Avoiding Plan Design Pitfalls

Designing a 401(k) plan is like walking a tightrope. A plan sponsor needs to balance the company’s resources and requirements with features that will encourage employee participation — without violating any tax law requirements. How can a sponsor achieve the appropriate balance? The following strategies may help. Note that communication is an important component of most.

MATCHES MATTER

Numerous studies have shown that offering employer matching contributions can encourage plan participation and increase employee contributions. But what if economic or industry conditions require an employer to reduce or eliminate its matching contributions? The employer should clearly explain the situation to employees in simple and concrete economic terms. For example, “We have to choose between cutting contributions and eliminating jobs.”

Before cutting matching contributions, a sponsor should review the plan document to make sure it allows the change. When adding a match provision to a plan, a sponsor needs to choose language that gives it the flexibility to change the match. Also, the summary plan description should make employees aware that any matching contributions could change in the future.

PLAN LOANS DO, TOO

Like matching contributions, allowing participants to borrow against their account balances can increase plan participation. Employees like to know they could access their money if they had to. However, for a plan loan feature to be effective and not a burden to the sponsor, plan participants should be informed of the potential consequences of taking a plan loan, so they don’t abuse the privilege. For instance:

- Loans can erode retirement savings.
- A participant who defaults on a plan loan can be hit with a deemed distribution and the resulting penalties and taxes.
- Participants often don’t understand the tax implications of a loan. First, the loan is paid back with after-tax money, and second, distributions are taxed again when they are made at retirement (or for another reason).

To keep plan administration manageable and discourage participants from abusing their loan privileges, many plans limit the number of loans a participant can have outstanding at any one time to one or two loans.

DEFAULT INVESTMENT OPTIONS

Another spot where sponsors can run into a design dilemma is default investment options for employees who fail to direct the investment of their retirement account assets. To minimize the possibility of loss, most sponsors choose a stable value or money market fund as their plan’s default investment.

However, because of the low returns these funds historically have earned, a better choice might be a lifestyle, asset allocation, or balanced fund. An alternative strategy some employers are using is to have undirected contributions default to a stable value or money market fund for a limited time — say, a year or less. At the end of that period, any still uninvested amounts are automatically transferred to a lifestyle or asset allocation fund.

If you would like assistance in reviewing a plan for design pitfalls or would like to add or change plan features, please give us a call. We also can advise you on materials to use to communicate plan features to employees.
Employers that sponsor retirement plans offering qualified joint and survivor annuities (QJSAs) as a benefit option, take note. The IRS recently issued final regulations on QJSA explanations*. Below, we summarize the more significant provisions that affect these plans.

The tax law defines a QJSA as an annuity for the life of the participant with a survivor annuity for the life of the spouse (if the participant is married) that is not less than 50% of (and not greater than 100% of) the amount of the annuity that is payable during the joint lives of the participant and the spouse.

For a married participant, a QJSA generally is the actuarial equivalent of a single life annuity benefit payable for the life of the participant. If a plan is subject to the QJSA requirements, a married participant’s plan benefits must be paid as a QJSA, unless the plan participant waives that form of payment and his or her spouse consents.

In addition, under the tax law, these plans are required to provide each plan participant with a written explanation of the:

- QJSA’s terms and conditions
- Participant’s right to make, and the effect of, an election to waive the QJSA form of benefit
- Rights of the participant’s spouse
- Right to revoke, and the effect of a revocation of, an election to waive the QJSA form of benefit

However, participants found that the required information didn’t adequately enable them to compare distribution forms without professional advice. And sponsors questioned how they should express the relative values of optional forms of benefit.

In 2002, the IRS issued proposed regulations to address these concerns. The proposed regulations specified requirements for disclosing the relative value of optional forms of benefit payable in lieu of a QJSA. The final regulations essentially incorporate the proposed regulations with a couple of changes.

**DISCLOSURES**

As under the proposed regulations, plans must include in their written QJSA explanation to participants descriptions of:

- Each available optional form of benefit
- The eligibility conditions for each optional form
- The financial effect of electing each optional form
- Any other material features of each optional form
- In the case of a defined benefit plan, the relative value of the optional form of benefit compared to the QJSA’s value

**BENEFIT COMPARISONS**

The final regulations also require that the relative values of all optional benefit forms be expressed in a uniform way that enables participants to compare the financial effects of each, without having to make calculations using interest or mortality assumptions.

In a departure from the proposed regulations, the final regulations allow a plan to use a uniform basis of comparison of relative value for both married and unmarried participants if the benefit options for all participants are the same.

To illustrate, under Company B’s plan the distribution for unmarried participants is a straight life annuity, and the QJSA form for married participants is a 50% joint and contingent annuity. Company B can choose to use the value of the straight life annuity as the basis for comparing optional forms of benefit for all participants.

In making comparisons, a defined contribution plan sponsor can use a reasonable estimate of the amount that would be payable under a purchased annuity contract, as long as the explanation states that the amount is an estimate and that participants have the right to request a precise calculation.

The final regulations apply to QJSA explanations for distributions with annuity starting dates on or after October 1, 2004. However, to be prepared, sponsors of plans offering a QJSA benefit should review their plans to ensure that the relative values for all optional benefit forms comply with the new regulations.

*T.D. 9099. The regulations also address requirements for qualified preretirement survivor annuity (QPSA) explanations. The final regulations are applicable to QPSA explanations provided on or after July 1, 2004.
**EBSA**

The U.S. Department of Labor’s Employee Benefits Security Administration (EBSA) has published a guide for plan sponsors and other plan officials who need assistance in meeting their reporting and disclosure obligations. Prepared with the assistance of the Pension Benefit Guaranty Corporation (PBGC), the Reporting and Disclosure Guide for Employee Benefit Plans contains basic ERISA disclosures, PBGC reporting and disclosure requirements for single-employer defined benefit pension plans, annual reporting requirements for IRS Forms 5500 and M-1, and a list of EBSA and PBGC resources. These resources include the agencies’ websites that contain laws, regulations, and other guidance relating to ERISA’s reporting and disclosure requirements. The Guide is available online at www.dol.gov/ebsa under “Publications” or by calling 1-866-444-3272 (toll-free).

**IRS**

Under the tax law’s anti-alienation rule, a qualified retirement plan must provide that benefits under the plan can’t be assigned or alienated. Violating that rule can cause the plan to lose its tax-qualified status. One exception to the rule is the enforcement of a tax levy issued by the federal government. The IRS used this exception in a recent private letter ruling to permit a 401(k) plan sponsor to honor a federal court’s garnishment order against a plan participant’s account without jeopardizing the plan’s tax status. The plan participant was convicted of federal drug-related offenses for which he was imprisoned and fined. At the request of the government, the court issued a garnishment order which directed the plan sponsor to pay the federal government money held in the plan on behalf of the participant to satisfy the government’s fine. Under a federal criminal procedure rule, a fine imposed as part of a criminal sentence or an order of restitution essentially is treated as if the liability of the person fined were a tax liability. Looking at two recent federal court cases that held that the federal government can collect criminal fines from a pension plan without disqualifying the plan’s tax-qualified status (PLR 200342007).

**LEGISLATION**

The Servicemembers Civil Relief Act, signed into law on December 19, 2003, updates the Soldiers’ and Sailors’ Civil Relief Act of 1940. Of note to plan sponsors: The new act retains the provision that generally requires a retirement plan (as well as other creditors) to drop plan loan interest rates to no more than 6% for participants on military leave who have loans with the plan. This interest rate remains in effect for the duration of the participant’s active military service. Under the new law, if loan repayment is suspended during the period of active military service, any interest in excess of 6% that might have accrued on the plan loan had the participant not taken military leave is permanently forgiven. The new act also expands the definition of “military service” to include active service of more than 30 consecutive days by members of the National Guard (P.L. 108-189).

**PBGC**

The Pension Benefit Guaranty Corporation (PBGC) has developed a new recordkeeping system, “My Plan Administration Account (My PAA) Authentication (continued on back)
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Records — PBGC,” for its online self-service center. My PAA is a secure web application that allows authenticated plan sponsors, administrators, pension practitioners, and other employee benefit professionals to file and pay premiums due to the PBGC under ERISA, check premium account histories, make plan termination filings, make reportable event filings, contact the PBGC with questions, and perform other plan maintenance tasks online. To open a My PAA online account, an individual has to register with the PBGC as the “filing coordinator” and receive a user ID and password. Once the PBGC has verified the filing coordinator’s authority to act on behalf of the plan, the coordinator can add other users to the account (PBGC Notice, 68 Federal Register 74655).

STATS

Despite employer efforts to educate plan participants about the advantages of rolling over 401(k) account balances to an IRA or another employer’s tax-deferred plan when they change jobs, many 401(k) participants are still cashing out their accounts. Here are the disheartening stats: 42% of job changers in 2002 took their plan distributions in cash. Of the remaining job changers, 52% rolled over their distributions to IRAs and 6% rolled them over to their new employer’s plan. The employee’s account balance seems to have been an important factor in the cashout decision. Almost three quarters (72%) of employees with balances between $5,000 and $10,000 took their distributions in cash. In contrast, only 20% of those with balances between $40,000 and $50,000 and 26% of employees with balances of between $30,000 and $40,000 cashed out their accounts. Age didn’t appear to be as great a factor. Among employees age 60 and older, 39% cashed out their 401(k) accounts. For those ages 50 to 59, a third cashed out, and in the 20-to-29-year age range, a full half took their distributions in cash (Hewitt Associates).