



## Suspend Deferrals After a Hardship Distribution

**SITUATION:** Our 401(k) plan allows hardship distributions. We use the tax law's safe harbor method of determining eligible hardships. We recently received a request for a hardship distribution and want to make sure we comply with all of the requirements.

**QUESTION:** Is there anything we should take particular care with?

**ANSWER:** In addition to confirming that the distribution meets one of the six "immediate and heavy financial needs" under the safe harbor method rules, make sure you have suspended elective deferrals by the participant receiving the distribution for six months.

**DISCUSSION:** Failure to suspend deferrals after a distribution is a common compliance error. Hardship distributions can be made only to satisfy an "immediate and heavy financial need of an employee." To qualify, the employee must have obtained all other currently available distributions and loans from the plan *and* be prohibited from making elective deferrals to the plan for at least six months following the distribution.

The safe harbor method permits hardship distributions to: (1) pay certain medical expenses incurred by the participant, participant's spouse, or dependents; (2) purchase a principal residence; (3) cover post-secondary educational expenses for the participant, the participant's spouse, children, or dependents; (4) prevent eviction from or foreclosure on

a principal residence; (5) pay the burial or funeral expenses of a spouse, parents, children, or dependents; and (6) pay expenses for the repair of damage to the participant's principal residence that would qualify for the income-tax casualty loss deduction.

While many compliance errors can be corrected under the IRS's Employee Plans Compliance Resolution System (EPCRS), the system doesn't specify a correction for failing to suspend employee deferrals following a hardship distribution. However, the IRS has outlined two possible correction methods. A plan may return the improper elective deferrals, adjusted for earnings, to the participant. This option complies with the EPCRS general rule that the plan and the affected participant(s) be restored to the same position they would have been in had the failure not occurred. Alternatively, the plan could suspend elective deferrals for a six-month period going forward. This correction wouldn't restore the participant to the same position if employer matching contributions for this period differed from those for the suspension period or if the employee quit employment before the end of the six-month period.

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## Thinking of Adding Target-date Funds?

The growing popularity of target-date funds has many employers considering adding them as an investment option under their retirement plans. If you are among those thinking of adding target-date funds, or if you've recently added them to your plan, you also may want to educate plan participants about these funds.

A recent study by the Center for Financial Security at Boston College found that many people, particularly those who are not currently invested in target-date funds, know little about them.

Here are some of the findings:

- Nearly a third (29%) of survey respondents incorrectly thought, or weren't sure whether, these funds are guaranteed against losses.
- Only 66% of them correctly agreed that target-date funds offer a diversified mix of stock and bond investments.
- 27% of respondents disagreed with, or were unsure about, the statement "target-retirement funds become more conservative as you approach the target year."

## Beneficiary Designation Procedures — Have Them

An unclear, missing, or out-of-date beneficiary designation can cause problems for your retirement plan. With an ambiguous designation, your plan will have to spend time and money to determine the proper beneficiary. With any of these issues, your plan could be open to lawsuits contesting a distribution to the named or default beneficiary.

For example, if a deceased participant had designated his or her ex-spouse as the primary beneficiary of a plan account, the plan death benefits may be distributable to the ex-spouse. A 2009 U.S. Supreme Court ruling held that the federal pension law's "plan documents rule" requires plan administrators to determine plan beneficiaries by looking solely at plan documents, not outside information sources. If your plan distributes the benefits to the ex-spouse as directed by the beneficiary designation, a current spouse or other family member might sue the plan to try and prove he or she is lawfully entitled to the plan's benefits — at a cost to your plan.

To help avoid these problems, your retirement plan should have written procedures in place to make sure participants' beneficiary designations are clear and up to date. Here are some procedural recommendations:

- Only accept designations made on a form your plan provides
- Make the instructions for completing the form short and simple to follow
- Review forms as they are received and return them to the participants for correction if necessary
- Give the participant a deadline for returning the form
- Contact the participant if the form isn't received by the deadline
- Consider asking all participants to review their designations and complete a new beneficiary form every five years

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## Safe Harbor 401(k) Plan — Right for Your Organization?

A safe harbor design allows a 401(k) plan to avoid annual nondiscrimination testing on pretax salary deferrals and employer matching contributions. Highly compensated employees can contribute the maximum annual amount allowed by law to the plan. The following questions and answers may help if you're considering a safe harbor 401(k) plan.

**What happens if a 401(k) plan fails the annual nondiscrimination testing?** Typically, a 401(k) plan that fails nondiscrimination testing must refund contributions to highly paid employees or recharacterize them as after-tax contributions if the plan allows.

**How do we qualify for the safe harbor?** You must choose either to make a nonelective contribution of at least 3% of compensation on behalf of each nonhighly compensated employee who is eligible to participate in your plan or use a qualifying matching formula. The basic matching formula is 100% of the first 3% of compensation deferred, plus 50% of deferrals between 3% and 5% of compensation. If your company is already making — or plans to make — contributions at these levels, you may want to consider using a safe harbor design even if your plan generally passes the nondiscrimination tests. It could help avoid problems in the future.

**What other requirements apply?** You must provide a notice of rights and obligations under the safe harbor plan to all eligible employees between 30 and 90 days before the start of *each* plan year. Employees who will become eligible during the year must be given reasonable advance notice. In addition:

- All safe harbor contributions are immediately 100% vested.

- You can't set conditions on the receipt of safe harbor contributions — for example, that plan participants be employed on the last day of the plan year or work at least 1,000 hours during the plan year. (However, the plan can have minimum age and service requirements that employees must meet before they are eligible for plan participation.)

- Safe harbor contributions generally can't be available for in-service withdrawal before age 59½.

- Plan documents must state whether safe harbor or non-safe harbor testing will be used.

**Can safe harbor matching contributions be stopped during the year?** You can reduce or stop safe harbor matching contributions during a plan year if you give your participants at least 30 days notice so they can change their elective deferrals if they want. But you'll have to perform annual nondiscrimination testing for the entire plan year.

**Are the safe harbor rules the same for a plan with a qualified automatic contribution arrangement (QACA)?** Not all of them. The QACA safe harbor matching contribution formula is a 100% match on the first 1% of compensation deferred and a 50% match on deferrals between 1% and 6%. Also, participants may be required to have two years of service before becoming vested in QACA contributions. And, the minimum employee deferral percentage must start at no less than 3% and increase at least one percentage point annually to no less than 6% (with a maximum of 10%) unless the participant elects otherwise.

**Can we change our plan for this year?** No, you can't add safe harbor provisions to an existing 401(k) plan during the plan year. Rather, you must amend your plan to add a safe harbor design for the next plan year. The amendment must be adopted before the first day of the new plan year.

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## RECENT DEVELOPMENTS In Benefit Plans

**Retirement Confidence.** The Employee Benefit Research Institute's (EBRI) *2011 Retirement Confidence Survey* found that workers are becoming more realistic about the amount of savings that they will need for a comfortable retirement. Still, many people don't make planning and saving for retirement a priority. While 59% of respondents say they are currently saving for retirement, more than half (56%) say they have less than \$25,000 in savings and investments, excluding the value of their primary residence

and any defined benefit plans. More than four in ten (42%) say they determined their retirement savings needs by guessing.

**DOL Examines Electronic Delivery.** The U.S. Department of Labor (DOL) is looking into whether and how to expand the standards for delivering plan information, disclosures, and notices to employees electronically. Under current regulations, plan sponsors generally can send notifications electronically to employees who (1) use a

computer as an integral part of their duties or (2) sign an affirmative consent to receive the information electronically rather than in paper form. Recent legislation allows plan providers to post information on a secure, password-protected website. Others must receive paper notifications. One suggestion to the DOL is the distribution of information through kiosks in the workplace. Supporters believe this option could get information out more efficiently and cost-effectively.