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Retirement PLAN news

Lifetime income options

Defined benefit (DB) plans traditionally offer a lifetime retirement income benefit. Lifetime income options are beneficial because they enable retirees to protect themselves from financial risks, including the risk of outliving their savings.

Over time, however, the number of individuals covered by DB plans has declined, while the number covered by 401(k) and other types of defined contribution (DC) plans has increased. This shift in the retirement plan landscape has been accompanied by a shift away from lifetime payments provided by DB plans and a surge in lump-sum cash payments (or installments) based on the value of a participant's 401(k) or other DC plan balance. There is great concern that this shift, along with longer life expectancies, will result in individuals outliving their DC account balances. One solution to this dilemma is to offer DC plan participants the option of receiving a lifetime stream of income.

As part of an initiative by the U.S. Department of the Treasury and the Department of Labor to expand lifetime income choices, the Treasury Department and the IRS recently issued two revenue rulings and two proposed regulations that will make it easier for plan sponsors to offer certain lifetime income options (e.g., full and partial lifetime annuities) to 401(k) and other DC plan participants.

Revenue Ruling 2012-3

This guidance addresses regulatory concerns about applying spousal protection rules to DC plans that offer deferred annuity contracts. The ruling provides methods that would allow a DC plan to offer a deferred annuity as an investment without subjecting the entire plan to the qualified joint and survivor annuity (QJSA) rules (including the qualified preretirement survivor annuity (QPSA) provisions).

The ruling uses three different situations to illustrate how a participant who has not yet reached retirement can invest (over a period of time or on one specific date) in a deferred annuity contract that will ultimately pay benefits (upon retirement or at a later date). Once the tax-deferred annuity goes into payment status, only that particular investment is subject to the QJSA rules. Outlining how spousal rights can be protected with respect to deferred annuities without subjecting the entire plan to the QJSA rules helps clear the way for DC plan sponsors to include deferred annuity contracts as a plan investment option.

Revenue Ruling 2012-4

Some employers sponsor both a DC plan and a DB plan. Rather than offer an annuity option in their 401(k) plan, certain employers may prefer to allow 401(k) participants who are ready to begin receiving retirement benefits to

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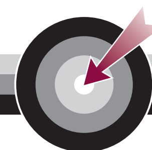


A look at SIMPLE IRAs

The name — SIMPLE IRA* — says a lot. And while plan rules *are* simple, there is limited flexibility. Here's an overview:

SIMPLE IRAs are required to operate on a calendar-year basis, and employer contributions must be funded for the entire year. SIMPLE IRA plan sponsors must provide all eligible employees with a plan notice 60 days before the beginning of each plan year. Once the notice is provided, the SIMPLE IRA must run for the entire year (or the remainder of the year for plans established after January 1) and cannot be terminated, unlike traditional 401(k) plans, which can be terminated at any time. Also, SIMPLE IRA plan features described in the annual notice cannot be changed during the year.

Terminating a SIMPLE IRA must be done prospectively, beginning with the next calendar year. Employees should be notified of the employer's intent to terminate the plan within a reasonable amount of time prior to the beginning of the 60-day period (which ends on December 31).

The following IRS examples illustrate some of these rules:

Example 1: Acme Company decided on November 18, 2011, to terminate its SIMPLE IRA plan as soon as possible. The earliest effective date for the termination would be January 1, 2013. Acme must notify its employees during 2012 that it won't sponsor a SIMPLE IRA plan for 2013.

Example 2: On November 18, 2011, Acme Company decided it would like to change its SIMPLE IRA plan matching contributions from 3% to 1%. Acme's SIMPLE IRA plan notice to employees (given on November 2, 2011) stated the match would be 3% for 2012. Acme must contribute 3% for 2012. The earliest effective date for Acme's change in matching contributions would be January 1, 2013. Acme must notify its employees during 2012 that it will reduce the matching contribution to 1% in 2013.

SIMPLE IRAs are subject to an exclusive plan rule, which means that for any calendar year in which a SIMPLE IRA is receiving contributions, retirement benefits may only be provided under a SIMPLE IRA. The employer may *not* provide benefits under a qualified retirement plan, such as a 401(k) or profit sharing plan, in the same year as the SIMPLE IRA. If an employer wishes to establish a 401(k) plan, he/she must follow the required steps to terminate the SIMPLE IRA plan by December 31 and wait until January 1 of the following year to start the 401(k) plan.

* SIMPLE stands for Savings Incentive Match Plan for Employees; IRA stands for individual retirement arrangement.

Lifetime income options

(Continued from page 1)

roll over some or all of their 401(k) account balance to the employer's DB plan and convert the rollover amount into an immediate annuity under the DB plan. Revenue Ruling 2012-4 addresses regulatory concerns about allowing such rollovers. The ruling contains detailed examples of how a plan may allow this type of annuity purchase while still complying with qualified plan rules.

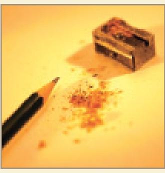
When converting a single sum rollover amount to an annuity, the DB plan must apply the same actuarial assumptions (using the applicable interest rate and mortality tables) that apply when calculating retirement benefits for DB plan participants. DC participants who elect such a rollover would receive election forms that require notarized spousal consent (for married participants) and a disclosure statement explaining the consequences should the plan terminate with insufficient funds to cover plan participant benefit liabilities.

Note: Although this ruling applies to rollovers made on or after January 1, 2013, plan sponsors may rely on the ruling with respect to rollovers made prior to that date.

Proposed regulations

In addition to the two revenue rulings, the IRS and Treasury Department announced two proposed regulations that, when issued as final regulations, would encourage the inclusion of lifetime income options in 401(k) plans. The first regulation introduces a new type of annuity — a qualifying longevity annuity contract (QLAC) — that would begin payout at an advanced age, such as 80 or 85. Once finalized, the regulation allows the amount used to purchase a QLAC to be excluded from the calculations that determine a participant's required minimum distribution (RMD) from age 70 until the annuity begins (ages 80 to 85).

The second proposed regulation would allow participants to split their pension benefit between an annuity and a lump-sum cash payment. DB participants are typically confronted with an all-or-nothing choice between the two options. The proposed regulation would streamline the calculation required for a split, thus making it easier for more DB plans to offer part of a participant's benefit as an annuity and part as a lump-sum payment.



Learning from the IRS LESE projects

The IRS's "Learn, Educate, Self-Correct, and Enforce" (LESE) projects give the IRS a streamlined way to examine defined contribution plan compliance issues. By sampling a small portion of Form 5500 returns, the IRS can see how well plans are complying with specific plan features.

After the examination of plan data is complete, the IRS works with the selected plan sponsors to correct their plans. The IRS also publishes the findings online and creates educational materials for plan sponsors regarding certain compliance issues. The LESE project web page can be found at: *www.irs.gov/retirement/article/0,,id=217083,00.html.*

Plan sponsors can use the information gathered from LESE projects to perform self-audits. Those who discover compliance issues may correct their plans using one of the IRS-approved correction programs, such as the Employee Plans Compliance Resolution System (EPCRS) or the 401(k) Plan Fix-It Guide.

Here are some results from recent LESE projects involving common plan features.

Small plans and participant loans

One LESE project involved an IRS review of about 50 small plans (with 10 or fewer participants), each with a total amount of participant loans in excess of $100,000. The IRS discovered prohibited transaction violations that resulted from failing to follow plan terms when issuing the loans. Some of the most common errors included:

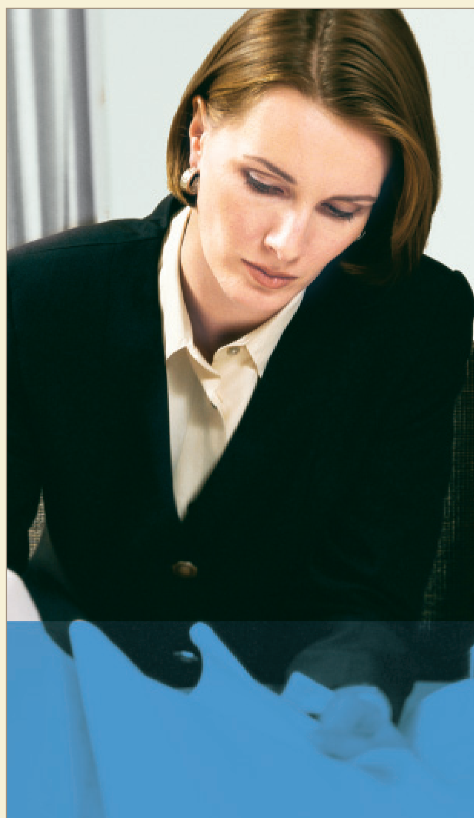
- Failing to monitor maximum loan amount limits
- Issuing loans without proper loan documentation
- Making no attempt to enforce loan repayments
- Allowing participant loans when plan documents do not permit such loans

As a result of the examinations, certain plans were required to remedy the errors. Some corrections involved paying an excise tax; others required restorative corrections involving repaying loan principal and accumulated interest. Plan sponsors are advised to review the terms of their plans to ensure they are administering their loan program in accordance with loan regulations as well as with their plan's loan policy.

Top-heavy 401(k) plans

In this LESE project, the IRS examined approximately 50 small 401(k) plans (with three to eight participants) that may have been subject to the top-heavy requirements (IRC Section 416). Seven of the plans failed to provide required minimum top-heavy contributions. The reasons included:

- Failing to perform a top-heavy test
- Improperly excluding an eligible employee from receiving a required top-heavy minimum contribution; in some cases, plan sponsors failed to recognize that one or more employees were eligible to make elective deferrals
- Failing to use the proper definition of compensation



It is important to verify that a plan is properly tested each year to determine if it is top heavy. Some types of 401(k) plans, such as safe harbor plans, offer an exemption from the top-heavy rules when certain conditions are met. When a plan is top heavy and, therefore, subject to a minimum required contribution, plan sponsors must ensure that all participants who are eligible for a top-heavy minimum contribution are identified and receive a contribution.

Bonding errors

While each LESE project focuses on a specific plan feature, the examination process may uncover other issues that require a correction. One of the most common errors discovered during these two LESE projects was that plan fiduciaries and persons who handle pension funds were inadequately bonded. ERISA Section 412 generally requires all persons, including fiduciaries, who "handle funds or other property" of an employee benefit plan to be bonded. (Plans covering only owners and their spouses are exempt.)

Each plan official must be bonded for at least 10% of the amount he or she handles, subject to a minimum of $1,000. The maximum bond per official for any one plan is $500,000 ($1,000,000 for a plan that holds employer securities). When inadequate bonding was discovered during these examinations, the correction called for plan sponsors to secure the required amount of bonding for plan fiduciaries.

RECENT developments

401(k) beneficiary court case

A participant designated his spouse as the beneficiary of his 401(k) account. They later divorced. As part of the divorce decree, his ex-spouse waived her right to any of his 401(k). The participant, however, died without changing the beneficiary designation form, leaving the ex-spouse as the beneficiary of record on the plan. The plan administrator followed the terms of the plan and distributed the deceased participant's balance to the ex-spouse in accordance with the documents filed with the plan.

In a reversal of a lower court's decision, the U.S. Court of Appeals for the Third Circuit ruled that a deceased participant's estate can sue the participant's ex-spouse to recover benefits that were paid to her from the 401(k) plan after she had waived her right to those benefits under a divorce decree (*Estate of Kensinger v. URL Pharma Inc.,* No. 10-4525, March 20, 2012).

In 2009, the Supreme Court ruled in a similar situation, where the benefit was waived in a divorce, and yet no new beneficiary form was filed, leaving the ex-spouse named as beneficiary on the plan. The Supreme Court case found that the plan administrator was correct to follow the plan's documents and procedures and to pay the ex-spouse, who was named as beneficiary. The Supreme Court was not asked to address whether a lawsuit could be later filed against the beneficiary after the benefits are paid in accordance with plan documents.

Note that in neither case was a domestic relations order (DRO) filed with the plan after the divorce was finalized. If a DRO had been filed with the plan, the plan could have verified that it was a qualified domestic relations order (QDRO) and then followed it. Under the circumstances, the plan administrator *had* to pay based on the beneficiary designation form.

Second six-year restatement cycle

The Pension Protection Act of 2006 (PPA) restatement cycle applies to prototype and volume submitter defined contribution (DC) plans. Document providers, as required, sent their mass-submitter plans to the IRS for review by April 2, 2012. The review process may take up to two years, so new documents and their opinion and advisory letters are expected early in 2014. At that time, the IRS will announce the deadline for employers to adopt the new PPA plan documents.

Note: The document adoption period for the first six-year restatement cycle (the "EGTRRA restatement") ran from May 1, 2008, through April 30, 2010.

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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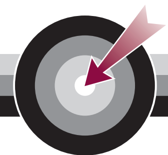

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