Background Information on the U.S. Department of Housing and Urban Development Retirement Plans

The federal Housing and Urban Development Department (HUD) indicates that a Housing and Redevelopment Agency may consider adopting one or more of the following types of private retirement plans (except as noted):

1. Internal Revenue Code (IRC) Sec. 401(a) Plan. This is the traditional form of qualified plan provided pursuant to IRC Sec. 401(a). Most Housing Agency plans will be of the defined contribution type. Large Housing Agencies may adopt a defined benefit plan if actuarially practical. Most plans are provided through an insurance company's prototype plan. In some cases, an independent sponsor may provide a master or prototype plan or similar arrangement.

2. IRC Sec. 401(k) Deferred Compensation Plan. As governmental entities, Housing Agencies may not establish Sec. 401(k) plans after May 6, 1986. Sec. 401(k) plans established by Housing Agencies before this date may be continued, and the effective dates for some of the changes in the Sec. 401(k) requirements are delayed two years for such plans (TRA'86 Sec. 11 16(f)).

3. IRC Sec. 403(b) Tax-Sheltered Annuity. Employees of certain tax-exempt organizations that meet the requirements of IRC Sec. 501(c)(3) are eligible under IRC Sec. 403(b) to exclude from their current gross income amounts paid by their Housing Agencies (through salary reduction or otherwise) towards the purchase of annuities or deposits in special custodial accounts in a regulated investment company. The total excludable contribution is limited by law. A tax-sheltered annuity plan may be used as a primary employee-provided retirement benefit program or with Housing Agency contributions as well. Amounts excludable from income through salary reduction remain subject to FICA taxes.

4. IRC Sec. 408(a) Individual Retirement Account. In the event a Housing Agency does not have a retirement plan for its employees, it may inform them that an individual retirement account or annuity (IRA) is available. No deductible IRA contribution can be made by active participants or their spouses in an employer-sponsored retirement plan, if their income is above a certain level. A married person with income less than $10,000, filing separately, whose spouse is covered by a retirement plan, can contribute to a deductible IRA. "Active participant" is defined as one who participated, whether vested or not, in a private or public employer-sponsored retirement plan for any part of the plan year ending within the individual's taxable year. This includes tax-sheltered annuities and Simplified Employee Pensions, but not IRC Sec. 457 plans. Spousal IRAs are available even if the spouse earns up to $250. Individuals who cannot make a deductible IRA contribution may make a nondeductible IRA contribution of up to $2,000. Those who cannot make the full $2,000 deductible IRA contribution may contribute the remainder of the $2,000 on a nondeductible basis. Earnings on the account will be tax-deferred. IRAs are subject to the same 10 percent tax on early distributions that applies to qualified plans (see paragraph 2-22). Qualified Voluntary Employee Contributions are no longer permitted. These IRA provisions are effective January 1, 1987. Information on IRAs is available through local banks, thrift institutions and insurance companies. 2-1 1/97

5. IRC Sec. 408(k) Simplified Employee Pension. Under a Simplified Employee Pension (SEP), a Housing Agency contributes to an IRA for each participant (IRC Sec. 408(k) as amended by TRA'86 Sec. 1108 and 1898(a)(5)). Thus, a SEP is a kind of defined contribution plan very similar to a Sec. 401(a) plan. A SEP can be an attractive alternative to a Sec. 401(a) plan, particularly for a small Housing Agency. A SEP requires no plan document other than IRS Form 5305-SEP, Simplified Employee Pension -- Individual Retirement Accounts Contribution Agreement, no IRS approval, no summary plan description, no annual IRS Form 5500, no summary annual report, no attorney, no actuary and no consultant. The maximum Housing Agency contribution under a SEP is the lesser of $30,000 or 15 percent. A SEP maintained by a governmental entity (i.e., a Housing Agency) cannot permit elective salary reduction deferrals for any of the difference between the Housing Agency contribution and the maximum SEP contribution permitted by law (i.e., the lesser of $30,000 or 15 percent). In tax years beginning after 1986, TRA'86 provides that, as an "active participant" in an employer-maintained retirement plan (the SEP), individuals may make nondeductible contributions to an IRA (which may be the SEP-IRA subject to the applicable IRA deduction limits of IRC Sec. 219(g) (as added by TRA'86 Sec. 1101). Earnings on nondeductible contributions are not subject to Federal tax until they are withdrawn, but when withdrawn the pro rata basis recovery rule applies (see paragraph 2-23). A SEP must cover every employee who has attained age 21, has performed service for the Housing Agency in at least three of the preceding five years, and receives at least $300 of compensation in the current year. More liberal participation is permitted. A SEP has full and immediate vesting. Employees are free to withdraw their contributions under a SEP at any time without restrictions but penalties for early withdrawal apply. A copy of each Form 5305-SEP shall be retained in the Housing Agency's files. Form 5305-SEP is not filed with IRS.

6. IRC Sec. 414(h)(2) Employer "Pick-up" Plan. Sec. 414(h)(2) permits a governmental entity (i.e., a HA) to "pick-up" mandatory employee contributions and deem such contributions to be employer contributions. These contributions are not taxable to the employee until received. For Federal income tax purposes, the employee's W-2 wages are reduced by the amount of the picked-up contribution. Rulings from the Social Security Administration have indicated that those funds which are obtained through a reduction in employee wages will

be considered covered wages for FICA purposes. This means that employees do not lose Social Security coverage. At least three contribution accounts must be maintained and the following conditions observed:

(1) Employee contributions made before the date of the Housing Agency pick-up. These must include interest earned. These contributions are paid from after-tax dollars and are not taxable to the employee upon distribution. These are fully vested.

(2) Employee contributions which are picked-up by the Housing Agency. These contributions have been paid from before-tax dollars and, together with interest thereon, are taxable to the employee when received. Since these contributions are derived from employee mandatory contributions, they are fully vested.

(3) Housing Agency contributions, together with interest thereon, are taxable when received. The appropriate vesting schedule will apply (see paragraph 2-18).

(4) Additional accounts will be required to segregate contributions where more than one type of investment media is provided.

(5) See paragraph 2-23 for treatment of after-tax employee contributions. 1/97 2-2

Since the employee mandatory contributions that have been picked-up by the Housing Agency are maintained in a segregated account and treated as though they were Housing Agency contributions, it is possible to provide the prerequisite 100 percent vesting on these contributions without a complex formula. Furthermore, by proper definition of wages, it is possible to consider the employee contributions which are picked-up by the Housing Agency to be part of basic compensation. This means that there will not have to be adjustments to employee-Housing Agency contribution rates to the retirement plan. In addition, other pay related benefits (e.g., life insurance) can be based on total pay including the Housing Agency's pick-up of employee contributions.

7. <u>IRC Sec. 457 Public Employee Deferred Compensation Plan</u>. IRC Sec. 457 provides for Public Employee Deferred Compensation (PEDC) plans on a tax-favored basis (IRC Sec. 457 as amended by TRA'86 Sec. 1107). A Housing Agency may adopt a PEDC program for full or part-time employees. There are no age or service requirements and participation is strictly voluntary. A PEDC plan may not use any age later than 70-1/2 for retirement purposes. Employees may voluntarily elect to defer a portion of their compensation to some later date (usually normal retirement age under the plan). Only employee contributions are involved. Before making PEDC contributions, an employee must enter into a participation agreement with the Housing Agency. The Housing Agency reduces the employee's salary by the designated amount and remits the payment to the insurer. (Note: Only the Housing Agency may remit contributions on behalf of a participant to a qualified PEDC arrangement.) With the exception of a "catch up" rule, the normal annual maximum contribution is 25 percent of compensation (before salary reduction), not to exceed $7,500 (TRA'86 Sec. 1107). Under the catch up rule, in each of the last three years before the year normal retirement age is reached under the plan, the plan may permit a catch up amount in addition to the regular maximum amount to be deferred. An eligible employee may participate in a PEDC, a qualified pension plan, a SEP and an IRA (to the extent allowable). By law, the Housing Agency is the owner and sole beneficiary under the terms of the PEDC contract. Also, all amounts deferred must remain assets of the Housing Agency and are subject to the claims of its general creditors. The employee must file a beneficiary designation with the Housing Agency. While contributions generally reduce a participant's gross income for Federal income tax purposes, FICA and FUTA taxes on the contributions must be paid. According to current legislation, benefits become available upon (1) separation from service; (2) retirement; (3) death; or (4) an unforeseeable emergency beyond the participant's control which creates a financial hardship as defined by IRS regulations. IRS does not permit loans. Distributions from Sec. 457 plans are treated as ordinary income and do not benefit from taxation of lump-sum distributions.

2-3. EXPENSES. Routine operating expenses for the administration of the plan may be paid from the basic contribution allowances or from forfeitures, dividends, or other plan assets. Routine operating expenses normally include record keeping, investment expense, commissions or other contract loading, and corporate trustee or administrator fees. The Housing Agency may pay for non-routine unusual expenses which are not covered by the insurance company or plan administrator as part of its routine service function. Nonroutine expenses may include an actuary's or legal counsel's fee, IRS user fees, fiduciary bonding, auditing expenses and one-time setup charges. Any such payment shall be subject to prior written approval of the appropriate HUD Field Office and funds must be available or otherwise budgeted. An officer or employee of a Housing Agency serving as a trustee-administrator should serve without compensation (but may be reimbursed by the plan for any necessary travel expenses). An individual cannot be the trustee of an IRA. 2-3 1/97

2-4. EFFECTIVE DATE. The effective date of a plan should coincide with the collection of required employee contributions. Any Housing Agency contribution will be subject to HUD budget approval, but may be made in advance of final approval where the Housing Agency has entered into an escrow agreement (see paragraph 2-30).

2-5. UNDERWRITING. In order to preserve and maintain the retirement plan's assets, it is recommended that the following guidelines be followed. The retirement plan will be underwritten on an accepted actuarial basis. Retirement plan assets will be managed only by a professional money manager, which may include a life insurance company, a corporate fiduciary such as an investment bank, or a regulated investment company such a mutual fund. Plan assets will be deposited in an eligible investment medium. Upon retirement or other termination of employment, unless a lump-sum settlement option is elected, benefits will be guaranteed by a life insurance company or retirement association through the purchase of individual or group policies.