

# The ADVISOR

## 401(k) Inside and Out

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## Move 'Em Out

Because maintaining small account balances for former employees can result in administrative burdens, many 401(k) plans automatically cash out accounts valued at \$5,000 or less — unless the departing employee elects a rollover to another plan or an IRA. New rules require that small balances be rolled over.

Under the new rules, plans must transfer automatic cash-outs of more than \$1,000 directly to an IRA set up for the former employee — unless the person elects to receive the distribution or have it paid directly to an eligible retirement plan or another IRA. Accounts valued at \$1,000 or less may also be rolled over for administrative convenience.

### Selecting an IRA Provider

For employers that are concerned about the fiduciary liability involved in selecting an IRA provider for cashed-out accounts, the U.S. Department of Labor's (DOL's) final regulations provide a safe harbor. You can fulfill your fiduciary duties by meeting these requirements:

- The rollover can't exceed \$5,000.
- The rollover must be to an IRA.
- The employer must have a written agreement with the IRA provider that addresses appropriate account investments and fees.
- Certain disclosures are required.
- The plan fiduciary cannot engage in a prohibited transaction when selecting the IRA provider.

The IRA provider cannot charge higher fees than would be charged for a comparable rollover IRA. Examples of possible account expenses include set-up charges, maintenance fees, investment expenses, termination costs, surrender charges, and similar fees charged by other IRAs.

### Investing the IRA

The investment chosen for the IRA should be designed to preserve principal and provide a reasonable rate of return, consistent with liquidity. Examples include money market mutual funds, stable value funds, and certificates of deposit.

In addition, the investment must be offered by a state or federally regulated financial institution. Regulated financial institutions are generally defined as a federally insured bank, savings association or credit union; an insurance company whose products are protected by a state guarantee association; or a registered investment company.

### Disclosures

Before an account is cashed out, the participant must be notified in writing either separately or as part of a rollover notice that, absent an affirmative election to receive the distribution or roll it over, his or her distribution will be paid to an IRA. As long as the notice is sent to the participant's last known mailing address, the notice requirement will be deemed satisfied, even if the mail is returned as undeliverable.

In addition, you must include a description of the plan's automatic rollover provisions for mandatory cash-outs in the summary plan description (SPD) or a summary of material modifications (SMM). The description must include:

- An explanation that the mandatory distribution will be invested in a product designed to preserve principal and to provide a reasonable rate of return and liquidity,
- A statement indicating how fees and expenses will be allocated to the IRA, and
- The name, address, and phone number of a plan contact (if not otherwise provided in the SPD or SMM) that can provide further information about the plan's automatic rollover provisions, the IRA provider, and the fees and expenses charged. ■

## Choosing a Default Investment for Your 401(k) Plan

Traditionally, many 401(k) plans have had a default investment — an investment that is used when employees neglect to make a decision about how to invest their plan accounts. Now, with the trend toward automatic enrollment, government regulators are focusing more attention on the types of investments that plans are using as a default. If you sponsor a 401(k) plan or a similar retirement plan, new guidance from the U.S. Department of Labor (DOL) will be of interest to you.

### Liability Relief

When a plan invests an employee's contributions in a default investment, the employer may be liable for investment losses if the investment doesn't perform well. But now there's a *qualified* default investment

alternative (QDIA). As long as a plan meets all of the DOL's requirements, a QDIA provides relief from fiduciary liability (though the employer must still prudently *select* the default investment).

### Qualified Investments

In its regulations, the DOL spells out the categories of investments that qualify as QDIAs. They include lifecycle and targeted retirement date funds that take into account an individual's age or retirement date, as well as funds that take into account the group of employees as a whole, such as balanced funds. Professionally managed accounts that take an individual participant's characteristics into consideration also qualify.

Stable value and money market funds, which frequently have been used as default

investments in the past, can be QDIAs only for the first 120 days after the employee's first elective contribution. A QDIA generally cannot hold securities issued by the employer.

### Other Requirements

To qualify for fiduciary relief, certain requirements must be met. Before investing your employees' contributions in a QDIA, your plan must give the employees the chance to direct their own investments. And the plan must permit employees to transfer out of the QDIA and into the other investments your plan offers with the same frequency available for the other plan investments (at least quarterly). You also must provide plan participants with certain notices and investment information. ■

## Handling Erroneous Hardship Distributions

With the housing crisis and uncertain economy, some plan sponsors have seen an uptick in requests for hardship distributions from their 401(k) plans. If you receive a hardship request, take care that any distribution you make meets IRS requirements and your plan's provisions. Below, we answer questions about hardship distributions and how to correct erroneous distributions.

### When can a 401(k) plan make a hardship distribution?

It depends on the method used to define hardship. When a plan uses the *facts-and-circumstances method*, the plan administrator reviews all relevant facts and circumstances in each individual situation. While the plan generally can allow a hardship distribution for any reason, it must have established rules to ensure that the distribution will be used for an immediate and heavy financial need.

For example, the need to pay funeral expenses of a family member would constitute an immediate and heavy financial need. A distribution made for the purchase of a boat or television would generally not be considered a distribution made on account of an immediate and heavy financial need. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.

Under the *safe-harbor method*, a plan can

allow hardship distributions to be taken for the following reasons: (1) to pay certain medical expenses incurred by the participant or the participant's spouse or dependents; (2) to purchase a principal residence; (3) to cover post-secondary educational expenses for the participant or the participant's spouse, children, or dependents; (4) to prevent eviction from or foreclosure on a principal residence; (5) to pay the funeral expenses of a spouse, parents, children, or dependents; and (6) to repair damage to the employee's principal residence that would qualify for the income-tax casualty loss deduction (without regard to whether the loss exceeds 10% of adjusted gross income).

Plans using a safe harbor method must restrict the employee from contributing to the plan (and all other qualified and nonqualified plans maintained by the employer) for a minimum of six months following the hardship distribution.

### What should a plan sponsor do if it discovers that a hardship distribution has been made in error?

A plan generally can use either the IRS's Self-Correction Program (SCP) or Voluntary Correction Program (VCP), as set forth in Revenue Procedure 2006-27, to correct a hardship distribution error, unless the plan is under IRS examination. In that case, the plan

generally will have to correct the mistake in accordance with a closing agreement under the Audit Closing Agreement Program (Audit CAP).

Take reasonable steps to ensure that the employee who received the distribution returns the erroneously distributed amounts to the plan. The employee also should be informed that any amounts not returned are not eligible for favorable income-tax treatment.

For example, these amounts cannot be rolled over to an IRA or another retirement plan. To ensure the error doesn't occur again, review plan procedures for approving hardship distributions and make sure that everyone with authority to authorize distributions is aware of those procedures.

**What can be done to avoid mistakes?** The IRS recommends (1) reviewing the plan document to see when and under what circumstances distributions can be made, (2) establishing hardship distribution procedures, and (3) looking for signs that the hardship distribution feature is being abused or badly managed. For example, too many hardship requests from employees in one department or division or from only highly compensated employees may be a sign of abuse or that all employees haven't been properly notified of the availability of hardship distributions. ■

## Sell Your Employer Match

Most 401(k) plan sponsors offer their employees some type of matching contributions. The most common match, according to the Profit Sharing/401(k) Council of America, is 50 cents for every dollar an employee contributes to the plan, up to 6% of compensation. The reason for offering this benefit is simple. The availability of matching contributions encourages employees to participate in their employer's plan and, in many cases, to contribute more to the plan — both of which can help at annual nondiscrimination testing time.

But many employees, particularly lower paid employees, fail to take full advantage of this important benefit. By some estimates, as many as two thirds of the lowest paid employees may not be contributing enough to

receive the full company match. What can you do to get all of your employees on board?

### Show Them the Money

To start, look at your enrollment and



educational materials to see how matching contributions are explained. Many employers find that a “free” money approach, pointing out that the employer is *giving* employees

extra money for retirement, is effective. Also helpful are illustrations showing the difference matching contributions can potentially make in their plan account balance at retirement.

### Target Education

Also consider reviewing your plan data to determine which participants are not taking full advantage of your matching contributions. You might want to target these employees with payroll stuffers or e-mail communications pointing out the benefits of matching contributions. Or, if employees who are not taking advantage of your match seem to be concentrated in certain departments, you may want to post matching contribution posters in those areas. Another idea is to briefly talk about your 401(k) plan and your match program at the performance/pay reviews of select — or perhaps all — employees. ■

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### 401(k) Inside and Out

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