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Internal Revenue Service

Summer Edition of *Retirement News for Employers* Discusses Hardship Withdrawals and Corrections to Plans for Faulty Implementation of Automatic Enrollment Provisions

The IRS recently published the Summer *Edition of Retirement News for Employers* http://www.irs.gov/pub/irs-tege/rne_sum09.pdf. Articles of interest to plan sponsors and those who administer retirement plans include those discussing the following:

- hardship withdrawals
- correction methods for automatic enrollment failures

Hardship Withdrawals

The IRS notes that hardship withdrawals have become popular in retirement plans as participants cope with economic problems. The plan document must contain all terms permitting hardship withdrawals and be administered consistent with the plan's written provisions. Relying on what the Internal Revenue Code legally permits raises red flags to the IRS upon examination, if plan document language conflicts with actual plan administration or is silent. Retirement plans need to be administered correctly at all times so plan documents should be reconciled with administrative protocols.

According to the two articles that discuss hardship withdrawals, an important step in determining whether a hardship withdrawal is permitted is documentation that the employee has taken any and all loans from the plan as well as any other plans of the employer in which the employee is a participant. In addition, there must be verification that the employee has taken any other available distributions, other than hardship distributions, from these plans.

The IRS also states that a common plan error is failure to enforce a plan provision suspending the employee from contributing to the plan and all other plans that the employer maintains for at least six months after receiving a hardship distribution. Failure to enforce the suspension requirement requires correction through the Employee Plans Compliance Resolution System (EPCRS).

Failure to Implement Automatic Enrollment Correctly

Some plan sponsors have amended their plans to include automatic enrollment but some employees are not making automatic contributions. According to the IRS, two common errors found in 401(k) plans are not giving an eligible employee the opportunity to make elective contributions and failing to execute an employee's salary deferral election.

The IRS reminds plan sponsors that the plan administrator and payroll provider should establish procedures so that the payroll provider has complete and updated information for eligible employees and their respective elections, as of the beginning of each pay period. Plan records should contain affirmative elections that the employee has requested that the elective deferral be reduced from the automatic enrollment default election to zero. To determine whether there has been a failure to correctly implement automatic enrollment, employers should periodically review payroll records of employees who are not making elective deferrals.

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In both cases, the employer can fix the problem by using one of the correction methods. The employee is fully vested in these contributions and the contributions are subject to the same restrictions on withdrawal that apply to elective deferrals. The only difference in the correction for the two situations lies in the calculation of the amount of the missed deferral. In the case of an erroneously excluded employee, the missed deferral is based on the average of the deferral percentages ("ADP") for other employees in the employee's category (for example, nonhighly compensated employees). In the case of failure to implement an employee's election, the missed deferral is based on the employee's elected deferral percentage.

Two examples of the automatic enrollment problems discussed in *Retirement News for Employers* as well as the "fix" available through the EPCRS are detailed below. The remedy for both requires the employer to make a corrective contribution of 50% of the missed deferral (adjusted for earnings) for the affected employee. Note that there is a difference in the correction method. In the case of an erroneously excluded employee, the missed deferral is based on the average of the deferral percentages ("ADP") for other employees in the employee's category (for example, nonhighly compensated employee). In the case of failure to implement an employee's election, the missed deferral is based on the employee's elected deferral percentage.

> Albert became eligible to participate in Engine's Plan on January 1, 2008. Due to an oversight, Engine did not give Albert the plan's enrollment materials. Included in the enrollment materials are: (i) a description of the plan, and (ii) the procedures for an eligible employee to elect to contribute an amount other than the automatic enrollment deferral percentage (including zero). Albert did not make any specific election and the Plan did not implement its automatic enrollment provision for Albert. As a result, Albert did not make any elective contribution to Engine's Plan in 2008. Albert earned $30,000 in compensation in 2008.
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> *In failing to provide Albert with the Plan's enrollment materials, the Plan effectively precluded him from making a timely election to contribute to the plan. Since Albert was erroneously excluded from the Plan, Albert's missed deferral would be determined using the applicable ADP for 2008. In this case, Albert's missed deferral is $1,200 (4% (ADP for NHCEs) multiplied by $30,000 (Albert's compensation for 2008)). The corrective contribution required for Albert is $600 (50% multiplied by his $1,200 missed deferral). The corrective contributions should be adjusted for earnings from the date that the elective deferrals should have been made through the date of the corrective contribution.*
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> Bobbi became eligible to participate in Engine's Plan on January 1, 2008. In November of 2007, the Plan sponsor gave Bobbi the Plan's enrollment materials. Bobbi did not make any specific election and the Plan did not implement its automatic enrollment provision for Bobbi. As a result, Bobbi did not make any elective contribution to Engine's Plan in 2008. Bobbi earned $30,000 in compensation in 2008.
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> *After receiving the Plan's enrollment materials, Bobbi did not submit an election form. By not making an affirmative election in this automatic enrollment plan, Bobbi has expressed her desire to contribute at the Plan's automatic enrollment deferral percentage of 3% of compensation. By failing to implement the Plan's automatic enrollment provisions, the Plan did not execute Bobbi's election. In this case, Bobbi's missed deferral is $900 (3% (Bobbi's elected deferral percentage) multiplied by $30,000 (Bobbi's compensation for 2008)). The corrective contribution required for Bobbi is $450 (50% multiplied by her $900 missed deferral). The corrective contributions should be adjusted for earnings from the date that the elective deferrals should have been made through the date of the corrective contribution.*

IRS Offers Mini-Course on 403(b) Plans

An 11 minute course, which covers the basics of 403(b) plans, has been produced by the IRS Office of Employee Plans. http://www.stayexempt.org/ep/403b_employees/player.html Presented as conversation between a new employee and a human resources professional, with accompanying slides, the course reviews the 403(b) rules on contributions, investment options, and distributions as well as certain tax implications.

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IRS Provides Additional Guidance on the Determination Letter Filing Delay for Governmental 401(a) Plans

The IRS recently published Rev. Proc. 2009-36, which modifies Rev. Proc. 2007-44, to provide that a remedial amendment cycle with respect to a governmental 401(a) plan will not end before the expiration of the 91st day after the close of the first legislative session that begins more than 120 days after a determination letter is issued for the plan. http://www.irs.gov/pub/irs-drop/rp-09-36.pdf This delay may also apply to the occurrence of certain other events relating to a determination letter application. It is important to note that this delay is available only if the application for the determination letter was timely submitted to the IRS.

In addition, the revenue procedure includes the guidance announced in November of 2008 implementing a one-time modification of the staggered remedial amendment program to permit sponsors of governmental 401(a) plans to submit for determination letters during either Cycle C or Cycle E. The deadline for Cycle C was January 1, 2009. The first deadline for filing a determination letter for a Cycle E plan is January 31, 2011.

IRS Requests Comments on Guidance on Combined Defined Benefit and 401(k) Plans Offered under the Pension Protection Act of 2006

The IRS published IRS Notice 2009-71 to request comments on guidance relating to eligible combined plans under 414(x) that was added by the Pension Protection Act of 2006 effective for plan years beginning after December 31, 2009. An eligible combined plan provides a vehicle through which an employer can maintain both a defined contribution plan and a defined benefit plan on a combined basis, thus reducing the administrative burdens and costs of maintaining separate plans.

According to 414(x), an “eligible combined plan” is a plan:

1) that is maintained by an employer that is a small employer at the time the plan is established;
2) that consists of a defined benefit plan and a defined contribution plan that includes a cash or deferred arrangement;
3) the assets of which are held in a single trust forming part of the plan and are clearly identified and allocated to the defined benefit plan and the applicable defined contribution plan to the extent necessary for the separate application of the Code; and
4) that meets the benefit, contribution, vesting, and nondiscrimination requirements under 414(x).

A small employer is an employer who employed an average of at least two but not more than 500 employees on business days during the preceding calendar year and employs at least two employees in the first day of the plan year. Written comments regarding possible issues to be addressed in guidance under 414(x) are due October 15, 2009.

Federal Trade Commission

Treatment of Retirement Plan Loans Clarified under Red Flags Rule

The Red Flags Rule and Guidelines released by the Federal Trade Commission help address identify theft threats by charging financial institutions and creditors to stay alert for signs or indicators that an identity thief is actively misusing another individual’s sensitive data, typically to obtain products or services from the institution or creditor. http://www.ftc.gov/bcp/edu/microsites/redflagsrule/faqs.shtm Enforcement of the red flags rule will begin November 1, 2009. Financial institutions and creditors that offer or maintain “covered accounts” are required:

- To have policies and procedures to identify patterns, practices, or activities that indicate the possible existence of identity theft,
- To detect whether identity theft may be occurring in connection with the opening of a covered account or an existing covered account, and
- To respond appropriately.

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Two recently released questions and answers discuss the fact that retirement plan loans are not subject to the red flag rules but individual retirement accounts are considered to be "covered accounts."

Our company offers individual retirement plans that allow participants to get loans from their own plan account. Does that make us or the plan a creditor under the Rule?

When participants in an individual retirement plan – say, a 401(k) plan – get loans, they're generally borrowing from their own funds. Just allowing participants to borrow from their funds would not – by itself – make the plan sponsor or the plan a "creditor" under the Rule.

If our company meets the definition of a "financial institution" or "creditor," are the individual retirement accounts we make available to our employees considered "covered accounts" that must be included in our written Identity Theft Prevention Program?

Individual retirement accounts generally qualify as "covered accounts." However, in certain cases – for example, 401(k) plans – the account that a participant establishes isn't with the employer or plan sponsor. Instead, the participant establishes an account with the plan itself, which is a separate legal entity. Under those circumstances, the employer would not need to include the retirement plan accounts in a written Identity Theft Prevention Program.

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