Pension Plan Fix-It Handbook

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Cash balance plans get more IRS guidance on interest crediting rates

by A. Paul Protos

The Internal Revenue Service (IRS) issued guidance recently on how to change interest crediting rates in a cash balance (CB) plan. The Issue Snapshot posted on the IRS website on May 31 analyzes some of the implications of amending a CB plan to actually or potentially decrease the interest crediting rate.

A CB plan is a defined benefit (DB) plan for which the benefit formula is structured to simulate a contribution formula commonly found in a defined contribution (DC) plan such as a profit-sharing plan. The formula in a DC plan specifies how the contribution is calculated for each participant.

Investment earnings that subsequently are earned by the trust are allocated to participants' accounts based on each participant's account balance. The formula in a CB plan specifies how a payroll credit is calculated for each participant. The CB plan also specifies a formula for how each participant's account will be credited with interest. As a result, this formula is called the

See *Protos*, p. 5

Tax reform requires plan sponsors to analyze 401(k) plan administration

by Todd B. Castleton

Many of the proposed changes to the federal tax code that would have directly affected tax-qualified retirement plans were dropped from the final Tax Cuts and Jobs Act (TCJA) signed into law December 22, 2017. But a few of these dropped changes were incorporated into the Bipartisan Budget Act of 2018, enacted in early February this year (see related February story).

The Budget Act's changes included easing some hardship distribution requirements and extending to victims of certain wildfire disasters the favorable distribution options that the TCJA had given to hurricane victims.

As a result of these changes, many 401(k) plans may need plan amendments to either bring them into compliance with the TCJA and the Budget Act, offer the distribution opportunities now permitted following this legislation, or comply with regulations implementing these provisions that have yet to be written. The deadline for adopting these amendments may not be until December 31, 2019, or later, and some plans may not require amendments at all.

See *Castleton*, p. 7

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Featured Columnists

In This Update

The following sections of the *Pension Plan Fix-It Handbook* have been updated in the August Supplement:

Updated information throughout ¶470–¶472 on limitations on the amount of includible compensation and compensation limits for defined contribution and defined benefit plans. ¶473 is deleted.

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Differences between worker, retiree perceptions about retirement income highlighted in EBRI survey

The latest edition of an annual retirement confidence survey illustrated key differences between what workers expect to be their most significant sources of income in retirement and which sources retirees have actually found to be the most significant when they no longer work. The Employee Benefit Research Institute's (EBRI) 2018 Retirement Confidence Survey analyzed the retirement outlook of both workers and retirees.

"Retirees continue to be more confident in their retirement security than workers," noted Craig Copeland, EBRI senior research associate and coauthor of the 28th annual EBRI survey report, released in April. "Just 17 percent of American workers say they are very confident in their ability to live comfortably throughout retirement, compared with nearly a third of retirees who say that they are very confident."

Expense confidence dropped

However, retiree confidence in having enough money to cover basic expenses and medical expenses dropped in the latest findings: 80 percent said they were very/somewhat confident about covering basic expenses this year compared with 85 percent in 2017. And 70 percent said they are very/somewhat confident about covering medical expenses this year versus 77 percent in 2017.

"Health care expenses in retirement appear to be playing a notable role in retirees' confidence. Retirees are less confident in being able to afford medical expenses and the share very confident in affording long-term care also declined," said Lisa Greenwald, executive vice president of Greenwald & Associates and coauthor of the report.

Meanwhile, workers are more likely to believe that income from work will be a significant source of income in retirement than retirees say they actually experience: 68 percent of workers expect work income to continue to be either a major or a minor source of income in retirement, but just 26 percent of retirees say that this income is a major or minor source, according to the survey press release.

Social Security expectations

Workers have the opposite expectation of Social Security versus what retirees are experiencing: Just 36 percent of workers expect Social Security to be a major source of retirement income, but 67 percent of retirees report that Social Security is a major source of income in retirement.

As explained by the EBRI survey press release, retirees' confidence that Medicare and Social Security will continue to provide benefits equal to what they are currently paying out significantly declined compared with 2017: 46 percent reported they were very or somewhat confident in Medicare this year, which is down from 52 percent in 2017, while 45 percent were very or somewhat confident in Social Security, which is down from 51 percent in 2017.

Eight in 10 workers (81 percent) said they expect that a workplace retirement savings plan, such as a 401(k) or 403(b), will be a major or minor source of income, but only 52 percent of retirees report that such a savings plan is a significant source of income for them.

Guaranteed lifetime income interest

Four in five current defined contribution (DC) participants express interest in putting some or all of their money in guaranteed lifetime income products regardless of whether the product is an in-plan investment option or a separate product purchased outside of the plan at the time of retirement.

For full survey results, visit EBRI.org.

EBRI is a private, nonpartisan, nonprofit research institute based in Washington, D.C., that studies health, savings, retirement, and economic security issues. It conducts independent research and education to inform plan design and public policy. ❖

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Retirement plan jargon can confuse the best of plan sponsors—Test your knowledge on these terms

by Michael A. Webb

As many of you are aware, there is a lot of retirement plan industry and legal jargon that is confusing, not only to plan participants but also to plan sponsors and those who work with them.

One of my goals is to make retirement plans more accessible by eliminating jargon and addressing technical retirement plan topics in a way that is more easily understood.

Three significant culprits

In this column, I address three of the most significant culprits of retirement plan terminology confusion that I have witnessed in the last 25-plus years. In fact, I suspect that even some of the savviest plan sponsors would fail a quiz asking them to correctly distinguish the terms below.

Fiduciary liability insurance vs. fidelity bond. In my experience, this is the number one set of terms that plan sponsors confuse.

To clarify, fiduciary liability insurance protects plan fiduciaries, the sponsoring employer, and the plan itself from claims arising from alleged fiduciary breaches. The coverage is not required under the Employee Retirement Income Security Act (ERISA) but is strongly recommended as a best practice.

However, a fidelity bond, which protects against employee fraud and dishonesty in the handling of plan assets, is required under ERISA. Each employee or individual who handles plan assets (for example, employees who remit funds to the recordkeeper) is required to be bonded.

Roth contributions vs. Roth conversions. A Roth contribution is a special type of elective contribution in which participants contribute after-tax money to their savings, on which they will owe no taxes on qualified distributions. These types of contributions have been permitted in retirement plans since 2002.

A Roth conversion allows a participant to move existing retirement plan assets from a traditional pretax account to a Roth account, with taxes paid at the time of conversion. Roth conversions have been allowed in retirement plans since 2010 but were restricted until 2012 to individuals eligible for a distribution.

Roth contributions and conversions are only allowed when a plan permits them, and because many plan sponsors did not fully understand the difference between the two transactions, those that originally amended their retirement plans to allow for Roth contributions did not later amend their plans to allow Roth conversions when the law permitted.

Multiemployer plans vs. multiple employer plans. These two terms are also often misunderstood, especially because they sound so much alike.

A multiemployer plan (often referred to as a "Taft-Hartley plan") is a collectively bargained plan maintained by more than one employer (usually within the same or related industries) and a labor union. Multiemployer plans have been in the news lately due to solvency issues.

On the other hand, multiple employer plans (commonly known as MEPs) are plans sponsored by employers that are not part of the same controlled group/affiliated service group of employers.

If you were already aware of all the distinctions described above, you should give yourself a pat on the back!

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What to do when a participant's elective deferral election is not followed

by Maria T. Hurd, CPA

One of the most common operational errors when administering retirement plans is the failure to implement a participant's elective deferral election or change in percentage.

Implementing elective deferrals in a timely fashion often requires more than one person or entity to make a change in the payroll system coding.

There are many ways in which plan processes can inadvertently go astray. In the case of missed deferral elections, the Internal Revenue Service (IRS) Employee Plans Compliance Resolution System (EPCRS) offers two options for employers completing a correction.

Two options

The first option is the one that had been available under Revenue Procedure (Rev. Proc.) 2013-12. Rev. Proc. 2013-12 was updated with, but not replaced by, Rev. Procs. 2015-27 and 2015-28, which offer a less expensive way to correct missed deferral errors but require that a notice be distributed to affected participants. The provisions of all three Rev. Procs. were incorporated in Rev. Proc. 2016-51.

The first option requires the employer to contribute a qualified nonelective contribution (QNEC) to the participant's account equal to 50 percent of the missed deferral, plus 100 percent of the match that would have been allocated for the full deferral, plus lost earnings. No notice to the participant is required under this method.

Under the second option, the employer does not need to contribute a QNEC if deferrals begin by the earlier of:

- The first payroll on or after the 3-month period that begins when the failure to withhold the first deferral occurred; *or*
- If the participant notifies the plan sponsor of the failure, the first payroll on or after the last day of the month following the month that notification is made.

However, if the deferral deposits begin after the 3-month grace period ends but within 2 years of the end of the plan year in which the operational failure occurred, the employer must deposit a QNEC of 25 percent of the missed deferral, 100 percent of the match for the entire deferral that should have been withheld, plus earnings.

In order to use this correction method, the plan sponsor must provide a notice of the failure to the affected participants no later than 45 days after the date the correct deferrals begin.

Components of required notice

The notice required by the second option must contain:

- General information relating to the failure, such as the percentage of eligible compensation that should have been deferred and the approximate date that the compensation should have begun to be deferred;
- A statement that appropriate amounts have begun to be deducted from compensation and contributed to the plan;
- A statement that corrective contributions have been made (or will be made);
- An explanation that the affected participant may increase his or her deferral percentage in order to make up for the missed deferral opportunity, subject to applicable limits under Section 402(g); *and*
- The name of the plan and plan contact information (including name, street address, e-mail address, and telephone number of a plan contact).

In most cases, the dollars involved in the correction of missed deferral deposits are not substantial, and employers choose the 50 percent or the 25 percent correction options based on their management style and whether they favor administrative simplicity or full transparency. Both methods are approved by the IRS through EPCRS.

Auditors, third-party administrators, Employee Retirement Income Security Act (ERISA) counsel, and investment advisers generally are all willing and able to collaboratively assist employers that inadvertently omit a deferral election change.

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interest crediting rate. This rate formula in a CB plan hasn't commonly been a function of the investment earnings that subsequently are earned by the trust.

There has been increasing interest in CB plans among plan sponsors because they are subject to DB plan compliance rules. DB plans can be structured to provide benefits greater in value than the maximum benefits available under DC plans.

The posting of this IRS Issue Snapshot followed the release of Revenue Procedure (Rev. Proc.) 2018-21 earlier this year (see related May column), which permitted providers of preapproved DB plan documents to include a choice of an interest crediting rate based on the actual rate of return in a CB plan.

One of the biggest challenges facing an employer sponsor of a CB plan comes from managing the investment of assets to generate returns that balance the liabilities generated by the interest crediting rate part of the benefit formula. Using the actual rate of return is seen by some practitioners as a useful design to meet this challenge.

While there does seem to be some consensus that this is true for large plans, there remains a fair amount of skepticism about how well using the actual rate of return will succeed for small plans. This skepticism centers primarily on the various compliance tests applicable to CB plans and relatively higher volatility in discrimination test results in a CB plan with few participants.

CB plans have increased in popularity, as the IRS has issued more guidance and clarifications on what is or is not permissible. Now that the regulatory environment is sufficiently stable, current and potential plan sponsors are more comfortable with the CB plan concept.

Similarly, practitioners such as actuaries, benefits attorneys, investment managers, financial advisers, third-party administrators (TPAs), and other retirement plan professionals are now better able to explain and to provide guidance to plan sponsors on the CB plan's impact on the plan sponsor.

Preapproved plan provisions

Preapproved plans include plan provisions that are in common use. These are a very large subset of the plan provisions permitted by IRS regulations, but preapproved plans do not encompass all possible permissible plan designs. A common goal of the IRS and preapproved plan document providers is to agree on a set of choices that, taken together, create a plan designed to comply with the regulations and to be operated in compliance with them, as well.

Plan sponsors and practitioners should pay careful attention to the language included in the preapproved plan adoption agreement and basic plan document. The plan document may include constraints on plan design that are more stringent than constraints in existing IRS regulations.

For example, provisions related to the choice of an interest crediting rate using the actual rate of return within a preapproved plan should be expected to address the assets on which the rate is based, to specify that the assets be sufficiently diversified to temper the overall volatility of returns, and to specify that the actual rate of return will include all actual returns, whether positive or negative.

Investment parameters

If the CB plan document includes provisions that set parameters related to the investment of the assets (such as diversification), the plan sponsor and investment fiduciaries should be certain to consider those parameters in structuring the investment of the trust assets. A failure to do so could result in a finding of a failure to follow plan provisions.

A small plan using the actual rate of return can have compliance issues in operation by investing too successfully. The CB plan interest crediting rate is used to project a participant's current hypothetical account balance to his or her normal retirement date. The projected amount is converted into an equivalent benefit payable annually.

If the rate is very high, the projected benefits will be very high. In small plans, most of the benefits belong to highly compensated employees (HCEs), so the inflated benefits can cause problems with nondiscrimination testing. Because most CB plans are established alongside a 401(k)/profit-sharing plan that provides more of the benefits to the non-highly compensated employees (NHCEs), the inflated benefits in the CB plan can cause very large fluctuations in the profit-sharing contributions needed to pass nondiscrimination testing.

A small plan using the actual rate of return also can have compliance issues in operation by investing poorly. A CB plan must accumulate hypothetical account balances at least equal to the payroll credits given. The cumulative effect of positive and negative actual rates of return cannot be negative. If the cumulative return is negative, the plan sponsor may have to make

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contributions to cover the principal amount of the payroll credits.

One concern with the availability of an actual rate of return in a preapproved plan document is when the practitioner assisting a plan sponsor doesn't understand the potential risks to the plan sponsor of making that choice. Many practitioners know of instances where choices were made in a preapproved plan without their implications being fully understood by the plan representative who was completing the adoption agreement. In a CB plan, an incorrect choice of an interest crediting rate during times of market volatility can be financially devastating to the plan sponsor. The plan sponsor should choose a knowledgeable document provider carefully.

The IRS recognizes that including actual rates of return as an option in preapproved plan documents will lead to more plans using this method. This, in turn, will increase the number of existing plans that will change their interest crediting rate to a method that can result in a decrease in the rate. The IRS Issue Snapshot provides the alternative methods that the plan can use if there is such a change. Note that the Issue Snapshot does not specifically address a plan that chooses to use the actual rate of return.

The Issue Snapshot notes that the "right to interest credits in the future that are not conditioned on future service constitutes a protected benefit under IRC Section 411(d)(6)."

Two approaches

The IRS discusses two approaches to address a change in the interest crediting rate.

The first approach is called the "A plus B method." In this method, there is a separate accounting for the balance accrued before the change ("A") and the balance accrued after the change ("B"). A participant's total account balance is A plus B. The balances in the A account continue to use the old interest crediting rate, and the balances in the B account use the new, lower interest crediting rate.

The second method is the "wearaway method." In it, there is a separate accounting for the protected balance accrued before the change in the interest crediting rate and for the total balance accrued using the new rate. Once the total balance exceeds the separate accounting of the protected balance accrued before the change in the interest crediting rate, the protected balance is considered to be "worn away."

The IRS Issue Snapshot further addresses a situation in which terminated participants no longer receive any payroll credits. Under the A plus B method, these terminated participants will continue to use the old interest crediting rate. Under the wearaway method, if the combination of the old and the new interest crediting rate falls within the market rate of return rules contained in IRS regulations, the wearaway method could be applied to all participants, including terminated participants.

The Issue Snapshot concludes with a list of "Issue Indicators or Audit Tips." These are directed at plan sponsors, practitioners, and IRS agents:

1. Review any plan amendments to see if they potentially decrease the interest crediting rate.
2. If there are reductions in the interest crediting rate, make sure that the plan protects the interest crediting rate "promise" in effect before the amendment. Either the A plus B or the wearaway approach will accomplish this.
3. Ensure that if the wearaway approach is used, the resulting rate does not exceed a market rate of return for participants who are not actively accruing benefits (in other words, principal credits) as of the date of the amendment.
4. If correction is needed, notify your manager and work with the field actuaries to develop a correction.

Given that the actual rate of return method can be positive or negative for any given year, it would be reasonable to expect that the comments in the new Issue Snapshot will apply to plans that change their interest crediting rate to the actual rate of return method in the current restatement period. For plans adopting the actual rate of return interest crediting rate, the A plus B method will be permitted, but the wearaway method will not.

Look for the IRS to issue further guidance and commentary as CB plans continue to increase in popularity.

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However, plan sponsors and administrators should not wait until 2019 to ensure they are complying with the TCJA and the Budget Act.

Some of the tax-code changes in the TCJA and the Budget Act will require all plan sponsors and administrators to evaluate their administrative procedures now, and possibly make changes to those procedures and ancillary documents, to ensure that their plans are administered in compliance with the plan document, as well as the Internal Revenue Code, as revised by the two acts. This article details three key areas that should be examined now.

Special tax notices

Code Section 402(f) requires plan sponsors to give written explanations of tax implications to recipients of qualified retirement plan distributions eligible for rollover treatment; these often are termed a "special tax notice." The Internal Revenue Service (IRS) periodically has issued model special tax notices that meet the requirements of Code Section 402(f), as well as updates to those models to reflect changes in the law.

When the IRS issued its model special tax notice updated for the Pension Protection Act of 2006 (PPA), it stated in Notice 2009-68 that if "the law governing the tax treatment of distributions or other provisions described in a safe-harbor explanation in this notice is amended after September 28, 2009, the safe-harbor explanation will not satisfy §402(f) to the extent that the safe-harbor explanation no longer accurately describes the relevant law."

As a result, plan administrators have since been on their own to update the special tax notice to ensure it remains accurate in between IRS updates. The IRS last updated the model special tax notices in Notice 2014-74 to incorporate changes in the law since 2009 but, as of yet, has not issued an update incorporating the Code changes made by the TCJA.

The TCJA change extending the period for rollover plan loan offsets (see January story) will require updating the model IRS special tax notice. Many 401(k) plans that allow participants to take loans from their account balances contain an acceleration provision requiring all outstanding loan balances to be repaid at termination of employment. If not repaid, the loan balance will be defaulted, offset against the participant's account balance, and deemed a taxable distribution includable in the participant's income.

The plan is also required to withhold income tax, usually at a flat 20 percent rate, which is deducted from the participant's account, as well, and the withheld amount is also includable in the participant's income for that tax year. The remaining account balance can be distributed to the participant and rolled over to an individual retirement account (IRA) or other qualified plan within 60 days (or directly rolled over in a trust-to-trust transfer).

Before the TCJA took effect, participants who had outstanding loan balances defaulted and offset at termination had 60 days to come up with other funds equal to the outstanding loan balance, plus any amount of tax withholding, and roll those funds into an IRA or other qualified plan willing to accept them.

If the defaulted amount was not rolled over within 60 days (or a waiver of the 60-day requirement was not obtained from the IRS), the offset amount plus any tax withholding amount would be includable in the participant's income for the tax year of the distribution.

The TCJA modified the rollover distribution rules for participants who have experienced a 401(k) loan balance default and offset due to acceleration of the loan at termination of employment. Participants now have until the participant's tax-filing deadline (usually April 15 of the following year or October 15 if extended) to come up with the funds equal to the offset plus tax withholding and make the rollover.

In several places in the 2009 IRS model 402(f) special tax notice as modified by Notice 2014-74, references are made to the 60-day rollover requirement and consequences that flow from failing to make a rollover within that time. Because the TCJA creates an exception to these consequences, the model special tax notice "no longer accurately describes the relevant law" and needs to be updated to avoid any inaccuracies or correct any statements that have now become misleading due to the new legislation.

Many plan administrators rely on their service providers to prepare and provide the special tax notice when processing distributions to participants. But under Code Section 402(f), the plan administrator is ultimately responsible for making the required special tax notice disclosure to the participant and could face a potential breach of fiduciary duty suit under the Employee Retirement Income Security Act of 1974 (ERISA) to the extent a participant relied on any inaccurate or misleading statements.

Consequently, plan administrators should update their special tax notices or check with their service providers to ensure that the appropriate updates have been made.

Compensation definition

It is always a good idea to periodically perform an internal self-audit of a 401(k) plan's definition of

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compensation to verify that the definition matches the administration in the plan sponsor's payroll and reporting system and, consequently, that the correct deferral and matching contributions are being made.

Compensation definitions specify remuneration elements that are either included or excluded when making contribution calculations. Improper treatment of various elements is a common operational error of 401(k) plan administration and a common focus of both the IRS's and the U.S. Department of Labor's (DOL) audit programs. If the plan documents and payroll system do not match, it can be a time-consuming and expensive error to correct. But in the wake of major tax reform legislation, a compensation self-audit can be vital to avoiding costly administrative errors and corrections.

The TCJA made several changes to the tax code that eliminated the ability for employers to deduct and employees to exclude from income certain fringe benefits received by the employees. For example, before 2018, the Code allowed an above-the-line deduction (meaning the amount is excluded from adjusted gross income rather than being an itemized deduction) for employees who incurred moving expenses.

Some 401(k) plans' definitions of compensation distinguish between fringe benefits that are includable in or excludable from gross income and will either be included or excluded from the plan's definition of compensation, depending on which tax category the fringe amount falls into. As a result, plan administrators will need to review their plan's definition of compensation and may need to change the payroll system to reflect whether the moving expense element of remuneration is included or excluded for 401(k) plan purposes if it is no longer excludable from taxable income.

Hardship distributions

The Code allows 401(k) plans to make hardship distributions to participants who experience an immediate and heavy financial need. In the 401(k) regulations, the IRS has identified six circumstances, known as "safe harbor" hardships, that are deemed to meet the requirements of being an immediate and heavy financial need. Plan sponsors may allow hardship distributions for any of these six reasons without conducting an independent evaluation of whether such a need exists.

Plans also may allow hardship distributions for other reasons (if the plan document so provides), but the plan administrator must make an independent assessment that the reasons the participant cites are actually necessary to meet an immediate and heavy financial need. Some plan sponsors have decided not to undertake this analysis and limit hardship distributions exclusively to the six safe harbors.

In light of the TCJA, however, plan sponsors that have limited their hardship distributions to the safe harbors now must change their hardship distribution processes for casualty-related home repair expenses due to an indirect change in the Code.

Treasury Regulation Section 1.401(k)-1(d)(3)(iii)(B)(6) provides that a distribution is deemed to satisfy a participant's immediate and heavy financial need if the distribution is for "expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income."

The TCJA did not directly amend the 401(k) hardship distribution options, but it did change Code Section 165, on which the home repair expense hardship safe harbor relies. The change limits the types of casualty losses that will meet that hardship safe harbor. (See April story.)

Before the TCJA, Code Section 165 covered a wide range of casualty losses. Revisions to that Code section made by the TCJA now limit casualty losses to those attributable to a presidentially declared disaster, such as a hurricane, flood, or wildfire.

The real consequence of the enacted change, however, is that administrators of 401(k) plans that rely exclusively on the safe-harbor reasons for hardship distributions may no longer make those distributions for casualty-related home repair expenses that are not attributable to presidentially declared disasters.

Another aspect of the 401(k) hardship distribution regulation requires plans allowing these distributions to suspend participants who take a hardship distribution from making salary deferrals for 6 months after the distribution. As part of the hardship distribution revisions enacted in the Budget Act, Congress directed the IRS to remove this 6-month suspension requirement.

Action required now

As a result of all of these changes enacted by the TCJA and the Budget Act, sponsors and administrators of 401(k) plans need to act now to ensure that their plans remain in compliance, even if the required deadline for adopting plan amendments may seem far off.

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