

employee benefits update

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Name that fiduciary

EBSA PROPOSES EXPANSION OF KEY DEFINITION

The Employee Benefits Security Administration (EBSA), the section of the Department of Labor that enforces retirement plan rules and legislation, issued a proposed ruling at the end of 2010 to expand the definition of the term “fiduciary.” Public hearings were held in March 2011, with advisor and benefits groups weighing in. The final regulations are expected to be released by the end of this year, with the definition effective 180 days after publication of the final regulations in the Federal Register.

Who is a fiduciary?

Many of the actions involved in operating a plan make a person or entity performing them a

fiduciary. Specifically, using discretion in administering and managing a plan or controlling the plan’s assets makes that person a fiduciary to the extent of that discretion or control.

A plan’s fiduciaries ordinarily include the trustee, investment advisors, individuals exercising discretion in the administration of the plan and, if the plan has an administrative committee, members of that committee. Attorneys, accountants and actuaries generally aren’t fiduciaries when acting solely in their professional capacities.

The key to determining whether an individual or an entity is a fiduciary is whether he, she or it exercises discretion or control over the plan.

What is “investment advice”?

Currently, federal regulations use a five-part test to determine whether a person or entity should be treated as a fiduciary when rendering investment advice. The term “investment advice” applies if the advisor doesn’t have discretionary authority or control as to the purchase or sale of securities or other property for the plan, and the person or entity:

1. Advises as to the value of the securities or other property, or makes recommendations as to the advisability of investing in, buying or selling securities or other property,
2. Provides such advice regularly,
3. Functions pursuant to a mutual agreement, arrangement or understanding,
4. Recognizes that the advice will serve as a primary basis for investment decisions with respect to plan assets, and
5. Tailors the advice to the plan’s particular needs.



Under this definition, advice given infrequently is seldom actionable by EBSA. Advice concerning all of a plan's assets isn't treated as fiduciary advice if given on a one-time basis.

How does the proposal change things?

Known among advisors as the pending "fiduciary standard," the proposed regulation expands the definition of fiduciary to include an investment advisor who:

1. Doesn't have discretionary authority or control with respect to buying and selling plan assets, and
2. Provides advice or recommendations to a plan, plan fiduciary, participant or beneficiary regarding the value, buying, selling, holding, or management of securities or other property.

The proposed definition includes individuals who provide investment advice to plans for payment or compensation. This may increase the legal or financial exposure of investment advisors and other plan counselors who receive compensation for handling or providing investment advice and guidance.

What are the pros and cons?

By now, both sides of the issue have stated their respective positions. Those in favor of the new definition believe it will help plan sponsors ensure they're getting the most prudent advice for their plans because those contributing to decisions will be more accountable. In fact, advisors can be held personally liable for plan losses resulting from a violation of their fiduciary duty.

Those opposed to the new definition believe it will limit an investment broker's ability to provide appropriate and clear guidance for fear of being held accountable. It may affect advice regarding fund selections within retirement plans, and the new definition may limit an advisor's capacity to recommend certain investment products to plan sponsors. It may also limit the amount of commission and other remuneration they receive.

Plan sponsors are always a fiduciary

As the plan sponsor, you always have fiduciary responsibility for your actions regarding your retirement plan. You cannot transfer this duty to an advisor or other party assisting the plan. ERISA puts clear expectations on plan fiduciaries, including:

- › Carrying out their duties prudently,
- › Acting solely in the interest of plan participants and their beneficiaries as well as with the exclusive purpose of providing benefits to them,
- › Following the plan documents (unless inconsistent with ERISA),
- › Diversifying plan investments, and
- › Paying only reasonable plan expenses.

Plan sponsors breaching these duties will be required to restore any losses to the plan or to restore any profits made through improper use of the plan's assets.



When should we act?

Most advisors are waiting for the final regulations to determine the outcome of this hotly debated topic. The new definition may considerably affect how paid advisors go about their work and may lead to more changes in the future. For plan sponsors, it will surely bring greater pressure to select appropriate plan advisors. 🕒



Upcoming compliance deadlines:

- 9/15** Extended deadline for corporate tax returns
- 9/15** Extended deadline for partnership tax returns
- 9/30** Summary annual report due for Form 5500s that were due July 31, unless extension is granted

Life isn't always easy

HARDSHIP DISTRIBUTIONS AND THEIR CONSEQUENCES

With unemployment numbers remaining high and the economy making a slow recovery, workers may need to use the money in their retirement accounts for emergency purposes. One way to do so is with a hardship distribution. Offering these to your retirement plan



participants can help them — but at a price they need to bear in mind.

IRS definition

The Internal Revenue Code defines a hardship distribution as a withdrawal for “an immediate heavy and financial need.” It allows six situations to qualify for a hardship distribution:

1. Expenses for medical care previously incurred by the employee, the employee’s spouse, or any dependents of the employee, or necessary for these persons to obtain medical care;
2. Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
3. Payment of tuition, related educational fees, and room and board expenses for the next 12 months of postsecondary education for the employee or the employee’s spouse, children or dependents;
4. Payments necessary to prevent the employee’s eviction from his or her principal residence or foreclosure on the mortgage or residence;

5. Funeral expenses; and
6. Certain expenses related to the repair of damage to the employee's principal residence.

A financial need may be immediate and heavy even if it was reasonably foreseeable or the employee voluntarily incurs it.

Amount permitted

A hardship distribution includes elective deferrals minus any earnings on those amounts. Some plans also allow distribution of employer matching and discretionary funds.

The distribution can't be greater than the amount required for the specific need. But it can include the amount needed to pay federal, state or local income taxes or penalties expected from the transaction.

Employer determination

The employer must determine whether the employee qualifies for a hardship distribution. Generally, if the employee has current assets that can resolve the immediate and heavy financial need, a hardship distribution isn't permitted.

The distribution can include the amount needed to pay federal, state or local income tax or penalties expected from the transaction.

Examples may include insurance policies that can be cashed out or borrowed from, elective or employee plan contributions that can be stopped, or assets that can be liquidated. Employers must also consider other distributions or nontaxable loans from the plan or another employer.

In addition, the employer must determine whether the employee can borrow funds from commercial sources on reasonable commercial terms. The employee may qualify for an exception from the



loan requirement if the distribution request is for the purchase of a principal residence and obtaining a loan would prohibit him or her from obtaining other necessary financing.

Employers may usually rely on an employee's representation that he or she is experiencing an immediate and heavy financial need, unless the employer knows other financial options are available to the employee.

Distribution consequences

Of course, taking a hardship distribution has some consequences. Once an employee takes a hardship distribution, he or she must cease making 401(k) deferrals for six months. Also, hardship distributions are taxable unless they come from a Roth 401(k). A participant can't roll a hardship distribution into an IRA or any other qualified plan.

In addition, if the participant is under age 59½, he or she may be subject to a 10% early withdrawal penalty.

Check your plan

Before discussing hardship withdrawals with employees, review your plan document to make sure your plan even offers them. Your plan document will identify what information the participant must provide to qualify for a hardship distribution. 🕒

The ABCs of ADP testing

Most any employee benefit plan sponsor has seen the term “actual deferral percentage” (ADP). But what exactly does it mean, and how does it affect your plan? It’s a test that all plan sponsors need to be aware of. In fact, the IRS requires qualified retirement plans to comply with ADP requirements — with consequences for failure to do so.

Calculating ADP

The ADP nondiscrimination test compares the average salary deferral percentages for highly compensated employees (HCEs) to the average salary deferral percentages for nonhighly compensated employees (NHCEs) within a plan. For 2011, an HCE is an employee with more than \$110,000 in 2010 compensation or an employee who owned more than 5% of the business during 2010 or 2011. The test ensures that the percentage deferred by HCEs in comparison with that deferred by NHCEs is within the IRS limits.

The IRS includes both pretax elective deferrals and designated Roth contributions in the ADP test. But the regulations exclude catch-up contributions. The test also includes anyone eligible to participate in the plan whether or not they defer and regardless of whether they’re active or terminated.

You calculate the ADP for each person by dividing their total annual deferral amount into their annual compensation for the plan year. (An eligible participant who elects not to participate has an ADP of zero.) Then you determine the average for the HCEs as a group and the NHCEs as a group.

Passing the test

To pass ADP testing, the general rule is that the HCE average cannot exceed the NHCE average by more than 2%. But the Internal Revenue Code (IRC) specifically states that the HCEs’ ADP must not exceed the greater of:

- 1) 1.25 times the ADP for NHCEs, or
- 2) The lesser of two times the ADP for NHCEs or the ADP for NHCEs plus two percentage points.



Unless the plan document specifically states otherwise, the IRC allows plans to measure the HCEs’ current year deferrals against the prior year’s NHCE deferrals. This approach, called the prior year testing method, helps minimize the potential for a failed test because the HCEs know what their ADP limit is for the current plan year.

If the plan document states that you must use the current year testing method, you can perform a projected ADP test midyear to help estimate the current year ADP limit. This estimate allows HCEs to adjust their deferral percentages in an effort to pass testing.

Correcting mistakes

Plan sponsors must correct a failed ADP test by March 15 of the year following the plan year for calendar year plans or within 2½ months after the close of the plan year for fiscal year plans. If the sponsor chooses to deposit a qualified nonelective contribution (QNEC), they have the statutory correction period to make the deposit (by no later than Dec. 31, 2011, for a failed 2010 test).

To bring the plan into compliance, the IRC provides two correction methods for a failed ADP test:

1. **Distribute excess contributions to HCEs.** Doing so will bring down their average salary deferral percentages enough to pass. The return of excess contributions to the HCEs is a taxable distribution to the individual in the distribution year. If an HCE is over age 50, some or all of the regular contributions may be reclassified as catch-up contributions, lowering the amount to be refunded.

If you use this method, you must do so by March 15 of the year following the plan year. If not, the plan sponsor must pay a 10% excise tax on the total amount of excess contributions.

2. Contribute a QNEC to some or all NHCEs.

This is immediately 100% vested and brings up the NHCE average salary deferral percentage enough to allow the HCEs to keep their deferrals in the plan. You must deposit the QNEC no later than Dec. 31 of the year following the close of the plan year in which the mistake occurred.

The plan administrator will determine the best method of correction depending on individual circumstances for each plan and employer. The method of correction doesn't have to be the same each plan year of failure.

Knowing your employees

Educating employees about the benefits of retirement saving can help encourage more plan participation and help those already participating to increase their deferral contributions. This, in turn, can help your plan pass future ADP testing. [🔗](#)

Don't be sorry — distribute your SAR

Employer-sponsored defined contribution plans, such as 401(k) plans and welfare benefit health plans, must provide participants with a summary annual report (SAR) each year. Plans that need to distribute SARs include funded plans (plans with assets held in a trust) subject to ERISA's reporting and disclosure requirements.

ERISA requires SARs to help protect employee benefit plan participants and beneficiaries. The report provides a brief overview of the information contained in the Form 5500 ("Annual Return/Report of Employee Benefit Plan") that plans must file annually.

The SAR also outlines participant rights and gives information on how to obtain additional information. For example, participants can request a full copy of the Form 5500 filed by the plan sponsor. (Note: You can charge participants copying costs for requesting such additional information.)

Plan sponsors must distribute SARs within two months after the due date of the plan's annual return, including extensions. For instance, if your plan is a calendar year plan, your Form 5500 was due July 31, 2011. That means you must distribute your SAR by Sept. 30, 2011. If you filed for an extension and have until Oct. 15, 2011, to file your Form 5500, you must distribute the SAR no later than Dec. 15, 2011.

If you miss the SAR distribution deadline, ERISA doesn't apply the same civil penalties applied to a late filing of Form 5500. Instead, the Department of Labor may discover a violation of the SAR rules during a plan audit. The agency can then penalize the employer up to \$100 each day it's not in compliance.

Bear in mind, the rules above apply to defined *contribution* plans. If you sponsor a defined *benefit* plan subject to ERISA, you must distribute an annual funding notice to the Pension Benefit Guaranty Corporation as well as each:

- › Plan participant and beneficiary,
- › Labor organization representing such participants or beneficiaries, and
- › Employer that has an obligation to contribute to the plan (in the case of a multiemployer plan).

No matter what type of plan you sponsor, work with your benefits advisor to ensure you distribute your SAR on time and in compliance with all applicable rules.