THE Pension Digest

March 2004
Published Since 1984

ALSO IN THIS ISSUE –

Collin W. Fritz and Associates, Inc.,
"The Pension Specialists"

IRS Issues Additional HSA Guidance

The IRS issued Notice 2004-2 on January 12, 2004. This Notice provided general guidance on HSAs. It was in "Question and Answer" format. There were 38 questions. On March 30, 2004, the IRS issued additional guidance. The IRS issued Notice 2004-23, Notice 2004-24, Revenue Ruling 2004-38 and Revenue Procedure 2004-22. The purpose of the additional guidance is to allow more individuals to open HSAs.

The IRS makes some clarifying statements in Notice 2004-23 regarding the special rule that a plan will not fail to be an HDHP because it does not have a deductible requirement for preventive care.

1. The IRS makes clear that an HDHP may provide preventive care benefits without having any deductible or with a deductible below the minimum annual deductible ($1,000 for self-only coverage and $2,000 for family coverage). The IRS also makes clear that an HDHP is not required to provide benefits for preventive care or to provide preventive care with a deductible below the minimum annual deductible.

2. Preventive care does not generally include any service or benefit intended to treat an existing illness, injury or condition.

3. The IRS defines the following types of care as qualifying as preventive care. These are safe harbors. Other services may also qualify as preventive care.

a. Periodic health evaluations, including tests and diagnostic procedures ordered in connection with routine examinations, such as annual physicals.

b. Routine prenatal and well-child care.

c. Child and adult immunizations.

d. Tobacco cessation programs.

e. Screening services. (See Appendix.)

4. The rules of Notice 2004-23 and other IRS guidance will be used to determine if health care required by state law to be provided by an HDHP without regard to a deductible is "preventive." That is, the exception for preventive care is not conditioned on State law requirements. Many times state insurance laws require health plans to provide certain health care without regard to a deductible, or on terms no less favorable than other care provided by the health plan. Consequently, such health plans presently fail to qualify as HDHPs.

5. The IRS has requested comments on whether drug treatments should ever be treated as preventive care. Should such treatment be granted only if solely by prescription? Should such treatment be granted only if the drugs are part of an overall treatment program? If so, the IRS asked the appropriate standards for differentiating between drug treatments which would qualify as preventive care and those which would not.

The IRS creates an important transitional rule in Notice 2004-25.

An important rule of Notice 2004-2 (Q/A-26) was that the qualified medical expenses must be incurred only after the HSA has been established. The IRS has decided that this rule should be suspended for the calendar year 2004, because individuals otherwise eligible to contribute to an HSA have not been able to establish an HSA because they have not been able to locate an HSA custodian/trustee willing or able to open HSAs. For the 2004 calendar year, it will be permissible for an eligible individual to establish an HSA on or before April 15, 2005, and to have the HSA pay, or reimburse on a tax-free basis, an otherwise qualified medical expense if the qualified medical expense was incurred on or after the later of: (1) January 1, 2004,or (2) the first day

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Reminder—

April 30, 2004 is the deadline to furnish Form 5498-ESA

Additional HSA Guidance,
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of the first month that the individual became an eligible individual. The suspension affects only the calendar year 2004. For calendar year 2005 the requirement will again exist that the qualified medical expense must be incurred only after the HSA has been established.

The IRS also creates a special transitional rule in Revenue Ruling 2004-38.

In order to qualify to establish an HSA an individual must be covered by a high deductible health plan (HDHP) and he or she may not be covered by another health plan which is not an HDHP. The IRS has apparently been informed that many individuals are covered by HDHPs, but they are also covered by either a separate prescription drug plan or a rider to the HDHP and such plan provides a prescription drug benefit which is not subject to a deductible, but is subject to a copayment for each prescription. The IRS discussed this situation in Revenue Ruling 2004-38. The IRS concluded that a plan that provides benefits for prescription drugs is a health plan and that such a plan does not qualify as permitted insurance or permitted coverage. The only way for an individual covered by an HDHP who has prescription drug coverage to be eligible for an HSA is if the prescription drug coverage also qualifies as an HDHP. Such plan may provide benefits for the prescription drug coverage only if the deductible limit has been met by the plan or the rider. If the individual receives the prescription drug benefit under a spouse's plan which is not an HDHP, he or she is not eligible to contribute to an HSA.

Transitional Rule. An individual who is ineligible to contribute to an HSA under the situation as described above, but who is otherwise eligible, will qualify to make HSA contributions for calendar year 2004 and calendar year 2005 (covering the months before January 1, 2006). The individual will be able to make contributions to the HSA based on the annual deductible of the HDHP.

This is a very important transitional rule, because there are many individuals who are currently in this situation - covered by an HDHP, but also covered by a separate prescription drug plan or rider which does not qualify as an HDHP.

The IRS furnished the following explanation for the need for the transitional rule. *"Because of the short period between the enactment of HSAs and the effective date of section 223(HSA), many employers and health insurance providers have been unable to modify the benefits provided under their existing health plans to conform to the statutory requirements for an HDHP."*

Summary. The IRS has recently issued additional HSA guidance. Individuals and their advisors certainly welcomes such additional guidance and the special transitional rules. It is a start. The IRS has generally adopted some positions which will encourage individuals to establish and fund HSAs. The relief granted to employers will be greatly appreciated. Employers will not be required to immediately modify their benefit programs. Hopefully, the IRS will move to furnish further HSA guidance. Obviously, the more certainty there is about the HSA rules, the more likely it is that individuals and employers will establish and contribute to HSAs.

APPENDIX
Safe Harbor Preventive Care Screening Services

Cancer Screening
Breast Cancer (e.g., Mammogram)
Cervical Cancer (e.g., Pap Smear)
Colorectal Cancer
Prostate Cancer (e.g., PSA Test)
Skin Cancer
Oral Cancer
Ovarian Cancer
Testicular Cancer
Thyroid Cancer

Heart and Vascular Diseases Screening
Abdominal Aortic Aneurysm
Carotid Artery Stenosis
Coronary Heart Disease
Hemoglobinopathies
Hypertension
Lipid Disorders

Infectious Diseases Screening
Bacteriuria
Chlamydial Infection
Gonorrhea
Hepatitis B Virus Infection
Hepatitis C
Human Immunodeficiency Virus (HIV)
Infection Syphilis

Mental Health Conditions and Substance Abuse Screening
Dementia
Depression
Drug Abuse
Problem Drinking
Suicide Risk
Family Violence

Metabolic, Nutritional, and Endocrine Conditions Screening
Anemia, Iron Deficiency
Dental and Periodontal Disease
Diabetes Mellitus
Obesity in Adults
Thyroid Disease

Musculoskeletal Disorders Screening
Osteoporosis

Obstetric and Gynecologic Conditions Screening
Bacterial Vaginosis in Pregnancy
Gestational Diabetes Mellitus
Home Uterine Activity Monitoring
Neural Tube Defects
Preeclampsia
Rh Incompatibility
Rubella
Ultrasonography in Pregnancy

Pediatric Conditions Screening
Child Developmental Delay
Congenital Hypothyroidism
Lead Levels in Childhood and Pregnancy
Phenylketonuria
Scoliosis, Adolescent Idiopathic

Vision and Hearing Disorders Screening
Glaucoma
Hearing Impairment in Older Adults
Newborn hearing

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The Tax Benefits of an HSA

The tax benefits cannot be better. As with most traditional IRA contributions, the HSA contribution is deductible. The earnings realized by the HSA are not presently taxed. HSA distributions which are used exclusively to pay qualified medical expenses are tax free.

Note that the HSA has the best features of the Roth IRA—some distributions are not taxed.

Also, note that the HSA is a lot like a "second" traditional IRA in the sense that any funds withdrawn after age 65, and used for non-medical reasons, will be taxable. But this is reasonable, since a tax deduction was received for the contribution, and taxation of the earnings has been deferred until distribution. If the account beneficiary withdraws HSA funds and uses them for non-medical reasons, he or she will be required to pay tax on such amounts. He or she will also be subject to a 10% additional tax if he or she is younger than age 65 at the time of the distribution, unless disabled.

In order to be eligible to make contributions to an HSA, an individual must meet the following four requirements: (1) he or she must be covered by a High-Deductible Health Plan (HDHP); (2) cannot be covered by an insurance plan which is not an HDHP (but there are some exceptions); (3) cannot be a dependent; and (4) must not have attained age 65. One does not become ineligible because one does not have compensation or one has too much compensation. An individual may contribute to his or her traditional IRA, Roth IRA, 401(k) and HSA. The HSA is in addition to the other tax-preferred accounts.

Time will tell if the tax advantages are great enough to induce many individuals (and employers) to accept a "high" deductible health plan. By law, the HDHP must provide coverage for catastrophic medical situations.

Frequently Asked IRA Questions

The following is taken from IRS literature concerning IRA questions which they are frequently asked.

Can the 10% penalty for an early withdrawal from an IRA be deducted in the Adjusted Gross Income section of Form 1040 as a penalty on early withdrawal of savings? *No, the additional 10 percent tax on early distributions from qualified retirement plans you pay for a premature withdrawal of an IRA does not qualify as a penalty for withdrawal of a savings account.*

How long do I have to roll over a distribution from a retirement plan to an IRA account? *You must complete the rollover by the 60th day following the day on which you receive the distribution. (This 60-day period is extended for the period during which the distribution is in a frozen deposit in a financial institution.) The IRS may waive the 60-day requirement in certain situations, such as in the event of a casualty, disaster, or other event beyond your reasonable control. To obtain a waiver, a request for a ruling must be made and a user fee of $90 will apply. A written explanation of rollover must be given to you by the issuer making the distribution.*

Do I report my nondeductible Roth IRA contribution on Form 8606? *There are no forms to report a Roth contribution. The financial institution which is the trustee of your Roth IRA will send you information on the amount in your Roth IRA. They will also send the information to the Internal Revenue Service.*

Use Form 8606 if you made a nondeductible contribution to a traditional IRA; converted from a traditional IRA, a SEP, or SIMPLE-IRA to a Roth IRA; received a distribution from a traditional IRA, a SEP or a SIMPLE-IRA and made nondeductible contributions to a traditional IRA, or received a distribution

Confusion Concerning Reason Code 4

There seems to be much confusion as to what code to use on IRS Form 1099-R, when a distribution is made from an inherited IRA to the beneficiary of the account. It must first be understood that when the financial institution moves the funds from the decedent's account to the beneficiary's account, this is a transfer; it is not a reportable event. When a payment is then made from this inherited account to the designated beneficiary, a reason Code 4 is used. This tells the IRS that the distribution came from an inherited IRA. A payment from an inherited IRA is always coded as "4."

The IRS does not wish to be notified when funds are transferred. However, the IRS does require that they be notified when a payment is made from an account.

In summary, the transfer of the inherited funds from the decedent's account to the designated beneficiaries account is not a reportable event. The payment of funds from an inherited IRA to the beneficiary IS a reportable event, and the 1099-R will always be completed using Code 4 as the reason code.

SEP Contributions and IRA Contributions for the Same Year

A person may make both a traditional IRA contribution and a SEP contribution for the same tax year, or a person may make a traditional IRA contribution even though his or her employer has made a SEP contribution for the same tax year. The general rule, however, is that the SEP contribution will make a person an active participant for IRA deduction purposes. Whether or not the person will be able to claim a tax deduction will depend upon applying the appropriate modified adjusted gross income limits. See the IRS Worksheet as set forth on page 5.

A person may also make a Roth IRA contribution and a SEP contribution for the same tax year. A person is eligible to make a Roth IRA contribution even though a SEP contribution is also made.

Set forth below are six situations. They will illustrate the applicable rules. Situations #1 - #3 illustrate the tax analysis for someone who is an employee. Situations #4 & #5 illustrate the tax analysis for someone who is self employed.

Situation #1. David, age 48, works for ABC, Inc. His filing status is single. His compensation is $30,000. His modified adjusted gross income is $35,000. David made a contribution of $3,000 to his traditional IRA on October 15, 2003, for 2003. On February 26, 2004, ABC, Inc. contributed $4,500 to David's SEP IRA for tax year 2003. This was 15% of his compensation. ABC Inc. also contributed 15% to every other eligible employee.

The $4,500 SEP contribution is excluded from David's income for federal income tax and social security tax purposes. David will be able to claim a tax deduction for his $3,000 contribution to a traditional IRA, since his MAGI is less than the threshold level of $40,000.

Situation #2. Ann, age 55, works for ABC, Inc. Her filing status is single. Her compensation is $70,000. Her modified adjusted gross income is $75,000. Ann made a contribution of $3,500 to her traditional IRA on September 15, 2003, for 2003. On January 26, 2004, ABC, Inc. contributed $10,500 to Ann's SEP IRA for tax year 2003. This was 15% of her income. ABC Inc. also contributed 15% to every other eligible employee.

The $10,500 SEP contribution is excluded from Ann's income for federal Income tax and social security tax purposes. Ann will NOT be able to claim a tax deduction for her $3,500 contribution to a traditional IRA, since her MAGI of $75,000 is greater than the threshold level of $70,000.

Situation #3. Mark, age 44, works for ABC, Inc. His filing status is single. His compensation is $40,000. His modified adjusted gross income is $44,000. David made a contribution of $3,000 to his traditional IRA on November15, 2003, for 2003. On January 31, 2004, ABC, Inc. contributed $6,000 to Mark's SEP IRA for tax year 2003. This was 15% of his compensation. ABC Inc. also contributed 15% to every other eligible employee.

The $6,000 SEP contribution is excluded from Mark's income for federal income tax and social security tax purposes. Mark will be able to claim a tax deduction for his IRA contribution only to the extent of $1,800 ($3,000 x 60%). Therefore, Mark will need to decide if he wishes to leave the other $1,200 in the traditional IRA as a nondeductible contribution, recharacterize it (along with the related earnings) to be a Roth IRA contribution or to withdraw it (and the related income) under the current-year/excess contribution rules.

Situation #4. Michelle, age 38, is self employed. Her filing status is also single. Michelle has a small business with two other employees. Her compensation (net business earnings) is $140,000. Her MAGI is $145,000. Michelle made a contribution of $3,000 to her traditional IRA in July of 2003, for 2003. For 2003 tax purposes, she wishes to make a SEP contribution for herself equal to 25% of her compensation. She had also made a SEP contribution on 3/10/03 for 2002 tax purposes.

Her SEP contribution for 2003 is $26,546. She is an active participant for IRA purposes for 2003. Her IRA contribution will be nondeductible. It either will need to be withdrawn along with the related income, or it will need to be recharacterized.

Situation #5. Ken, age 46 is self employed. His filing status is also single. Ken does not have any employees. His compensation (net business earnings) is $86,000. His MAGI is $94,000. Ken made a contribution of $3,000 to his traditional IRA in September of 2003, for 2003. For 2003 tax purposes, he wishes to make a SEP contribution for himself equal to 25% of his compensation. This will be his first SEP contribution, as he is establishing his SEP in 2004, for tax year 2003. The contribution will be made on April 13, 2004.

His SEP contribution is $15,986. In addition, it appears his traditional IRA contribution for 2003 will be deductible, since a SEP contribution had NOT been made on his behalf during the period of January 2, 2003, to December 31, 2003. IRS Notice 87-16 sets forth the following special rule. An individual is considered an active participant only if employer contributions, employee contributions or forfeitures are allocated to his or her account with respect to a plan year ending with or within his or her taxable year. Since there was no SEP contribution during 2003, he is not an active participant for 2003. He will be an active participant for 2004 purposes.

Summary. The purpose of this article has been to discuss the various tax rules which apply to making SEP contributions and traditional IRA contributions. Of course, the IRA custodian is not to be a tax advisor. However, if you wish to receive SEP and IRA deposits, the likelihood of receiving such deposits increases the more you understand the applicable tax rules.

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SEP & IRA Contributions in the Same Year, Continued from page 4

Worksheet 1–2. **Figuring Your Reduced IRA Deduction for 2003**

(Use only if you or your spouse is covered by an employer plan and your modified AGI falls between the two amounts shown below for your coverage situation and filing status.)

Note. *If you were married and both you and your spouse contributed to IRAs, figure your deduction and your spouse's deduction separately.*

IF you ...	AND your filing status is ...	AND your modified AGI is over ...	THEN enter on line 1 below ...
are **covered** by an employer plan	single or head of household	$40,000	$50,000
	married filing jointly or qualifying widow(er)	$60,000	$70,000
	married filing separately	$0	$10,000
are **not covered** by an employer plan, but your spouse is **covered**	married filing jointly	$150,000	$160,000
	married filing separately	$0	$10,000

1. Enter applicable amount from table above . . . . 1. ________

2. Enter your ***modified AGI*** (that of both spouses, if married filing jointly) . . . . 2. ________

   Note. If line 2 is equal to or more than the amount on line 1, **stop here.** Your IRA contributions are not deductible. See *Nondeductible Contributions.*

3. Subtract line 2 from line 1. **If line 3 is $10,000 or more, stop here.** You can take a full IRA deduction for contributions of up to $3,000 ($3,500 if 50 or older) or 100% of your (and if married filing jointly, your spouse's) compensation, whichever is less . . . 3. ________

4. Multiply line 3 by 30% (.30) (by 35% (.35) if age 50 or older). If the result is not a multiple of $10, round it to the next highest multiple of $10. (For example, $611.40 is rounded to $620.) However, if the result is less than $200, enter $200 . . . . 4. ________

5. Enter your compensation minus any deductions on Form 1040, line 28 (one-half of self-employment tax) and line 30 (self-employed SEP, SIMPLE, and qualified plans). If you are filing a joint return and your compensation is less than your spouse's, include your spouse's compensation reduced by his or her traditional IRA and Roth IRA contributions for this year. If you file Form 1040, do not reduce your compensation by any losses from self-employment . . . . 5. ________

6. Enter contributions made, or to be made, to your IRA for 2003 but **do not** enter more than $3,000 ($3,500 if 50 or older). If contributions are more than $3,000 ($3,500 if 50 or older), see *Excess Contributions,* later. . . . . 6. ________

7. **IRA deduction.** Compare lines 4, 5, and 6. Enter the smallest amount (or a smaller amount if you choose) here and on the Form 1040 or 1040A line for your IRA, whichever applies. If line 6 is more than line 7 and you want to make a nondeductible contribution, go to line 8 . . . . 7. ________

8. **Nondeductible contribution.** Subtract line 7 from line 5 or 6, whichever is smaller. Enter the result here and on line 1 of your Form 8606 . . . . 8. ________

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Form 5500-EZ Filing Requirements

It's not too early to start thinking about filing Form 5500-EZ (Annual Return of One-Participant Retirement Plan) for the 2003 plan year. If you have customers that sponsor a qualified retirement plan that covers a sole owner, a sole owner and spouse, or only partners in a partnership, then Form 5500-EZ may need to be filed. A qualified retirement plan, as used here, includes profit-sharing plans, money purchase plans, 401(k) plans, HR-10 and Keogh plans. For plans covering more participants than those referenced above, Form 5500 must be filed.

Who must file Form 5500-EZ?

1. An employer who has a one-participant plan that held more than $100,000 at the end of any plan year beginning on or after January 1, 1994. Even if total plan assets are subsequently reduced to $100,000 or less, Form 5500-EZ must be filed every year thereafter.

Example: Plan assets in a plan that otherwise satisfies the requirements for filing Form 5500-EZ totaled $105,000 at the end of the 2002 plan year, and a distribution occurred in 2003 so that total plan assets were $95,000 at the end of the 2003 plan year. A Form 5500-EZ must be filed for the 2003 plan year and for all following years because plan assets in the prior year exceeded $100,000.

2. If an employer has two or more one-participant plans, and the combined assets exceed $100,000. As noted above, Form 5500-EZ must be filed even if the combined assets subsequently fall below the $100,000 threshold.

3. A terminated one-participant plan must file a Form 5500-EZ for their final year even if the total plan assets have always been less than $100,000. The final plan year is the year in which distribution of all plan assets is completed.

Required Attachments

Schedule P (Annual Return of Fiduciary of Employee Benefit Trust) must be attached to Form 5500-EZ. Filing Schedule P starts the statute of limitations.

When to File—

All required forms and schedules must be filed by the last day of the 7th calendar month after the end of the plan year. For calendar year plans, the 2003 return must be postmarked no later than August 2, 2004, since July 31 falls on a Saturday.

An employer may get an extension of up to 2 1/2 months by filing Form 5558 (Application for Extension). If an employer meets certain requirements, an extension of time to file is automatically granted.

Penalties

The Internal Revenue Code imposes a penalty of $25 a day (up to $15,000) for not filing returns in connection with pension or profit sharing plans by the required due date.

Conclusion

Since the financial markets performed well in 2003, some of your customers may now meet the filing requirements. While CWF realizes the employer's accountant may prepare Form 5500-EZ, this is also a service CWF provides for a $60.00 fee. Please contact us if you wish to learn more about this service.

Illustration of Separate Beneficiary Accounting Rules

Laura Boyer, age 77, died on 11-4-03. She had been paid her RMD for 2003 prior to her death. She had designated her four children as her IRA beneficiaries—Anna (12-9-46); Maria (10-9-51); David (12-29-54) and Miguel (10-4-60). Each received a 25% share. The IRA had a FMV balance of $32,400 as of 12-31-03. Separate inherited IRA accounts were set up for the four beneficiaries on March 16, 2004.

What required minimum distributions must be made for 2004, 2005, 2006, etc.?

Laura died after her required beginning date. There will need to be four (4) required distributions made to the four beneficiaries in 2004, and subsequent years, until the share of each has been completely distributed.

The standard RMD formula is: 12-31-xx FMV balance as divided by a distribution period.

When there are multiple beneficiaries, the general rule is that the oldest beneficiary is used to determine the distribution period. The Single Life Table is used to calculate the distribution period for all inherited IRA situations.

Anna, Maria, David and Miguel will each need to be paid their share of the 2004 required distribution. Anna is the oldest beneficiary. Her age is 58 in 2004. The Single Life Table shows that the distribution period for a person age 58 is 27 years. Each has an RMD amount of $300 calculated as follows: $32,400 ÷ 27.0 ÷ 4 = $300.

Why isn't there a separate calculation made for each beneficiary for 2004?

The reason is: separate accounts are recognized for purposes of calculating the RMDs only after the later of: (1) the year the separate accounts are established; or (2) the year of the accountholder's death. Since Laura died in 2003, the

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Separate Beneficiary Accounting Rules, Continued from page 6

calculations will be permissible for 2005, and subsequent years, but not for 2004 purposes.

The distribution periods for 2005 and subsequent years will be determined as follows:

Beneficiary	Anna	Maria	David	Miguel
Age in 2004	58	53	50	44
Initial Distr. Period for Calculation Purposes	27.0	31.4	34.2	39.8
Distr. Period 2004	27.0	27.0	27.0	27.0
Distr. Period 2005	26.0	30.4	33.2	38.8
Distr. Period 2006	25.0	29.4	32.2	37.8
Distr. Period 2007	24.0	28.4	31.2	36.8
Distr. Period 2008	23.0	27.4	30.2	35.8

Annual Rules

There is a second special separate accounting rule to remember. The second special rule is that the separate accounts must be established by December 31 of the year after the year the accountholder died. This requirement has been met, since the separate inherited accounts were established on March 16, 2004. If the separate accounts had not been established until March 16, 2005, then Maria, David and Miguel would not qualify to use the longer distribution periods based on their respective ages. For simplicity purposes, let's assume the FMV of Miguel's inherited IRA on 12-31-04 will be $8,300. His RMD for 2005 will be $214. If he is allowed to use the distribution period of 26.0, his RMD would be $319.

Obviously, applying the separate account rules will be more important for large "trust" IRAs.

Many times one or more of the inheriting beneficiaries will want to take out more than the RMD amount. Can this excess be used to reduce a subsequent year's RMD amount? It cannot be. If Anna would take a complete distribution of her $8,100 share, can her siblings not take their RMD amount of $300? No—each beneficiary must withdraw their RMD amount of $300 regardless if another beneficiary withdraws much more than their RMD.

In summary, the IRS did authorize the use of separate RMD calculations for individual beneficiaries when an accountholder dies leaving multiple beneficiaries. The first requirement is that there must be separate accounts established, or a separate accounting performed, for each inheriting beneficiary. Such separate accounts must be established no later than December 31 of the year after the accountholder died. For purposes of determining the distribution period for a beneficiary, the separate accounts are recognized only after the later of: (1) the year the separate accounts are established, or (2) the year of the accountholder's death. If the separate accounts (inherited IRAs) are established in the same year that the accountholder died, then the separate accounting will apply for the following year. If the separate accounts are established during the first calendar year following the accountholder's death, then the separate accounting periods for each beneficiary will not apply until the second year after the accountholder's death. If the separate accounts are established during the second or later calendar year following the accountholder's death, then the distribution period must still be based on the age of the oldest beneficiary.

An Introduction to ADP Testing

One of the trademarks of a qualified 401(k) plan is that it may not discriminate in favor of highly compensated employees (HCEs) as to benefits or contributions. Consequently, each year a qualified 401(k) plan must satisfy a series of tests. One such test is the Actual Deferral Percentage (ADP) test, which compares the rate at which HCEs and non-highly compensated employees (NHCEs) make elective deferrals to the plan. In establishing the test, Congress acknowledged that HCEs are more likely to utilize elective deferrals, and as a result, the average level of elective deferrals among HCEs will usually be greater than the average level of elective deferrals amongst NHCEs. However, the increased utilization must be within specified limits.

Five Steps to Completing an ADP Test

Step 1: Identification of Eligible Employees

An eligible employee is an employee who has satisfied the plan's age and service requirements as outlined in the plan's adoption agreement. Once an employee is eligible, the employee remains eligible for the entire plan year and, absent plan amendment, subsequent plan years. An eligible employee is included in the test even if he or she chooses not to make elective deferrals. Also, an eligible employee is included in the test even though he or she may be temporarily precluded from making deferrals because they have received a plan loan or hardship distribution.

Step 2: Breakdown between Highly Compensated and Non-Highly Compensated Groups

An employee is considered highly compensated if he or she:

A. Was a more than 5% owner at any time during the current plan year or the preceding plan year, or

B. Earned compensation from the employer in excess of an inflation-adjusted $80,000 during the preceding year, and if the employer so elects, was in the top-paid group of the employer for the preceding year. For 2003, the adjusted limit is $90,000.

Keep in mind that the 5% owner rule also requires careful analysis of the ownership attribution rules for families and trusts. Under these rules, a spouse is deemed to own the interest held by the other spouse, and an employee is deemed to own the interest held by his or her parents, children, and grandchildren. An adopted child is also taken into consideration. Not included are siblings, grandparents and in-laws.

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An Introduction to ADP Testing,
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Step 3: Calculating Individual Actual Deferral Ratios

The Actual Deferral Ratio (ADR) is determined by dividing the employee's elective deferrals for the plan year into the employee's annual compensation. This computation is required to be performed for each eligible participant.

Step 4: Calculating Each Group's ADP

This step is performed by adding together the actual deferral ratios of each employee in the group then dividing that number by the total number of employees in the group. As indicated earlier, an eligible employee who makes no elective deferrals is counted with an ADR of zero. For purposes of calculating an individual's ADR and the group's ADP, the percentage is rounded to the nearest 1/100th of a percentage.

Step 5: Application of the ADP Test

This step compares the HCEs' ADP to the NHCEs' ADP calculated in step 4. The HCEs' ADP may only exceed the NHCEs' ADP by specific limits.

ADP Test Limits

NHCEs' ADP	Maximum HCEs' ADP Limit
0% - 2%	2 times the NHCE ADP
2% - 8%	NHCE ADP + 2%
Greater than 8%	1.25 times the NHCE ADP

Example: Let's assume John Smith and Richard Anderson each own 50% of the outstanding stock of ABC Manufacturing. The company has five additional employees eligible to participate in the company's 401(k) plan, including Jane Smith, spouse of John Smith.

Since John and Richard each have more than 5% ownership, they will be considered HCEs. Remember, Jane Smith is deemed to be a 5% owner because of the family attribution rules.

Employee	Compensation	Elective Deferral	ADR
Richard Anderson	$70,000	$7,000	10.00%
John Smith	$70,000	$3,500	5.00%
Jane Smith	$25,000	$625	2.50%
Total			17.50%
HCEs' ADP (17.50% divided by 3)			5.83%

Employee	Compensation	Elective Deferral	ADR
Andy Carlson	$60,000	$4,350	7.25%
Ruth Garnett	$50,000	$4,500	9.00%
Steve Michaels	$35,000	$0	0.00%
Ann Washington	$20,000	$600	3.00%
Total			19.25%
NHCEs' ADP (19.25% divided by 4)			4.81%

As noted, the NHCEs' ADP is 4.81%, limiting the HCEs' ADP to 4.81% plus 2% for a maximum of 6.81%. ABC Manufacturing's 401(k) Plan passes the ADP test, since the HCEs' ADP was only 5.83%.

Definition of Compensation

When performing an ADP test, one must pay particularly close attention to the definition of compensation, as this impacts the calculation of the ADRs. Some plans define compensation as that amount paid during the plan year with respect to which the ADR is being calculated. Still, many plans provide that only compensation paid during the portion of a plan year that an employee is eligible to participate will be taken into account. The plan's adoption agreement or basic plan document should indicate which definition of compensation should be applied for the ADP test.

Timing of Test

The ADP test should be completed within 2 1/2 months after the end of the plan year. This will allow the employer to make any refunds required to pass the test and avoid a 10% excise tax penalty.

In a future newsletter, we will look at a plan that fails the ADP test, and explore an employer's options for correcting the test.

Do Disability Payments Qualify As Compensation for IRA Contribution Purposes?

We think they do if such disability payments are reported on the Form W-2. Set forth below is Rev. Proc. 91-18. We believe the IRS still follows the Revenue Procedure. It should be noted, however, the IRS does not list disability payments as qualifying as compensation in Publication 590.

Sec. 1 Purpose. The purpose of this revenue procedure is to provide guidance regarding the definition of “compensation” which is used to determine if an individual qualifies to make contributions to an Individual Retirement Account (IRA).

Sec. 2 Background. Section 219(f) of the Internal Revenue Code, and section 1.219-1 of the Income Tax Regulations define compensation for purposes of contributing to an IRA. In general, contributions to an IRA are based on “compensation” that is includible in gross income for services actually rendered, and that is not deferred compensation.

The service has been asked to clarify whether certain types of income can be used as compensation for IRA purposes. These include (1) disability pay, (2) unemployment compensation, (3) accrued annual leave, (4) sick leave (5) an incentive award, and (6) termination pay.

Sec. 3 Scope of Application. As a matter of administrative convenience, the Service will treat as a “safe harbor” the amount properly shown in box 10 (Wages, tips, other compensation), less any amount properly shown in box 14 (nonqualified plans), on Form W-2, Wage and Tax Statement for 1990 (box 16 for 1991) (or similar designation in future years). Accordingly, this amount can be used in calculating an individual’s compensation for purposes of determining his or her deductible and nondeductible, as is appropriate, contribution to an IRA.