january/february 2012

Retirement PLAN news

Qualified default investment alternatives

The Pension Protection Act of 2006 (PPA) created the qualified default investment alternative (QDIA) largely to promote the use of automatic enrollment arrangements in 401(k) plans.

The QDIA provides a safe harbor from fiduciary risk for plan sponsors that choose investments for participants who are either automatically enrolled or who fail to make their own investment decisions. Employers that provide a QDIA for employees who fail to direct their own investments will have no legal liability for market fluctuations or investment outcomes when the QDIA regulations are followed.

The Department of Labor's (DOL's) QDIA regulations became effective December 24, 2007, just in time for the 2008 debut of the eligible automatic contribution arrangement and the qualified automatic contribution arrangement.

The QDIA

PPA's goal is for the QDIA to meet workers' long-term retirement savings needs and not just preserve capital. Rather than specify certain investment products, the final QDIA regulations spell out "mechanisms" for investing participant contributions. Investment categories that qualify as QDIAs include:

- A product with a mix of investments that takes into account the individual's age, retirement date, or life expectancy (for example, a lifecycle or target retirement date fund);
- A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (for example, a balanced fund);
- An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (for example, a professionally managed account); and
- A capital preservation product, but only for the first 120 days of participation. After 120 days, the plan fiduciary must redirect the participant's investment into one of the other QDIA categories (unless the participant opts out of the plan or redirects his or her investments during the first 90 days).

Variable annuity and other pooled investments. The QDIA may be offered through variable annuity contracts or through pooled investment funds, provided the QDIA regulations are satisfied.

Grandfathered stable value funds. Plans that used stable value products as default investments prior to December 24, 2007, were permitted to leave those funds in the stable value products. No fiduciary relief is provided for default contributions made to stable value products after that date.

ERISA supersedes state law. The PPA and the final QDIA rules provide that ERISA supersedes any state law that would prohibit or restrict automatic contribution arrangements, regardless of whether such arrangements qualify for the safe harbor.

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2012 COLA limits

The IRS has released the cost-of-living adjustments applicable to the dollar limitations for pension plans (and other items) for the 2012 tax year. Limits related to retirement plans increased for the first time since 2009.

IRS Limits	2012	2011
401(k), SARSEP, 403(b), and 457 plan deferrals/catch-up	$17,000/ $5,500	$16,500/ $5,500
SIMPLE plan deferrals/ catch-up	$11,500/ $2,500	$11,500/ $2,500
Compensation defining highly compensated employee*	$115,000	$110,000
Compensation defining key employee/officer	$165,000	$160,000
Defined benefit plan limit on annual benefits	$200,000	$195,000
Defined contribution plan limit on annual additions	$50,000	$49,000
Maximum compensation limit for allocation and accrual purposes	$250,000	$245,000
IRA contributions/catch-up	$5,000/ $1,000	$5,000/ $1,000

* 2011 amount for use in 2012 plan year tests

Traditional IRA changes. There also are changes in 2012 to the adjusted gross income (AGI) "phaseout" limits for determining what portion of contributions to a traditional IRA are deductible. For taxpayers who are active participants filing a joint return (or qualified widow(er)s), the deduction begins to phase out with a combined AGI of $92,000 (up from $90,000). For taxpayers other than "married filing separate returns," the deduction phaseout begins at $58,000 AGI (up from $56,000). For a taxpayer who is not an active participant but whose spouse is an active participant, the deduction phaseout begins at a combined AGI of $173,000 (up from $169,000).

Roth IRA changes. There is also an AGI-based limitation for determining the maximum Roth IRA contribution. For married taxpayers filing a joint return (or qualified widow(er)s), the contribution phaseout begins at $173,000 (up from $169,000). The AGI phaseout for single taxpayers begins at $110,000 (up from $107,000).

Qualified default investment alternatives

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Additional QDIA requirements

Following are summaries of other key requirements:

- Generally, a QDIA may not be invested in employer securities.
- A plan may not restrict participants from transferring the funds in a QDIA to any other investment alternative available under the plan. The transfer must be permitted with the same frequency that applies to other plan investments but *not less than* quarterly.
- A QDIA must be managed by an investment manager, a plan trustee, a plan sponsor who is a named fiduciary, or an investment company registered under the Investment Company Act of 1940.

Fiduciary relief

For the safe harbor protection to apply, employers must satisfy the following conditions:

- Assets must be invested in one of the QDIA investment categories.
- Participants must have had the opportunity to direct their investments but failed to do so. If a participant files an investment directive later, that directive will supersede the QDIA.
- A notice must generally be provided at least 30 days in advance of an employee's eligibility or his or her first investment in a QDIA. A notice must also be filed 30 days in advance of each subsequent plan year.
- Investment materials for the QDIA (i.e., prospectuses, account statements, etc.) that are provided to the plan must also be furnished to participants invested in the QDIA.
- No surrender charge, liquidation or exchange fee, redemption fee, or similar expense will be charged to a participant who switches from a QDIA to another investment during the first 90 days after his or her first automatic enrollment deferral is withheld and invested in a QDIA. However, ongoing fees related to the operation of the investment *may* be charged. After the 90-day period, restrictions, fees, and expenses of the plan will apply.
- The plan must offer a "broad range of investment alternatives," as defined in the regulations in ERISA Section 404(c).

Note: The DOL has proposed regulations regarding participant-level fee disclosures for target date funds and target date funds that are QDIAs. More information will be provided when regulations are finalized.

Early distribution penalty: Exceptions to the rule

To help discourage participants from using their retirement savings for purposes other than their retirement, the law imposes a penalty tax on certain early distributions. Early distributions are generally defined as amounts distributed from qualified retirement plans or traditional IRAs before the age of 59½.

The taxable amount of *any* distribution must be included in the participant's gross income for the year. If it's an *early* distribution, the participant may have to pay an additional 10% early withdrawal penalty on the taxable portion.

Not all distributions from qualified plans and traditional IRAs prior to age 59½ are subject to the 10% excise tax. The exceptions are outlined below.

Exceptions to the 10% penalty on distributions prior to age 59½

Reason for distribution QP = qualified plan, IRA = traditional individual retirement account	Exception? QP	Exception? IRA
Separation from service in or after the year that the individual reaches age 55	Yes	No
Disability (as defined in IRC Section 72(m)(7))	Yes	Yes
Payments made on or after the participant's death	Yes	Yes
First-time home purchase — up to $10,000	No	Yes
Roth conversion, provided the conversion remains in the Roth IRA for five years	Yes	Yes
IRS tax levy	Yes	Yes
"Qualified" post-secondary education expenses	No	Yes
Payment of unreimbursed medical expenses exceeding 7.5% of AGI	Yes	Yes
Hardship withdrawal, deemed loan, plan termination	No	N/A
QDRO distribution paid to alternate payee	Yes	N/A
Transfer of IRA incident to divorce	N/A	Yes
Corrective distributions: excess deferrals, excess annual additions, ineligible employees, etc.	Yes	N/A
Corrective distributions: excess IRA contribution paid prior to tax-filing due date, including extensions Note: Earnings distributed are subject to 10% penalty	N/A	Yes
Qualified disaster distributions, for limited geographic areas (as declared by President or defined in law) and for a limited time	Yes	Yes
Permissive withdrawals from an eligible automatic contribution arrangement	Yes	N/A
Qualified reservist distribution (individual called into active duty for more than 179 days)	Yes	Yes
Payment of health insurance premiums, provided conditions are met	No	Yes
Distribution of dividends passed through under an ESOP	Yes	N/A
Distribution of employer securities with net unrealized appreciation (NUA) if NUA is excluded from gross income; NUA is exempt from 10% penalty	Yes	N/A
Substantially equal payments paid in accordance with Rev. Rul. 2002-62	Yes	Yes
Distribution after participant/IRA owner reaches age 59½	Yes	Yes

For more information:

- Consult your plan document
- See IRS Publication 575, *Pension and Annuity Income*
- See IRS Publication 590, *Individual Retirement Arrangements (IRAs)*

RECENT developments

Second restatement cycle begins

Preapproved defined contribution plans (i.e., master and prototype documents and volume submitter defined contribution plans) must be redrafted, reviewed and approved by the IRS, and readopted by employers every six years. The first IRS preapproved document restatement cycle (EGTRRA restatement) came to a close in 2010, and the second restatement process has begun. The IRS is now reviewing documents that have been drafted in accordance with the Cumulative List for 2011, which includes provisions from the Pension Protection Act of 2006 (PPA), additional law changes, and subsequent guidance. In the spring of 2014, the IRS will formally announce the approval of plans and set the deadline for employers to readopt their plans. The time period to restate for PPA is expected to be about two years.

Electronic disclosure guidance

The Department of Labor (DOL) has issued an interim policy regarding the use of electronic media to satisfy the upcoming new participant fee disclosure regulations. The regulations require sponsors of participant-directed individual account plans to provide participants and beneficiaries with additional information about plan investments, fees, and expenses.

The guidance provided in Technical Release (TR) 2011-03 provides rules for plans regarding the electronic communication of investment-related disclosure requirements. Several methods are offered for furnishing information electronically. The release also provides rules for disclosures that are included in pension benefit statements and for disclosures that are *not* included in pension benefit statements.

Priority Guidance Plan

Each year, the U.S. Treasury Department and the IRS issue a Priority Guidance Plan to identify and prioritize tax issues that should be addressed. The list focuses resources on those items that are most important to taxpayers and tax administration.

Topics from the 2011-2012 Priority Guidance Plan that are germane to the retirement plan industry include final regulations on suspending or reducing safe harbor contributions; providing a voluntary compliance program for late filers of Form 5500-EZ; and updating the Employee Plans Compliance Resolution System (EPCRS), specifically to include a non-amender procedure for 403(b) plans. Other goals include issuing preapproved plan procedures for 403(b) plans and developing boilerplate language for drafting preapproved plans.

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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