NRP
NATIONAL RETIREMENT PARTNERS

# The Advisor

401(k) Inside and Out

*401k Advisors USA*

THE ADVISOR
JANUARY 2007
VOL. 3, NO. 1

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## LEGISLATIVE CHANGES AND THE IMPACTS ON NON-QUALIFIED PLANS

**LEGISLATIVE CHANGES AND THE IMPACTS ON NON-QUALIFIED PLANS AND THE USE OF COLI AS A FUNDING VEHICLE**

THE PENSION PROTECTION ACT 2006 & AMERICAN JOBS CREATION ACT 2004

**BACKGROUND**

For the past several years companies have dealt with uncertainty regarding the potential impacts of new legislation that would affect how non-qualified benefit plans are administered. Additional changes to how companies can use corporate owned life insurance (COLI), which is often used to fund certain corporate liabilities, have added to the confusion. As a result many companies have decided to do nothing. They have chosen not to implement new plans, modify existing plans or examine their funding until there was clarification. Fortunately, the confusion surrounding these issues has been clarified and companies can examine their plans with the full knowledge and understanding of what will be required.

The two new regulations are the American Jobs Creation Act of 2004 (AJCA) and the Pension Protection Act of 2006 (PPA). The AJCA created a new section of Tax code 409A that limits specific provisions in non-qualified retirement plans. The PPA impacts how companies can utilize life insurance in the funding of their benefit plans. The specifics of these two laws may be found in the Appendix to this article. What is more significant than the specific do's and don'ts is the fact that companies now have specific codified regulations regarding the administration and funding of their non-qualified benefit plans. The new regulations allow companies to proceed with implementing or modifying their plans with the knowledge and guidance of the government defined provisions. The regulations provide companies with an opportunity to re-examine their plans and funding and take steps to ensure that they are in full compliance of these rules.

**CONCLUSION**

As a result of these legislative changes, companies now have specific direction under the law to administer their non-qualified plans as well as to use life insurance as a funding mechanism. Questions existed prior to this regarding what features and benefits were acceptable and allowable, how much insurance could companies use and how the plans should be structured. The lifting of this veil of uncertainty provides a tremendous opportunity for companies to establish or modify their plans according to the law. Just as the pension legislation of the 1980's and 1990's provided greater specificity for the management of companies' 401(k) plans, the new rules and regulations give companies a set list of rules to follow for their non-qualified plans and the funding of those plans. This could not be better news for companies as much of the gray areas of administration and funding have been eliminated. Furthermore, the guidance provided by these laws can be easily implemented and followed.

For tax paying companies, the benefit of using life insurance is substantial; as a result they should review their existing funding to ensure compliance with the new regulations, as well as making sure the products are the most efficient available today. Doing so will result in retirement plans which provide excellent benefits for participants, substantial cost savings for the company and protection under the law.

**APPENDIX**

**American Jobs Creation Act of 2004**

The AJCA legislation impacts non-qualified plans. The law was signed on October 22, 2004 and puts a new section of the tax code, 409A, in place. 409A impacts all deferred compensation plans and deferrals made in 2005 or later. The key provisions of Section 409A:

- The "Haircut" provision, which allows participants to take their money out early with a deduction of some type (often 10%), is no longer permitted.
- The acceleration of retirement distribution elections will no longer be permitted.
- Distributions to "key employees" must be made six months from the date of termination or retirement.
- The re-deferral of In-Service Distribution elections are permitted but must be received at a minimum of five years

## LEGISLATIVE CHANGES AND THE IMPACTS ON NON-QUALIFIED PLANS (CONT.)

from the date of the original distribution election.

- Disabled Participants can elect to begin receiving retirement payments or continue to defer.
- The legislation allows companies to "grandfather" their existing deferred compensation plan (deferrals through 2004). All deferrals made after December 31, 2004, would not be eligible to become "grandfathered" and would therefore be subject to 409A legislation.
- Any change to an existing plan that is deemed a material modification will subject all deferrals (both pre- and post-2005 deferrals) to the new regulations.

Failure to comply with these regulations will mean the immediate taxation of all balances to the participants of the plans.

**Pension Protection Act of 2006**

The Pension Protection Act of 2006 was enacted on August 17, 2006. While most of the press has focused on the impacts to qualified plans, especially defined benefit plans, significant changes were made to how companies may utilize life insurance in the funding of their liabilities. Within this law is a section that has been referred to as "COLI Best Practices". This new legislation codifies some specific requirements for companies that utilize COLI. Specifically:

- Only the top 35% of employees by compensation may be insured.
- Employees must be informed that the company intends to insure their lives and the amount of insurance that will be in place at the time the policy is issued. Employees must sign a consent allowing the employer to purchase the insurance on their life.
- The company must report to the IRS the following items:
  - The number of employees at year end, and
  - The number of employees insured under the COLI policies, and
  - The total amount of COLI in force, and
  - The employer's name, address and type of business, and
  - Confirmation that the employer has a valid consent from each insured employee (or the number of insured employees for whom insurance was not obtained).

Failure to comply with these regulations will result in the taxability of any death benefits received by the company.

***This piece is intended to provide authoritative information on the subject covered and is not a solicitation. It is not intended to provide specific legal or tax advice.***

***Securities offered through Oberlin Financial Corp.***

# RISING INTEREST RATES – CAVEAT EMPTOR

**Rising Rates – Stable Value General Accounts – Caveat Emptor!**

The Fed raised rates another quarter point on June 29 to mark its 17th straight rate increase. This process has increased the short-term interest rate target from 1% to 5.25% over a 23 month period. For consumers, the fed funds rate affects rates on a variety of loans, including credit cards and corporate loans. For fixed income investors, short to intermediate term holdings may lose market value. For defined contribution plan sponsors, a much less understood consequence of rising rates can have significant implications to one of the most popular investment options…The Stable Value Option (SVO).

As defined contribution participants experienced the risk inherent in equities post 9/11, significant asset flows shifted to more conservative investment options including money market, bond and stable value options.

During this time period, Stable Value products generally provided much higher returns than money market accounts and less volatility than bond funds. By definition, contributions made to SVO products are credited with a stated interest rate that is announced periodically and may vary from period to period.

Sounds pretty safe....but

**What are the risks in a rising interest rate environment?**

First, the stable value declared rate will over time lag spot rates as all existing assets were invested in a lower yield environment.

While new money will be invested in the higher interest environment, the participant may be disappointed to see a blended rate which lags what they see available in the way of short term CD's, money market accounts or even Treasury Bills.

Second, and of great concern from a fiduciary standpoint, is the risk of experiencing a significant market value adjustment if the plan decides to remove this investment option or change service providers.

Market value adjustments are generally not applicable to participant directed distributions, but some stable value options will impose a limit on the amount of plan assets that participants can reallocate or transfer from the SVO.

For instance, no more than 10% - 50% of the SVO balance can be removed from the account over a 12 month period. We strongly advise you to research your plans to determine whether this provision exists in your clients SVO.

While the concept of market value calculations makes logical sense, all adjustment formulas are not equal. It is easiest to understand the rationale for a market value adjustment if one looks at an insurance company General Account as a hypothetical bond.

If a 5 year corporate bond was bought for

# Rising Interest Rates – Caveat Emptor (cont.)

$1000 last year with a coupon payment of 4% and that bond was to be sold a year later after interest rates had risen to 5%, who would buy a lower yielding bond when new bond issues would pay the investor a higher interest rate?

No rationale investor would do this and there would be no liquidity in the bond market if there were no other alternative. However, the bond market is liquid because the holder of the lower interest rate bond can sell that bond at a discount; instead of selling the bond for $1000, it would be sold at a lesser value which would provide the buyer with an equal yield over the remaining life of the bond. This explains the axiom that bond prices have an inverse relationship to the movement of interest rates.

When a plan sponsor desires to exit an insurance company stable value product, the insurance company must sell the underlying fixed income securities. If this event transpires in a rising interest rate environment, then the market value of the assets will be less than the stated book value.

In most instances, plan sponsors are surprised to hear of this and most consider the market value adjustment a "penalty or deferred sales charge" which they should attempt to negotiate.

While the actual process of marking the assets to market is not subjective, the formula used by each insurance company may vary, and some calculations indeed impose a penalty like feature in the calculation.

Not all SVO products impose a market value adjustment feature. There are many, high quality Stable Value separate accounts, Pooled GIC and Synthetic GIC alternatives which do not impose this feature. Instead, there are provisions within the contract which limits redemptions to contract holders in the event that a stated percentage of the fund is being requested for withdrawals. In most instances, requests for withdrawals will not be denied for a period greater than 12 months.

The message is clear; know what your clients are invested in, know what alternatives may exist within the existing providers' lineup and most importantly make sure your client understands the risk of a rising interest rate on this element of their plan.

# Advisor-Focused Firms Flying High

Friday, December 29, 2006

If it weren't for some of the other stories on this list, 2006 could have been known as the year of the advisor for the 401(k) industry. As multiple DC market segments reach saturation and become zero-sum games, more and more providers find themselves turning to retirement plan intermediaries to gain access to plans. On the other side of the equation, plan sponsors find themselves and their providers under increasing scrutiny from lawmakers and lawyers alike, and so they, too, are turning to advisors, but for guidance and advice. The stage has been set for the spotlight to turn on advisors, and three national firms have burst onto the scene, striving to unite advisors behind their banners: CapTrust Financial Advisors, National Financial Partners, and National Retirement Partners. Each made significant moves this year, and each has its own unique approach to the marketplace, but they're all hungry for the same thing: top-producing DC advisors.

NRP certainly grabs the most attention of the three. The firm, formerly known as 401(k) Advisors USA, got off to a running start this year by hiring COO and ING vet Bob Francis, and then acquiring a number of advisory firms. They also snagged lured several industry heavyweights in as affiliates, including two executives to beef up their nets, alongside existing top advisor-affiliates like Dorann Cafaro and Barbara Delaney. 401kExchange and MFS Retirement veteran Dick Darian and former ExpertPlan president and CEO Tim O'Brien joined NRP this fall as executive vice presidents in charge of acquisitions and recruitment, and ex-Gallagher Retirement Services big wig David Hinderstein jumped over in September to run is own affiliated firm. In addition to hooking more brokers, NRP is also looking to snag a broker-dealer firm, which would allow its members to avoid using outside BDs.

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# Pension Plan Limits For The Tax Years 2001 – 2007

On October 18, 2006, the Internal Revenue Service announced cost of living adjustments applicable to dollar limitations for pension plans and other items for Tax Year 2007.

Section 415 of the Internal Revenue Code provides for dollar limitations on benefits and contributions under qualified retirement plans. It also requires that the Commissioner annually adjust these limits for cost of living increases.

Many of the pension plan limitations will change for 2007. For most of the limitations, the increase in the cost-of-living index met the statutory thresholds that trigger their adjustment. For example, the limitation under Section 402(g)(1) on the exclusion for elective deferrals described in Section 402(g)(3) is increased from $15,000 to $15,500. This limitation affects elective deferrals to Section 401(k) plans and to the Federal Government's Thrift Savings Plan, among other plans.

# Pension Plan Limits For The Tax Years 2001 – 2007 (Cont.)

| **401k Plan Limits for Plan Year** | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|---|---|
| 401k Elective Deferrals | $15,500 | $15,000 | $14,000 | $13,000 | $12,000 | $11,000 | $10,500 |
| Annual Defined Contribution Limit | $45,000 | $44,000 | $42,000 | $41,000 | $40,000 | $40,000 | $35,000 |
| Annual Compensation Limit | $225,000 | $220,000 | $210,000 | $205,000 | $200,000 | $200,000 | $170,000 |
| Catch-Up Contribution Limit | $5,000 | $5,000 | $4,000 | $3,000 | $2,000 | $1,000 | n/a |
| Highly Compensated Employees | $100,000 | $100,000 | $95,000 | $90,000 | $90,000 | $90,000 | $85,000 |
| **NON 401K RELATED LIMITS** | | | | | | | |
| 403(b)/457 Elective Deferrals | $15,500 | $15,000 | $14,000 | $13,000 | $12,000 | $11,000 | $8,500 |
| SIMPLE Employee Deferrals | $10,500 | $10,000 | $10,000 | $9,000 | $8,000 | $7,000 | $6,500 |
| SIMPLE Catch-Up Deferral | $2,500 | $2,500 | $2,000 | $1,500 | $1,000 | $500 | n/a |
| SEP Minimum Compensation | $500 | $450 | $450 | $450 | $450 | $450 | $450 |
| SEP Annual Compensation Limit | $225,000 | $220,000 | $210,000 | $205,000 | $200,000 | $200,000 | $170,000 |
| Social Security Wage Base | $97,500 | $94,200 | $90,000 | $87,900 | $87,000 | $84,900 | $80,400 |

* Limit for Puerto Rico in 2005 and 2006 is 10% of the annual compensation of the employee, up to a maximum of $8,000 annually.

**Details of the 2007 Cost-of-Living Limits**

Effective January 1, 2007, the limitation on the annual benefit under a defined benefit plan under Section 415(b)(1)(A) is increased from $175,000 to $180,000. For participants who separated from service before January 1, 2007, the limitation for defined benefit plans under Section 415(b)(1)(B) is computed by multiplying the participant's compensation limitation, as adjusted through 2006, by 1.0334.

The limitation for defined contribution plans under Section 415(c)(1)(A) is increased from $44,000 to $45,000.

The Code provides that various other dollar amounts are to be adjusted at the same time and in the same manner as the dollar limitation of Section 415(b)(1)(A). These dollar amounts and the adjusted amounts are as follows:

The limitation under Section 402(g)(1) on the exclusion for elective deferrals described in Section 402(g)(3) is increased from $15,000 to $15,500. The annual compensation limit under Sections 401(a)(17), 404(l), 408(k)(3)(C), and 408(k)(6)(D)(ii) is increased from $220,000 to $225,000. The dollar limitation under Section 416(i)(1)(A)(i) concerning the definition of key employee in a top-heavy plan is increased from $140,000 to $145,000.

The dollar amount under Section 409(o)(1)(C)(ii) for determining the maximum account balance in an employee stock ownership plan subject to a 5 year distribution period is increased from $885,000 to $915,000, while the dollar amount used to determine the lengthening of the 5 year distribution period is increased from $175,000 to $180,000.

The limitation used in the definition of highly compensated employee under Section 414(q)(1)(B) remains unchanged at $100,000. The dollar limitation under Section 414(v)(2)(B)(i) for catch-up contributions to an applicable employer plan other than a plan described in Section 401(k)(11) or Section 408(p) for individuals aged 50 or over remains unchanged at $5,000.

The dollar limitation under Section 414(v)(2)(B)(ii) for catch-up contributions to an applicable employer plan described in Section 401(k)(11) or Section 408(p) for individuals aged 50 or over remains unchanged at $2,500.

The annual compensation limitation under Section 401(a)(17) for eligible participants in certain governmental plans that, under the plan as in effect on July 1, 1993, allowed cost of living adjustments to the compensation limitation under the plan under Section 401(a)(17) to be taken into account, is increased from $325,000 to $335,000. The compensation amount under Section 408(k)(2)(C) regarding simplified employee pensions (SEPs) is increased from $450 to $500.

The limitation on deferrals under Section 457(e)(15) concerning deferred compensation plans of state and local governments and tax-exempt organizations is increased from $15,000 to $15,500.

The compensation amounts under Section 1.61 21(f)(5)(i) of the Income Tax Regulations concerning the definition of "control employee" for fringe benefit valuation purposes is increased from $85,000 to $90,000. The compensation amount under Section 1.61 21(f)(5)(iii) is increased from $175,000 to $180,000.

The limitation under Section 408(p)(2)(E) regarding SIMPLE retirement accounts is increased from $10,000 to $10,500.