

The Swerdlin Quarterly

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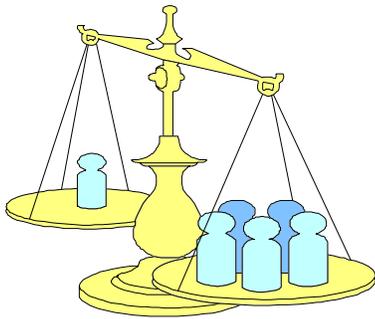
Actuaries ❖ Employee Benefit Consultants

First Quarter 1997

The 401(k) Top-Heavy Trap

The Internal Revenue Code (IRC) defines “key employees” as those who meet any of the following criteria:

- * 5% or greater owner of the company;
- * An officer whose compensation exceeds \$60,000 (as indexed);
- * One of the 10 employees owning the largest interest in the company with compensation over \$30,000; or
- * Lineal ascendants and descendants of any of the above.



If, on the last day of the preceding plan year, the account balances of all the key employees in a plan exceed 60% of the total for all participants, the plan is top-heavy. The IRC stipulates certain minimum requirements for all plans that become top-heavy.

(Continued on page two)

**IN
THIS
ISSUE**

- 1 The 401(k) Top-Heavy Trap
- 3 Your Workers: Employees or Independent Contractors?
- 4 Can Employees Contribute Unused Vacation Days to Your Plan?
- 5 Make-up Contributions
- 5 Investing Ex-Employee's Accounts
- 6 Where in the World

Dorn's Corner

As we begin a new year, I begin the second half of my life. I just celebrated my 50th birthday and I realize that my first 50 years were only in preparation for what I will do the next “x” years. It is now time for me to become an adult. When I was 21, I did not have much information about what it means to be an adult. Now that I do, this is what it looks like to me to be an adult:

- I am calm and centered, regardless of circumstances;
- I take action (even when I do not feel like it);
- I speak from my heart; I have my attention on others rather than myself;
- I appreciate others (their faults as well as their gifts);
- I speak up when I disagree;
- I consider what is best for the whole;
- I consider how my thoughts, my words, and my actions affect others;
- I accept my own “darkside” as part of me, without judgment;
- I understand that listening is not passive, and the listening can significantly affect a conversation; and
- I allow for the appropriate expression of my childlike playfulness.

IT'S GOOD TO BE A GROWNUP!

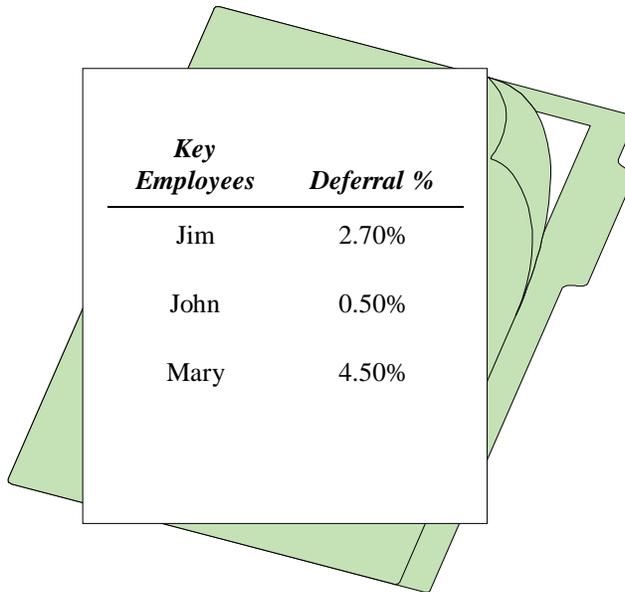
The 401(k) Top-Heavy Trap

(Continued from page one)

First, an accelerated vesting schedule may be required. Second is the requirement that takes many employers by surprise. An employer contribution, in addition to any employer matching contribution, of at least 3% of compensation must be made for all plan participants *even if they are not deferring!* There is one exception to this mandatory contribution. If no key employees defer over 3% of their compensation into the plan, then the top-heavy minimum contribution rate is the highest deferral rate of all the key employees.

“employers need to watch the status of their plans from year to year”

For example, Hypothetical Company, Inc. has three key employees whose total account



<i>Key Employees</i>	<i>Deferral %</i>
Jim	2.70%
John	0.50%
Mary	4.50%

balances at the end of the last plan year equal \$80,000. The account balances for all participants equal \$120,000. The key employees' accounts make up 66.67% of the total; therefore, this plan is top-heavy for the current plan year. To determine the top-heavy minimum contribution, the deferral percentages for each of the key employees must be examined.

Because Mary's deferral percentage exceeded 3%, the top-heavy minimum contribution for the plan year is 3%. If Mary's

deferral had been 2% rather than 4.50%, the required top-heavy contribution would drop to 2.70% which is the highest key employee deferral rate.

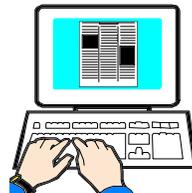
In order to avoid the surprise of having to make an additional contribution to the plan, employers

need to watch the status of their plans from year to year. Should a plan become top-heavy, the employer can avoid making the top-heavy minimum contribution if none of the key employees make deferrals into the plan for the year in question.

If you are concerned about your plan becoming top-heavy, please call us. We will be glad to discuss this with you. ■

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Your Workers: Employees or Independent Contractors?

The answer to this question is not as easy as it may appear.

Classifying workers has nothing to do with titles, but instead relies on working arrangements. A recent court case involving software giant, Microsoft has proven that no one is immune to this confusing issue.

Misclassifying workers can be an expensive mistake. It affects eligibility for benefit plans, and the testing of these plans for discrimination and minimum participation. A worker's

classification also affects your deduction limits and income tax withholding requirements.

The IRS just released a training manual for its agents, to help them distinguish between an independent contractor or an employee. This manual attempts to define the current common law standard for identifying employees and it provides employers guidance on this sticky issue.

According to the IRS manual, a worker is an employee of the employer, if the employer has the right to control and direct

the worker. If the worker is subject to the will of the employer about what work will be done and how it will be done, an employer-employee relationship exists. This is true even if the employer does not actually direct or control the worker, but merely has the right to do so.



The IRS identified three main areas of control: Behavioral Control, Financial Control and Relationship of the parties.

Behavioral Control:

Behavioral control is determined by the level of instruction and training provided to a worker. If a worker is given detailed instructions on how, where and when to complete a project, he or she is most likely considered an employee. On the other hand, if instructions are limited to a product or service, the worker is more likely to be a contractor.

Financial Control:

Financial control of a worker is based on the following:

1. Has the worker made a significant investment?
2. Does the worker have any expenses that are not reimbursed?
3. Are the worker's services available to the market?
4. How is the worker paid (hourly or by the job)?
5. Can the worker have a profit or loss?

A private contractor should have some level of financial risk. The more dependent the worker is on the employer, the likely the worker is considered an employee.

Relationship of the Parties:

Relevant facts about a work relationship include the intent of the parties, treatment of employee benefits, ability to terminate the relationship, as well as whether the work performed is part of the regular business activity of the employer. Additional factors to consider include part-time or full-time work, location and hours. ■

Can Employees Contribute Unused Vacation Days to Your Plan?

A recent article in The Wall Street Journal announced the IRS will now allow employees contribute unused vacation pay into their 401(k) plans. It even hinted that they could do so beyond the \$9,500 employee deferral limit. This article has received a lot of attention, it does not tell the whole story.

It is based on the following facts. An employer asked for the IRS for a Private Letter Ruling, to clarify some rules. The employer has a “use-it-or-lose-it” vacation policy. Employees earn paid vacation time on a calendar year basis and must use that time during the same calendar year or it is forfeited. (Note: employees are allowed to accrue up to two weeks of vacation.) The employer asked the IRS if they contribute the value of the unused vacation time to their 401(k) Plan, would it be included in the employees’ gross wages for FICA tax purposes.

The IRS concluded if they employer contributes the vacation pay to the plan, it will be excluded from FICA tax wages. They reason that the employee did not have the option to receive the vacation time in cash. Therefore, it is not part of a cash or deferred arrangement, and is

not subject to the \$9,500 deferral limit. However, it would still be considered an employer contribution to the plan.

“a contribution based on unused vacation pay could fail testing”

In a Private Letter Ruling, the IRS answers only those questions actually asked. In this ruling, the IRS did not create any new rules. They clarified existing rules. The IRS never addressed the issue of how the “vacation pay” employer contribution would affect the plan.

Contributions to a plan are subject to non-discrimination tests. If highly paid employees have more unused vacation than lower paid employees, then a contribution based on unused vacation pay could fail testing.

It is important to understand that a Private Letter Ruling cannot be relied on by anyone other than the individual requesting it. Even if you think you are in a similar situation, the IRS could interpret your circumstances differently. If you are considering putting unused vacation pay in your plan, the only way to ensure IRS approval is to request and obtain a Private Letter Ruling. ■



Make-Up Contributions

Can a 401(k) plan participant who misses the \$9,500 deferral limit make up these “missed contributions” later by writing a check to the plan? Unfortunately, the answer is “No.”

A 401(k) plan is a salary deferral plan. This means employees can choose to defer (put off receiving) some of their pay and save it in the plan. Once they receive their pay it's too late. You can't defer something you've already received.

Don't be tempted to make an exception. Allowing an employee to contribute compensation already received to the plan would jeopardize the tax-status of your plan. If the IRS discovers this violation, it could cost you thousands of dollars to correct.

In order to avoid this problem in the future, have an employee contribute a slightly higher percentage of pay to the plan. As the end of the year approaches, you can then cut the employee off at the maximum benefit level. ■



Investing Ex-employees' Accounts

Do you limit the investment options for ex-employees? If so, you may need to change this procedure.

If your retirement plan allows active employees to choose among a broad range of investments, you cannot limit terminated employees to a single investment (such as the money market fund). Some employers have limited the investment options of ex-employees to encourage them to withdraw their money out of the plan, reduce the participant's investment risk and cut administrative expenses.

According to a recent IRS ruling,

this practice imposes a “significant detriment” on the ex-employee. As such, it would be considered an immediate distribution of the employee's benefit, without valid consent. The IRS could take away the favorable tax-status of your plan if you continue this practice. Unofficially, an IRS spokesman stated that limiting loans or hardship withdrawals not considered a significant detriment to ex-employees. Therefore, you don't need to offer these options to terminated participants, but you must continue to offer the plan's full range of investments. ■

Swerdlin & Company

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- Regulatory Compliance
- Educational Presentations
- Special Studies

We are dedicated to making your employee benefit program a tool for reaching your organizational goals.

We provide services for:

- Profit Sharing Plans
- 401(k) Plans
- Money Purchase Plans
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- Defined Benefit Plans
- ESOPs

- Age-Weighted Plans
- New Comparability (Cross-Tested Plans)
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Give us a call to discuss how we can help you make the most of your employee benefit program.

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Where in the World (Wide Web)

The Internet is a vast resource for just about any kind of information anyone could ever want, and quite a bit you would never want. Without a starting point, the Net can be very intimidating. This is the first of what will be a regular feature in *The Swerdlin Quarterly*. Each quarter, we will highlight several of the thousands of web pages dealing with retirement, investments and employee benefits. Happy Surfing!

www.benefitslink.com

Benefits Link is on of the most thorough sites we have found. In fact, we often use it for our research. It includes the text of the Internal Revenue Code and ERISA, as well as several forums for asking questions of various benefits professionals. Also included are postings for benefits-related job openings and job candidates.

www.irs.ustreas.gov

The Internal Revenue Service home page allows you to go right to the source with your tax-related questions. You can download many IRS forms and publications and search the site by topic. This page provides a link for you to send questions to the IRS via electronic mail. The site is somewhat slow due to the lack of computer power on the IRS side. To speed things up, you can select the "text only" version once you arrive at the page.

www.ssa.gov

The Social Security Administration home page helps you gain an understanding of the program that makes up a large portion of many retirees' incomes. This site explains many of the benefits and programs offered by Social Security. It even allows you to electronically submit a request for a personal

estimate of future benefits.

www.qnf.com

The Quicken Financial Network is another site that is very thorough. It allows you to get stock and mutual fund quotes, current financial news, life insurance information, and tax information including deadlines. This page also includes a library for research. One of the most unique features is a retirement planner that allows you to input current assumptions on such items as salary, savings, inflation, etc. It takes these assumptions, calculates your estimated retirement income and if necessary, make suggestions on how to meet your financial goals.

While we have researched each of these web pages, we neither endorse any products or services offered, nor do we make any claims as to their validity, accuracy or appropriateness.

