

2010 TAX-FILING DEADLINE EXTENDED TO APRIL 18, 2011

On November 4, the IRS issued Notice IR-2011-1 which includes an extension to the filing deadline for the 2010 tax year. Taxpayers will have until Monday, April 18 to file their 2010 tax returns and pay any tax due because Emancipation Day, a holiday observed in the District of Columbia on April 16, will be celebrated on Friday, April 15. By law, District of Columbia holidays impact tax deadlines in the same way that federal holidays do; therefore, all taxpayers will have three extra days to file this year. Taxpayers requesting an extension will have until October 17, 2011 to file their 2010 tax returns.

Note: Contributions to IRAs can be made at any time during the year but no later than the tax filing deadline (April 18, 2011 for 2010), not including extensions.

IRA DISTRIBUTIONS FOR QUALIFIED CHARITABLE DONATIONS EXTENDED

The Pension Protection Act of 2006 allowed certain IRA holders the opportunity to donate assets in their IRA to qualified charitable organizations. If it's done correctly, the distributions are tax-free and not included as ordinary income. The provision applies for Traditional and Roth IRAs and does not typically apply to distributions from active SEP or SIMPLE IRAs unless an employer contribution was not made to the SEP or SIMPLE IRA during or for the year the charitable distributions are made.

Originally, this benefit was available only through December 31, 2009. However, on December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which included a provision that extends the qualified charitable donation (QCD) benefit through December 31, 2011. In addition, the bill provides a one-month extension that permits QCDs made from January 1 through January 31, 2011 to be treated as having been made on December 31, 2010. If a taxpayer makes the election as prescribed by the IRS, then the distribution made in January 2011 will count towards:

- The taxpayer's \$100,000 exclusion limitation for the 2010 calendar year and
- The taxpayer's required minimum distribution (RMD) for the 2010 calendar year.

Eligibility and donation limit

To be eligible for QCDs, IRA holders must be at least 70 ½ years of age on or before the actual day of making the donation. In addition, to qualify as a QCD, the IRA custodian/trustee must make the distribution directly to the qualified charity. Any distributions, including RMDs, which the IRA owner actually receives cannot qualify as a QCD.

For those who do qualify by age, their maximum QCD is limited to \$100,000 per tax year. Any distributions in excess of this limit will not qualify for the tax exclusion benefit and will be treated as ordinary income. Note that distributions of base contributions and tax-paid conversions to Roth IRA holders are generally not considered taxable income.

Benefit of excluding income

By not including a QCD from an IRA as ordinary income, an individual's adjusted gross income is not increased, which could affect the ability to qualify for Roth contributions or have other tax ramifications.

Qualified charities

For information pertaining to qualified charities, go to the IRS web site, www.irs.gov/individuals, and select the "Charities and Non-Profits" tab and review the "Search for Charities" section.

EDUCATION SAVINGS ACCOUNT (ESAs) BENEFITS EXTENDED

Provisions were included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) that increased certain benefits for ESAs. Contribution limits were increased to \$2,000, donor eligibility was expanded, the definition of "qualified educational expenses" was expanded to include K-12 expenses, Hope and Lifetime Learning Credits were coordinated with ESA distributions, and the filing deadline for contributions was changed to the tax return due date, not to include extensions.

Although EGTRRA was due to expire December 31, 2010, the increased benefits for ESAs are extended until December 31, 2012 through the signing of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

ROTH IRA WITHDRAWALS AFTER 2010 CONVERSIONS

Under a provision in the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), the \$100,000 AGI restriction has been eliminated for Roth IRA conversions as of January 1, 2010. This allowed taxpayers with AGI of \$100,000 or more to convert their Traditional, SEP, or SIMPLE IRAs (after two years), or retirement plan assets to Roth IRAs in 2010 and beyond.

Tax considerations

For conversions completed in the year 2010, taxes can be deferred. Unless a taxpayer affirmatively elects full taxation in 2010, a 2010 Roth IRA conversion will be taxed “ratably” by reporting 50% of the taxable amount converted in 2011 and 50% in 2012.

Accelerated taxation for distributions

TIPRA includes a provision intended to discourage the withdrawal of converted assets until their 2011 and 2012 tax obligations are satisfied.

Under the provision, if a 2010 converted amount is subsequently withdrawn in 2010 or 2011, the amount of the distribution will be added as ordinary income to the IRA holder’s taxable income reported in the year of the distribution. The same amount will be subtracted from the income that would have been reported in the individual’s 2012 tax filing.

Accelerated Taxation for Pre-2012 Withdrawals

Year	Action	Income Reportable in 2010	Income Reportable in 2011	Income Reportable in 2012
2010	Converted \$100,000 (50/50 taxation)	\$0	\$50,000	\$50,000
2010	Withdraw \$25,000* (50/50 taxation)	\$25,000	\$50,000	\$25,000
2011	Withdraw \$25,000* (50/50 taxation)	\$0	\$75,000	\$25,000
2012	Withdraw \$25,000* (50/50 taxation)	\$0	\$50,000	\$50,000

*10% pre-mature penalty applies if under 59 ½ years of age

Distribution ordering rules

Assets must be distributed from Roth IRAs in a defined order. Annual contributions must be distributed first, followed by taxable conversions, non-taxable conversions, and lastly earnings. In the event that a Roth IRA owner has other assets held in Roth IRAs, in addition to amounts converted in 2010, the individual must determine (according to these ordering rules) what portion, if any, of a distribution in 2010 or 2011 is subject to the accelerated 2010 conversion taxation rules. Note that all Roth IRAs owned by the individual must be taken into consideration.

Non-Roth employer plan conversions

In addition to conversions from Traditional, SEP, or SIMPLE (after two-years from the first contribution date) IRAs, the two year ratable 50/50 taxation option is available for 2010 conversions from non-Roth type employer-sponsored plans. The tax acceleration rules for pre-2012 distributions will also apply.

This information is for educational purposes only. It is always recommended that you seek the aid of a competent tax advisor or tax attorney to assist you with tax advice and guidance.

RECOGNIZING LOSSES ON IRA INVESTMENTS

According to IRS Publication 590, Individual Retirement Arrangements (IRAs), under certain conditions, individuals may be eligible to recognize the loss on a Traditional or Roth IRA investment when filing their income tax return.

Conditions for a tax loss

In order for a tax-filer to claim a loss in a Traditional IRA, the following conditions must be met:

1. All amounts in all Traditional IRAs (not Roth IRAs) owned by that individual must be distributed.
2. The total Traditional IRA distributions must be less than the individual’s unrecovered basis, if any.

The same holds true for Roth IRAs; Traditional IRA assets are not considered when meeting these requirements, but all Roth accounts for an individual must be distributed.

Determining basis

“Basis” is defined as the total amount of non-deductible contributions in the individual’s Traditional IRAs that were reported on IRS Form 8606 (Nondeductible IRAs and Coverdell ESAs). “Unrecovered basis” is created when assets are distributed and the value of the investments distributed is lower than the amount of all nondeductible contributions (the basis). Note that distributions may be taken “in-kind.”

For example, an individual has a Traditional IRA and previously reported \$5,000 as a non-deductible contribution (the basis). In 2010, the value of the IRA is now \$4,000 and the individual takes a complete distribution. The individual has a net unrecovered basis of \$1,000 (\$5,000 - \$4,000) and can claim the loss as a miscellaneous itemized tax deduction. Note, however, a tax-filer’s miscellaneous expenses must exceed a minimum of 2% of AGI. For instance, if an individual has AGI of \$50,000, a miscellaneous tax deduction would be allowed for amounts exceeding \$1,000 (2% of \$50,000). For the above example, if no other miscellaneous itemized expenses are reported, the amount does not exceed the minimum and, therefore, a deduction is not available.

Given the recent drop in value of most investments, many IRA holders may be able to take advantage of the loss at this time with the prospect of improved security value at a future date.

For additional information, reference IRS Pub. 590 Individual Retirement Arrangements (IRAs) at www.irs.gov.

IN-PLAN ROTH CONVERSIONS

Roth accounts in 401(k)s and 403(b)s have been allowed since 2006. The Small Business Jobs and Credit Act of 2010 established the ability for non-Roth accounts in 401(k), 403(b), and governmental 457(b) plans to be converted to Roth accounts within the same plan. Prior to this, non-Roth accounts in these plan types could only be converted to a Roth if rolled outside of the plan into a Roth IRA.

Provided a plan sponsor amends its plan document to allow for this provision, in-plan Roth conversions are permitted after September 27, 2010 for 401(k) or 403(b) plans and after December 31, 2010 for governmental 457(b) plans. In all cases, the monies converted must meet the rules required for an in-plan Roth conversion.

What funds can be converted?

Employee salary deferrals must meet the requirements for an in-service distributable event under the terms of the plan (e.g., reaching age 59 ½) in order to be eligible to convert. Plan sponsors may want to consider expanding the available in-service distributable events available under a plan, as these events can be made specific to in-plan Roth conversions only.

Employer contributions that are vested can be converted if the contributions have aged for two years or the employee has been a participant in the plan for at least five years, provided these contributions meet the requirements for an in-service distributable event.

Only distributions that are “eligible for rollover” may be converted. Therefore, hardship withdrawals, required minimum distribution amounts, and corrective distributions may not be converted.

What are the tax implications?

A 10% early distribution penalty tax does not apply to the converted amount, though it would apply to a rollover or distribution of the taxable portion of the in-plan Roth conversion that occurs within five years of the original in-plan Roth conversion. The taxable amount of the in-plan Roth conversion is not subject to a 20% withholding tax.

Unlike conversions or rollovers to Roth IRAs, in-plan Roth conversions may not be “recharacterized” or returned back to the pre-tax accounts from which they came.

Administration of In-Plan Conversions

The in-plan conversion feature is not required to be added to a plan by the plan sponsor, though a plan must first permit the Roth account feature in order to do so. A plan amendment can apply retroactively to allow for 2011 Roth contributions, or Roth contributions and in-plan Roth conversions, provided that the amendment is in place by December 31, 2011. Thereafter, amendments for Roth contributions and in-plan Roth conversions will need to be in place prior to allowing participants to take advantage of these features.

Currently, few retirement plan vendors and third-party administrators (TPAs) have prepared their recordkeeping systems to accommodate in-plan Roth conversions. Further clarifications of this new law should lead to widespread availability.

Plan loans that are included as part of an in-plan Roth conversion are not considered new loans. The taxable amount of the loan is the outstanding loan balance.

There is no spousal consent required prior to conducting an in-plan Roth conversion.

Planning point

Adding the in-plan conversion feature can be a valuable benefit used to attract and retain talented employees.

Converting pre-tax deferrals and employer contributions to an after-tax Roth account can have its advantages. High net worth individuals unable to transfer their plan balances to Roth IRAs now have the opportunity to take advantage of Roth accounts before their retirement or leaving their current employer.

Communicating how it works and what assets are eligible are key steps for providers, TPAs, and plan sponsors to take in order for participants to understand and assess in-plan conversions. For further details concerning in-plan Roth Conversions, please go to the IRS web site at: www.irs.gov/ep and select the In-Plan Roth Rollovers link.

RETIREMENT PLAN DESIGN STRATEGIES

In mid-2010, Towers Watson conducted a survey of plan sponsors (entitled “New Strategies in Defined Contribution Plan Design”) to better understand what employers are doing to improve the success of their defined contribution (DC) retirement plans during these tough economic times. Defined contribution plans, such as 401(k), profit sharing, 403(b), and money purchase plans, are the dominant type of retirement plans sponsored by private sector employers in the United States, covering nearly half of all private sector workers. With older style “pension plans” (i.e., defined benefit plans) being made available less frequently to workers, an analysis of data in the defined contribution market can give a very good indication as to how a key portion (outside of Social Security and personal savings) of the U.S. retirement savings system is performing.

Background

Towers Watson is a leading global professional services company that helps organizations improve performance through effective people, risk, and financial management. A key focus area of Towers Watson is employer retirement plans, where they consult with companies on retirement plan design, funding, investing, governing, and employee engagement. Towers Watson’s “New Strategies in Defined Contribution Plan Design” survey involved 334 plan sponsors, representing over 5.3 million plan participants, \$387 billion in defined contribution plan assets, and 14 industry sectors, including manufacturing, financial services, and health care.

Plan participation rates

When measuring the success of a DC retirement plan, such as a 401(k) plan, one main place to focus is on the percentage of eligible employees that elect to participate in the plan. Over 75% of the plans surveyed indicated that their plan participation rate was 70% or higher. The majority of plans in the pharmaceutical, energy, and financial services sectors had participation rates of 80% or better. The Towers Watson survey probed deeper here, in order to analyze the plan design elements that resulted in different plan participation rates.

Automatic enrollment

One of the more interesting design developments in 401(k) plans of late has been the automatic enrollment of employees. Here, employees have the ability to subsequently opt out of the plan, rather than enroll into it. The survey indicated that 57% of the plans surveyed automatically enroll employees into their plans. Of that 57%, approximately 18% auto-enroll all employees, and

39% auto-enroll only new employees. The manufacturing sector had the most plans that auto-enroll, while the retailing sector had the least amount of plans that auto-enroll.

Auto enrollment has a profound effect on plan participation rates. Of the respondents that auto-enroll all employees, 93% report a participation rate of at least 70%, and 84% of respondents that auto-enroll only new employees report the same 70% or higher participation rate. With respondents that do not auto-enroll employees, only 53% report a 70% or higher participation rate, in comparison.

The successful participation rates in many automatically enrolled retirement plans has to do with the fact that many employees don't actively take the time to opt out of participating in the plan. The plans surveyed by Towers Watson supported this fact, as 53% of plan sponsors that auto-enroll all employees report a 5% employee opt out rate, while only 5% of those same plan sponsors report an opt out rate of 15% or more. For plan sponsors that auto-enroll only new employees, 59% reported an opt out rate of 5%, while 5% report an opt out rate of 15% or more.

Automatic enrollment coupled with automatic escalation

Increasingly common with automatically enrolled plans is to add automatic escalation of the contribution deferral level made by plan participants. Of those plans in the survey that auto-enroll employees, 58% also automatically escalated employee contributions. Plans that automatically enroll all employees were most likely (68%) to automatically escalate as well. This is most likely due to the fact that the IRS discrimination test safe harbor requires, in part, the combination of automatically enrolling all employees with automatically escalating their contributions. The most common auto escalation approach reported was to start contribution levels at 3% of salary and to then increase that rate each year by 1%, with a 6% cap on auto-escalated contributions. This specific approach to auto escalation also fits into the requirements to comply with the IRS discrimination test safe harbor.

Automatically escalating contributions had a positive impact on plan participation rates, as 79% of plan sponsors that chose to escalate reported an 80% or better plan participation rate. On the other hand, only 50% of plans that chose not to automatically escalate contributions report an 80% or better plan participation rate.

Interestingly, the opt out rate of employees that are in an auto-escalated plan is extremely low. Of plans that chose to auto-escalate, an opt out rate of 15% or more was reported by only 1% of those plans, while an opt out rate of 15% or more was reported by 10% of plans that chose not to auto-escalate.

All in all, auto-escalation is a newer design element than straight auto-enrollment, so it will be interesting to see if the high participation rates/low opt out rates will continue in the years ahead as participants are required to defer more money into their 401(k) plans.

Matching contributions

Arguably, there is no better incentive for employees to participate in a 401(k) plan than for a company to match (i.e., provide "free money") plan participant retirement plan contributions. The vast majority of the plans surveyed (94%) reported that they did provide company matching contributions. However, since late 2008, 13% of those plans polled reported suspending their match, and an additional 5% reported lowering their match. Plan sponsors with lower participation rates were more likely to suspend their match; 21% of plans with participation rates of 40% or lower did so, whereas only 7% of plans with participation rates of 80% or above decided to suspend their match.

Of the plans that suspended their match, 46% have reinstated a match, though only 37% have actually reinstated the full match. Of those that have not reinstated the match as of yet, 49% indicate that they are currently considering reinstating at least some type of match within the next 12 months. Improvements in the status of suspended or decreased matching contributions should be consistent with improvements in the overall economy.

Match suspensions from an industry perspective were most common among retailers (27%) and manufacturers (21%). Those plan sponsors within the pharmaceutical and food and beverage industries did not change their matching contributions.

Conclusion

DC plans, such as 401(k) plans, are now the main retirement plans utilized by plan sponsors, covering over 55 million plan participants and \$4 trillion in assets. A key aspect to how successful these plans can be has to do with the design features used in these plans. For many years, the concept of companies matching the employee plan contributions has been the primary design element to encourage plan participation. However, company matching contributions have not led to a 100% participation rate for most plans, thus leading to a focus on more innovative design elements such as automatically enrolling employees and/or automatically escalating their retirement plan contributions. The Towers Watson survey shows that it can be seen as a best practice for plan sponsors to utilize automated plan design elements from a cost, effectiveness, and consistency standpoint.

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