primary basis" to be considered fiduciary advice.

## ▶ Electronic disclosure

The EBSA is requesting comments from the public concerning possible modifications to, or expansion of, the current standards governing ERISA-required disclosures that are delivered electronically to

employee benefit plan participants. The initiative stems from the substantial changes in technology that have been made since the original standards were issued in 2002. EBSA states that any potential modification or expansion must include best practice considerations and address the need to protect the interests of participants and beneficiaries. The deadline for public comment was June 6, 2011.

## ▶ An IRS list

The IRS has released its 2011 Dirty Dozen Tax Scam list, and it includes a reference to abusive retirement plans. The IRS is focused on two particular transactions: (1) attempts to avoid contribution limits by misreporting the fair market value of contributed assets and (2) the failure to report transactions as early distributions subject to the 10% penalty.

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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