Guide to
Assigning & Loaning Benefit Plan Money

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4th Circuit Enforces Beneficiary Rights Waiver in DRO

A properly named beneficiary of an ERISA-covered plan may waive his or her right to receive the plan benefit under state domestic relations law, and those waivers can be enforced without interfering with ERISA plan administration, the U.S. 4th Circuit Court of Appeals recently ruled.

The decision is similar to that in a case from the U.S. District Court from the Western District of Michigan, which Contributing Editor Todd Castleton profiled in last quarter's column, but has a broader impact because it was handed down by a federal circuit court. ***Page 2***

401(k) Plan 'Leakage' May Set Balances Back Five Years

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For plan sponsors, the challenge lies in communicating this potential damage to participants who seek access to some of their retirement money before their working years end. Some participants, in fact, harm their ability to save for the long term by taking advantage of early withdrawal features, said independent investment consulting firm Callan Associates in a study called "Sealing Leaks: Addressing 401(k) Leakage and its Impact on Retirement." ***Page 4***

IRS Launches Compliance Project To Probe 401(k) Plan Loan Defaults

IRS' Employee Plan Compliance Unit recently disclosed its intention to investigate whether plan administrators are properly treating and reporting defaulted loans from qualified 401(k) plans. The agency disclosed plans to start this project in a teleconference for practitioners on May 13 to discuss its final report on the Section 401(k) Compliance Check Questionnaire.

In the phone forum, IRS Director of EP Examinations Monika Templeman said some of the data gleaned from the questionnaire caused IRS to be "very concerned in the plan loan area." From 2006 to 2008, 60 percent of 401(k) plans surveyed reported an increase in defaulted loans, while 47 percent of plans had an increase in the number of outstanding loans. ***Page 8***

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Fourth Circuit Enforces Waiver of Beneficiary Rights in Domestic Relations Order

By Todd B. Castleton

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A properly named beneficiary of an ERISA-covered plan may waive his or her right to receive the plan benefit under state domestic relations law, and those waivers can be enforced without interfering with ERISA plan administration, the 4th U.S. Circuit Court of Appeals recently ruled. The decision is similar to that in a case from the U.S. District Court from the Western District of Michigan which we profiled in last quarter's column but has a broader impact, since it was handed down by a federal circuit court.

ERISA-covered employee benefit plans must pay death benefits to a participant's beneficiary who has been properly named under the procedures the plan document outlined, regardless of any state-law claim that the beneficiary had waived his or her right to receive the benefit. This point was made abundantly clear by the U.S. Supreme Court in *Kennedy v. Plan Administrator for DuPont Savings & Investment Plan*, 555 U.S. 285 (2009). The Supreme Court left open the question, however, of whether a plan beneficiary's waiver of his or her right to retain the benefit once it has been distributed from the plan may be enforced against that beneficiary. This was the issue presented to the 4th Circuit in *Andochick v. Byrd*, 709 F.3d 296 (4th Cir. 2013).

Background of the Case

Scott Andochick and Erica Byrd were husband and wife. Erica earned a benefit under her employer's 401(k) and life insurance plans. Erica filed separate beneficiary designations with each of the plans, both naming Scott as the beneficiary. Subsequently, Scott and Erica divorced, and the final divorce judgment incorporated their marital settlement agreement.

The agreement provided that Scott waived all interest in Erica's 401(k) account, death benefit and the life insurance death benefit. The agreement further provided that Scott agreed to complete any documentation required to comply with the agreement. Erica then died before she had filed any new beneficiary designations for the survivor benefits with the 401(k) or life insurance plans.

Both administrators of the plans separately determined that the survivor benefits under each of the plans must be paid to Scott, because he was the properly designated beneficiary under the terms of the plan. This determination was consistent with the Supreme Court's decision in *Kennedy.* Erica's parents, the Byrds, as the administrators of her estate, appealed the administrators' decisions.

The administrator of the 401(k) plan affirmed its decision, but the life insurance plan administrator could not reach a decision and stated it intended to file an interpleader action, which would deposit the benefit with a court and have the court determine who was the rightful recipient.

Scott refused the Byrds' request to sign waivers of the benefits under the terms of the final divorce judgment. Instead, Scott filed an action in the U.S. district court in

See *Plan Documents Rule*, p. 3

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Plan Documents Rule (continued from p. 2)

Virginia seeking a declaration that the waiver provisions in the final divorce judgment were preempted by ERISA and, therefore, unenforceable against him. In response, the Byrds filed an action across the Potomac River in Maryland state court to enforce the waivers in the final divorce judgment. The Maryland court found Scott in contempt of the final divorce judgment, and ordered him to relinquish any interest in Erica's plan benefits.

The Byrds returned to federal court in Virginia — which had stayed its proceedings until the Maryland court action was resolved — seeking to dismiss Scott's declaratory judgment action. The district court agreed with the Byrds and directed the plan administrators to pay the benefits to Scott. At the same time, the court required Scott to waive his claim to these benefits and distribute them to Erica's estate according to the state court's order. Scott appealed this decision to the 4th Circuit.

> It remains crystal clear that plan administrators must pay benefits according to the terms of the written plan document and participants' beneficiary designations properly completed in line with those terms.

The 4th Circuit agreed with the district court that the Supreme Court's *Kennedy* decision required the plan administrators to pay the benefits to Scott, because Scott was the only beneficiary properly named according to the terms of the ERISA-covered plans. But that was not the end of the analysis of whether Scott could keep the benefit.

The 4th Circuit noted that the *Kennedy* decision was based on three important ERISA objectives:

1) simple plan administration;
2) avoiding double liability for plan administrators; and
3) ensuring that plan beneficiaries receive their benefit quickly, without the nonsensical administrative dealings caused by vague rules.

None of these ERISA preemption concerns would be infringed, the appellate court found, by allowing post-distribution actions to enforce a state-law waiver.

In particular, the 4th Circuit found that enforcement of the waiver does not prevent the ERISA beneficiary from quickly receiving the benefit; it merely prevents him from keeping what he quickly received. The court cited a case with nearly identical facts from the 3rd Circuit, *Estate of Kensinger v. URL Pharma, Inc.,* 674 F.3d 131 (3d Cir. 2012), in which the court stated that "the goal of ensuring that beneficiaries 'get what's coming quickly' refers to the expeditious distribution of funds *from plan administrators*, not to some sort of rule providing continued shelter from contractual liability to beneficiaries who have *already received* plan proceeds."

The 4th Circuit also cited several other state law decisions that had reached similar results. Consequently, the 4th Circuit held that ERISA does not preempt post-distribution suits against ERISA beneficiaries, and affirmed the district court order requiring Scott to turn over the benefits to Erica's estate.

Plan sponsors and administrators should find comfort in the *Andochick* decision because federal courts are maintaining the clear obligations of plans to pay benefits according to the terms of their ERISA-covered plan. The courts also are willing to back plan administrators' determinations, and will resolve the claims of competing beneficiaries. But it remains crystal clear that plan administrators must pay benefits according to the terms of the written plan document and participants' beneficiary designations properly completed in line with those terms.

Plan Administration

401(k) Plan 'Leakage' May Set Balances Back Five Years, Report Says

Participants who engage in the various forms of 401(k) plan "leakage" — which include cashouts, hardship withdrawals and loans — may experience the same financial impact as if they delayed contributing to a plan for five years, according to a research report obtained by Thompson Information Services.

For plan sponsors, the challenge lies in communicating this potential damage to participants who seek access to some of their retirement money before their working years end.

The opportunity to borrow or make taxable early withdrawals from 401(k)s was built in to these defined contribution plans to attract workers to them when the plans started gaining prominence in the early 1990s. But some participants, in fact, harm their ability to save for the long term by taking advantage of these features, said independent investment consulting firm Callan Associates in a study called "Sealing Leaks: Addressing 401(k) Leakage and its Impact on Retirement." The report is available to Callan clients at http://callan.com/research/papers.

Callan, whose report is based on research from its own DC practice leader and the Employee Benefit Research Institute, looked at the impact of leakage factors on workers' ability to retire with sufficient savings, scrutinizing in particular practices related to leakage by those in the lowest-income quartile. The researchers defined "retirement success" as the replacement of approximately 80 percent of income in retirement through a combination of 401(k) accumulation and Social Security.

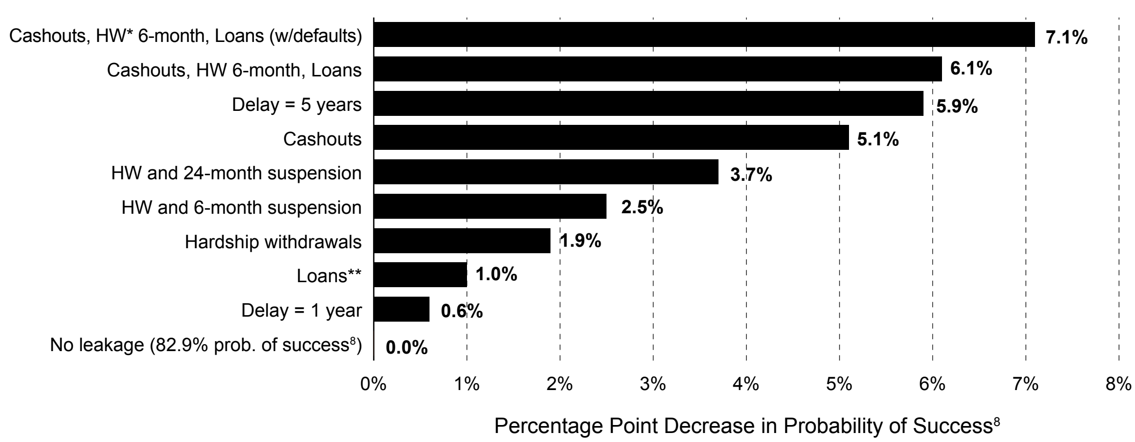
Measuring the Impact of Leakage

The researchers found that:

- Cashouts alone, which more than 40 percent of terminated plan participants chose instead of rolling their balances into a new retirement savings structure such as an individual retirement account or leaving their balances in their existing 401(k) plans, reduce by 5.1 percent the probability of workers' ultimately replacing 80 percent of income.
- Hardship withdrawals, which under IRS regulation require at least a six-month suspension of employee contributions, can be expected to damp workers' chances of replacing most of their income in retirement by as much as 3.7 percent.
- Loans, assuming no default by participants, were found to have only a "modest" impact on worker income-replacement potential, lowering it by just 1 percent.

See *Leakage*, p. 12

Impact of Leakages For Automatic Enrollment Plans: *Lowest income quartile*



Source: EBRI/ERF Retirement Security Projection Model, versions 100810a1-100810a16.

* HW=Hardship withdrawals.

** Assumes money being loaned comes from fixed income and not equity, and that there are no defaults.

Wells Fargo Finds More Older Workers Took Plan Loans in 4Q

Although many 401(k) plans offer participants loans, a statistic that plan sponsors don't want to see is the number and size of those loans increasing. But some of them are seeing just that, according to Wells Fargo.

A recent study by the banking company of fourth-quarter 2012 activity at the defined contribution plans it administers found an increasing number of participants taking loans out of their retirement savings, with those in their 50s leading the increase. Twenty-eight percent more participants in Wells Fargo 401(k) plans had new loan balances compared with the same period in 2011, and balances rose 7 percent to an average of $7,126 from $6,662 that quarter the year before.

The success of a 401(k) plan depends on employee participation, particularly that of non-highly compensated employees. If employees are told that their funds will be tied up until termination of employment, they may be less likely to participate than if they can have access to the funds during employment. A plan loan program may provide that type of encouragement and at the same time avoid the disadvantages of in-service withdrawals such as adverse tax consequences and depletion of retirement savings.

Plan loans that participants can repay offer the employee a chance to use his or her money without terminating employment or permanently depleting retirement savings. (See ¶460-¶469 in the *Guide to Assigning and Loaning Benefit Plan Money* for more about starting and administering a 401(k) plan loan program.)

Most Borrowers in Their 50s

Among the 1.9 million eligible participants in Wells Fargo-administered DC plans, the largest number — 34.2 percent — of those taking out new loans in the fourth quarter were workers in their 50s, followed by 28.9 percent in their 60s. Participants in their 40s comprised 27.3 percent of workers with new loan balances, Wells Fargo said in a press release April 11.

Overall, nearly one-fifth of participants with money in the company's 401(k) plans had at least one outstanding loan at the time of the study, with an average balance of $7,764. As might be expected, the younger the participant, the greater the loan tends to be as a percentage of his or her 401(k) account balance. Those under 30 relied on plan loans to a lesser extent; just 9 percent of them held an outstanding balance, according to Wells Fargo's research.

"The increased loan activity, particularly among older participants, is concerning because those are the years when workers can start to make 'catch-up' contributions and really need to focus on preparing for retirement," Laurie Nordquist, director of Wells Fargo Retirement, said in the press release. "However, we know that this age is also the 'sandwich' generation, caught between paying for their kids' education and supporting elderly parents, which makes saving for retirement even more challenging."

Nordquist expressed more concern about the so-called leakage occurring when employees cash out their 401(k) savings when leaving an employer than she did about the loans. "Those dollars are often spent, whereas with loans funds are often repaid and stay in the retirement nest egg," she said.

Employee Contributions Up

Plan sponsors and administrators can be encouraged by the Wells Fargo finding that people are contributing more of their income to their 401(k) now. In the fourth quarter, the company reported a decrease of 1.8 percent in those deferring 3 percent or less for retirement and growth of 1.3 percent in the number of people contributing 10 percent or more. Many increasing their deferral rates were in their 20s and 30s.

The study also found that 25.2 percent of all 401(k) assets that Wells Fargo administers are in managed investment options, up 4.1 percent from a year ago. But nearly 20 percent of those 65 and older have their entire balance in a single investment. Fourteen percent of participants in that age group have all their money in fixed-income instruments, Wells Fargo said.

Finding out More

Use ¶460-¶469 in the *Guide to Assigning and Loaning Benefit Plan Money* for more information on establishing and administering a 401(k) plan loan program.

Court Decisions

Surviving Spouse DRO Not Qualified if Submitted After Participant Retirement, Court Affirms

It's essential for benefits plan administrators to understand the ultimate goals of their qualified domestic relations procedures: to resolve QDRO determinations in a timely manner and to minimize the extent to which the plan and its administrator become involved in a domestic relations dispute. Once the plan administrator becomes a target in any litigation, the plan risks having to spend time and expense defending itself in court.

A recent state high court decision supporting the assertion by a plan administrator that a surviving spouse's DRO couldn't be qualified because it didn't satisfy ERISA requirements provides an interesting example of a case in which the administrator's action was endorsed. (QDROs originate in state family law courts as DROs. The proposed DRO is then forwarded to the retirement plan's administrator for approval or qualification as a final QDRO.)

The Minnesota Supreme Court recently affirmed a 2012 decision by a state appeals court in *Langston v. Wilson McShane Corp.* (828 N.W.2d 109). It found a DRO issued after a plan participant's retirement requesting distribution to an alternate payee of some or all of a surviving-spouse benefit payable to another beneficiary can't be qualified, because it required plan administrator Wilson McShane to pay a type of benefit not provided in the plan.

This case examines whether surviving-spouse benefits governed by ERISA and provided by a plan vest for the participant's current spouse at the time of the participant's retirement. Also at issue in this case was whether state or federal courts had jurisdiction over the suit filed by the alternate payee.

Background of the Case

Patricia and Gary Langston were divorced in 1993. As part of their divorce, Patricia received a portion of Gary's future pension plan distribution, including survivor benefits. The plan Gary participated in was administered by William McShane for the Twin Cities Carpenters & Joiners. Patricia's lawyer was to draft a proposed QDRO, but didn't do so until 2005. By that time, Gary had remarried and retired.

The plan administrator rejected qualifying the order from Patricia, as the pension was now in "pay status" after Gary's retirement in 2004. In addition, Gary had designated his new wife, Shelly James, as the recipient of his survivor benefits. Patricia's DRO seeking one-half interest in Gary's monthly pension payments was issued in July 2005 by a county district court; Gary died in October of that year. When it reviewed Patricia's DRO, Wilson McShane rejected it but responded that a revised DRO could be submitted permitting her to collect a portion of current pension payments.

Patricia challenged the plan administrator's decision in state district court (*Langston v. Wilson McShane Corp. (Langston I)*, 776 N.W.2d 684 (Minn. 2009), and won her claim to survivor benefits, but that ruling was reversed by the Minnesota Court of Appeals, which held that federal courts had exclusive jurisdiction over Patricia's challenge to the plan's decision. The Minnesota Supreme Court granted review and determined that Patricia was a "beneficiary" able to challenge the plan administrator's decision to not qualify the DRO, and the case was remanded to state district court.

In March 2013, the Minnesota high court affirmed the state appeals court's ruling that the plan administrator was correct to determine that Patricia's DRO couldn't be qualified because it requires the plan to pay a type of benefit not provided by the plan, once the participant retired and his benefits were vested with his current spouse.

"If a QDRO can serve as the basis to change the recipient of surviving spouse benefits after a participant has retired and begun receiving benefits, a pension plan's ability to rely on … actuarial calculations would be undermined," the Minnesota Supreme Court ruling said, in supporting Wilson McShane's decision.

Finding out More

For more information about qualifying and administering DROs when they are submitted after a participant is in pay status, see ¶368 in the *Guide to Assigning and Loaning Benefit Plan Money.*

To review the Minnesota Supreme Court ruling from March 2013, go to: http://mn.gov/lawlib/archive/supct/1303/OPA102219-0327.pdf.

‘Top-Hat’ Executive Benefits Not Protected From Garnishment by ERISA, Court Rules

Creditors of retirement plan participants sometimes try to tap into a participant’s supplementary benefits under various legal arrangements, including garnishment and domestic relations orders. If a plan administrator or adviser is faced with the prospect of a participant’s deferred compensation being assigned to a creditor, the administrator must be familiar with a number of complicated tax and ERISA rules to handle the request properly.

Supplemental Executive Retirement Plans, one of several types of supplemental “unfunded” plans known as a “top-hat plans,” sometimes are offered to highly compensated employees and management as part of their compensation package. As such, these plans usually are considered exempt from ERISA anti-alienation provisions. Plan sponsors may opt to offer an anti-alienation provision to employees eligible to participate in its SERP.

However, a judge in the U.S. District Court for the District of Maryland recently ruled in *Sposato v. First Mariner Bank*, (No. 1:2012-cv-01569, March 28, 2013) that such protection for deferred compensation may not be assumed, despite the plaintiff’s argument that his SERP was protected in this way by his former employer.

But because top-hat plans are designated for HCEs, they are exempt from certain ERISA protections, including anti-alienation, Judge Catherine C. Blake reminds in her ruling on the plaintiff’s claim. This finding especially applies to creditors not party to the anti-alienation protection agreement that may exist as a contract between plan sponsor and participant.

Background of the Case

Charles F. Sposato formerly was chairman of Cecil Bank in Maryland and participated in a SERP there. First Mariner Bank brought three actions against Sposato in the Circuit Court of Baltimore City to enforce judgments against him to receive proceeds through garnishment from Sposato’s Cecil Bank SERP as a debt Cecil Bank owes Sposato.

The Baltimore Business Journal reported in November 2011 that Sposato, according to a separate lawsuit filed by First Mariner, borrowed $3 million back in April 2006. First Mariner alleged that Sposato violated the terms of the loan by failing to promptly make payments and to transfer to First Mariner 345,061 shares of Cecil Bancorp stock pledged as collateral. The complaint also alleged that Sposato defaulted on two other loans from First Mariner, one for $2 million and one for $1.5 million. First Mariner won a $3 million judgment in that case.

Sposato, in his case in federal district court against First Mariner, claimed that his SERP benefits aren’t subject to garnishment because of ERISA provisions and also because Maryland’s state law enforcing garnishment can’t preempt federal ERISA regulation.

First Mariner requested that the district court dismiss the case because Sposato’s SERP lacked ERISA protection, and that motion was granted.

> A plan administrator faced with a participant’s deferred compensation being assigned to a creditor must be familiar with complicated tax and ERISA rules.

Judge Blake disagreed with Sposato’s assertion that Maryland law was not applicable in his case. “[Maryland’s garnishment law] does not interfere with the administration of plans like SERP but merely provides a process by which a plan participant’s creditor can access benefits to which they have a lawful claim when the SERP would otherwise distribute to the plan participant,” the judge wrote in her decision.

She also wrote that whether garnishment violates the terms of the Cecil Bank SERP itself and whether those terms are enforceable in this case “is determined by elements of contract law.”

Blake ruled that because Sposato’s SERP benefits are not protected by ERISA, they are “at least partially subject to First Mariner’s writs of garnishment.” Sposato’s requests for summary judgment were denied both on the issue of ERISA protection and partial protection by another law.

Finding out More

To review the Sposato decision, go to: http://www.mdd.uscourts.gov/Opinions/Opinions/Sposato-28Mar2013.pdf.

For further information on assignment of unfunded deferred compensation benefits, see ¶641 in the *Guide to Assigning & Loaning Benefit Plan Money.*

Agency Roundup

IRS Launches Compliance Project to Investigate 401(k) Plan Loan Defaults

The IRS' Employee Plans Compliance Unit recently disclosed its intention to investigate whether plan administrators are properly treating and reporting defaulted loans from qualified 401(k) plans.

IRS disclosed plans to start this project in a teleconference for practitioners on May 13 to discuss its final report on the Section 401(k) Compliance Check Questionnaire. The questionnaire was a compliance project EPCU undertook to explore how plan sponsors were using IRS' compliance tools and what the agency could do to further foster plan compliance with the 401(k) rules. (See related story in May *The 401(k) Handbook* newsletter.)

IRS prepared and sent a questionnaire to a random sampling of employers sponsoring 401(k) plans of all sizes. Those that did not respond voluntarily to the questionnaire were compelled to respond through IRS audit enforcement mechanisms. IRS issued its final report on the questionnaire in March 2013, breaking out the results according to plan size by participant.

'Very Concerned in Plan Loan Area'

In the phone forum, IRS Director of EP Examinations Monika Templeman said some of the data gleaned from the questionnaire caused IRS to be "very concerned in the plan loan area." From 2006 to 2008, 60 percent of 401(k) plans surveyed reported an increase in defaulted loans, while 47 percent of plans had an increase in the number of outstanding loans. Yet, during this same period, there was a decrease in the number of new loans being originated.

IRS officials said they are concerned that this data may indicate that older loans are not being repaid in a timely manner and, consequently, not being properly defaulted and reported.

Another plan loan compliance concern mentioned during the phone forum was whether loan terms set forth in plan documents are being followed. In addition, IRS said it has noticed from other compliance sources such as the Employee Plan Compliance Resolution System and plan audits — that in the wake of the economic downturn, some plan administrators have not been enforcing their limit on the number of loans a participant may have outstanding at one time; some plans are even allowing plan loans when the terms of the plans do not provide for them, the report said.

As a result, EPCU plans to launch a Learn, Educate, Self-correct, Enforce project to examine plan loan compliance, particularly as it relates to defaulted loans. According to the IRS' website:

> LESE examinations are small and quick projects where we select retirement plan returns for examination based on "judgment sampling." They do not involve selection of returns through statistical sampling methods, but the random selection of approximately 50 examinations with one (or more) similar characteristics that we believe may reveal problems. We use the focused examination concept to measure compliance levels of the selected groups' retirement plans.

Because this is a compliance project and not an audit, EPCRS will be available to correct loan and other errors uncovered during the investigation, including self-correction, if applicable.

Do Your Own Compliance Check

Because noncompliant loans from tax-qualified plans are taxable distributions to participants, plan sponsors may want to consider doing a compliance check of their own to determine whether they are meeting IRS requirements. This should include verifying that:

- the administration of plan loans is accurately reflected in the plan document;
- the summary plan description and other participant communications (for example, websites and forms) accurately reflect the plan document's loan terms;
- all plan loans are evidenced by a legally enforceable agreement and the other requirements of Code Section 72(p) have been met;
- the plan is limiting the number of outstanding loans each participant may have, consistent with any plan document limit; and
- loans that are not being repaid are being defaulted by the appropriate deadline specified in the plan document, and the taxable distribution is being properly documented and reported.

The *Guide to Assigning & Loaning Plan Benefit Money's* ¶438 includes a basic loan compliance checklist

See ***IRS Loan Investigation*****, p. 9**

Revised PBGC Booklet on QDROs Provides New Guidance, Model Forms

The Pension Benefit Guaranty Corporation late last year updated its booklet, "Qualified Domestic Relations Orders & PBGC" to simplify the handling of these orders by plan sponsors and administrators whose pensions are under PBGC trusteeship.

A defined benefit pension plan that does not have enough funds to pay benefits may be terminated if the employer-sponsor faces severe financial difficulties, such as bankruptcy, and cannot continue to maintain the plan. In these cases, PBGC — a federal agency created by ERISA — takes over the plan as trustee and pays pension benefits, subject to certain legal limits, to plan participants and beneficiaries. When PBGC takes over a terminated plan, it also administers the QDRO requirements for the affected plans.

PBGC is responsible for guaranteeing the payment of basic pension benefits earned by workers and retirees in private-sector DB plans.

In the updated booklet for practitioners, PBGC has included model QDROs and accompanying guidance. The latest edition includes four main changes from the edition published in September 2009.

1) If a participant already is "in pay status," the agency will not suspend benefits upon receipt of a draft DRO or any pleading intended to add PBGC as a party to a domestic relations action, including a request for joinder, or joining of parties in the order. Instead, PBGC will suspend benefits only upon receipt of an original signed DRO or a certified or authenticated copy.

2) For a participant who is not in pay status, but whose application is pending, the QDRO booklet provides that PBGC will place a hold on putting the participant in pay status upon receipt of a draft order or any pleading intended to add PBGC as a party to a domestic relations action, including a request for joinder.

3) Per the new QDRO booklet, if a separate interest order (an order that divides the participant's retirement benefit (rather than just the payments) into two separate portions with the intent of giving the alternate payee a separate right to receive a portion of the retirement benefit to be paid at a time and in a form different from that chosen by the participant) is silent as to what happens if an alternate payee dies before commencing benefits, PBGC will treat the separate interest as reverting to the participant. The separate interest will not be forfeited to PBGC.

4) The revised booklet also clarifies the options presented to participants and alternate payees in the PBGC model orders.

Finding out More

For additional information on how QDROs are administered when PBGC takes over a terminated plan, see ¶340, Q&A 13, in the *Guide to Assigning & Loaning Benefit Plan Money.*

IRS Loan Investigation (continued from p. 8)

that provides additional information useful to conducting a loan audit.

Other interesting findings from the IRS' final report from its compliance questionnaire include:

- Sixty-five percent of 401(k) plans allowed loans, although that number climbed to 88 percent for plans with more than 2,500 participants.
- A breakdown of various loan interest rates charged by 401(k) plans (see box):

Interest Rate	Plans
Prime Rate	16%
Prime Rate Plus 1 Percent	46%
Prime Rate Plus 2 Percent	19%
Prime Rate Plus 3 Percent	1%
Local Bank Rate	11%
Other Rate	8%

- Ninety-three percent of 401(k)s with loans require repayment through payroll deduction.
- Thirteen percent of 401(k)s allow a participant to continue making loan repayments after termination of employment.

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Finding out More

To read the full Final Report on the 401(k) Compliance Questionnaire's results, go to: http://www.irs.gov/pub/irs-tege/401k_final_report.pdf.

Retirement Industry Counters 'Frontline' Accusations With Data on Plan Participant Fees

Education is often the best antidote to negative news about 401(k) plans. With this in mind, several retirement industry spokesmen have provided statistics to defend retirement plan management practices after the recent airing of a TV documentary that may have concerned some 401(k) participants.

The U.S. retirement investment community was quick to react to the April 23 Public Broadcasting Service "Frontline" program "The Retirement Gamble," which raised questions about how America's financial institutions protect retirement savings. The show focused on the "bewildering and frightening challenge for millions of Americans" it says saving for retirement poses. It examined "opaque" investment fees that Frontline correspondent Martin Smith contended chip away at workers' savings over the years to compensate well-paid money managers sometimes hired by their plan sponsors.

The Investment Company Institute responded to the program with an April 23 fact sheet that emphasized the benefits of high-volume institutional investing that most defined contribution plan participants enjoy. Based on its year-end 2012 research with the mutual fund consultancy Lipper, ICI said that because most 401(k) plan participants are offered and favor lower-cost funds, the average asset-weighted expense ratio for participants investing in equity funds was 0.63 percent that year, less than half the 1.4-percent simple average for all equity funds.

The PBS documentary, which referred to "high management fees" 401(k) participants face, said that the average actively managed mutual fund carries an annual expense of 1.3 percent of a 401(k) plan participant's balance, with some funds charging 2 percent and some as much as 5 percent a year.

As ICI continued, "84 percent of 401(k) plan assets in equity mutual funds were invested in funds with expense ratios of less than 1 percent at year-end 2012." Thirty-five percent of 401(k) assets invested in that way were in funds with expense ratios less than 0.50 percent, the industry institute said. "In fact, fees for mutual funds in 401(k) plans have been falling — even as plans offer more and better services to participants — and the fund industry has strongly supported greater transparency for plan fees," the institute said in another fact sheet distributed the day before the show aired.

In general, ICI and other industry advocates stressed the value that 401(k) and other types of plan sponsors and participants derive from the fees paid to manage their investments. "[A]ll retirement savings systems — defined contribution, defined benefit pension or hybrid approaches — involve the payment of fees and expenses for the costs of necessary services," the institute said.

ICI also reminded participants and sponsors that employer retirement plans offer educational materials through mailings, brochures, website information, and tools and calculators, and these have costs as well.

The American Society of Pension Professionals & Actuaries, with more than 8,500 members who provide consulting and administrative services for qualified retirement plans, also reacted strongly to the "Frontline" report.

The organization's executive director and CEO, Brian Graff, said in a news release posted on the ASPPA site April 24 that the program "relied too heavily on a study ["The Retirement Savings Drain: Hidden & Excessive Costs of 401(k)s" by think tank Demos in May 2012] we

See *Frontline*, p. 11

Key Reminders for Plan Sponsors

- Fees pay for services that are valuable to investors.
- Research shows fees for mutual funds in 401(k) plans have been falling recently.
- Defined contribution plan participants benefit from lower-cost funds and shared operating expenses made possible through institutional investing.
- As mutual fund shareholders, plan participants are sensitive to fees in a competitive 401(k) market.
- Critics frequently exaggerate 401(k) fees.
- Plan characteristics, such as size and investment objective, influence plan fees.
- The mutual fund industry supports improving transparency of fees.

Source: Investment Company Institute,"Retirement: Key Facts and Positions, 401(k)s and Fees," April 2013

Check Your Plan Loan Administration For Residential Loan Evidence

By Summer Conley, Drinker Biddle & Reath

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My law firm, Drinker Biddle & Reath, recently handled an issue for a client that highlights the importance of overseeing plan service providers. You may ask why that is true, because service providers are in the business of helping administer retirement plans. A plan sponsor can just assume the plan is being administered correctly, right? The short answer is no — even reputable companies make mistakes.

In this case, the issue related to the administration of participant loans. Many, if not most, 401(k) plans permit plan participants to take loans from their accounts. While plan loans are permitted by the federal tax Code, there are a number of restrictions that apply. If the loan fails to comply with these restrictions, it can result in a "deemed" taxable distribution to the participant and could raise a qualification issue for the plan.

Generally, plan loans must be issued for a term of five years or less. There is an exception, however, if the loan is "used to acquire a dwelling unit which will within a reasonable time be used as a principal residence of the participant." When the loan is used for that purpose, the term may be for a longer period set by the plan or the loan policy; often, the term can be as long as 30 years. But if a residential loan is made, what evidence or documentation should be obtained to establish that the loan is being used for that purpose, and, equally as important, who should obtain it? Is a representation by a participant sufficient?

In the case involving our client, the agreement with the plan service provider indicated that it would obtain documentation necessary to verify the purpose of the loan. Unfortunately, when IRS questioned whether the loans were, in fact, proper residential loans, neither the plan sponsor nor the service provider had detailed records, such as a copy of the purchase agreement or other similar documents. (While there is no explicit requirement for such proof in the Code regulations or other IRS guidance, we are aware of several instances in which IRS raised this issue, indicating that such documentation was necessary to demonstrate that the loan was proper.)

> The plan sponsor should monitor the administrator to ensure that policies and procedures are being followed.

It is not surprising that the plan sponsor lacked the records, because it thought it had delegated the job of obtaining proper documentation to the service provider. At the same time, the plan sponsor did not know that the service provider also lacked the information.

There are two morals to this story, one of which is obvious and the other of which is less so.

The first is that plan sponsors should check their loan practices and procedures to make sure that appropriate evidence (beyond a participant representation) is being obtained in connection with residential loans. Plan sponsors may address loan procedures in one of two main ways:

1) the plan sponsor may develop policies and procedures that it follows in-house in administering loans; or

2) the plan sponsor may rely upon a third-party administrator to adopt and implement policies and procedures for administering loans.

The second moral is that even if it is relying on the TPA, the plan sponsor should monitor the administrator periodically to ensure that the policies and procedures are actually being followed.

Frontline (continued from p. 10)

debunked when it first came out about a year ago that overstated typical 401(k) plan mutual fund fees."

Aon Hewitt, a global retirement consulting firm, also defended employer plan sponsors after "The Retirement Gamble" was seen by many plan participants. In a press release issued April 26, Aon Hewitt said, "larger plans have been able to leverage their scale to provide tools and investments at much lower costs than available outside the of the retail market. Our research shows employees who participate in an employer-sponsored retirement plan are significantly more prepared to meet their savings goals in retirement."

Leakage (continued from p. 4)

- But taken together, these three actions were found by the researchers for the Callan report to cut by 6.1 percent workers' probability of replacing 80 percent of their income — roughly the same blow to the likelihood of retirement financial success that would come from a five-year delay in participating in a plan at all.

The researchers' analysis applied only to plans with auto-enrollment and auto-escalation, and to employees with at least 30 years of eligibility.

The Callan study, using 2010 data, said just over one-fifth of DC plan participants eligible for loans have one outstanding, with a mean value borrowed of about $6,850, or 14 percent of the average account balance.

Steps Sponsors Can Take to Reduce Leakage

"(L)eakage in DC plans can be an insidious drain on retirement income over time, and should therefore … be a primary concern," the Callan report said. It affirmed efforts by policymakers and plan sponsors to focus on improving plan participation, especially via auto-enrollment and automatic employee contribution escalation, which have demonstrated the ability to make participants save earlier and more.

The report urges sponsors to prioritize addressing the causes of leakage in retirement savings through plan design and proactive communication. "(P)lan sponsors can stem considerable damage caused by leakage" in these ways, the Callan report continued.

It also suggested the findings in the 401(k) report can be extrapolated to other plan types.

Thompson's *The 401(k) Handbook* also offers these basics on administering a plan loan program:

- Many plans limit the number of hardship withdrawals that an employee can make during a particular period, process withdrawals only at the end of a plan quarter and establish a minimum withdrawal amount.
- Most plans also allow employees to designate the investment vehicle from which the withdrawal is to be made.
- Although a plan may charge an administrative fee for processing withdrawal requests, most plans do not.
- Hardship withdrawals generally are includable in the employee's income, and are subject to an additional tax of 10 percent of the taxable amount if the withdrawal is made before the employee attains age 59½ or becomes disabled or uses such amounts for deductible medical expenses (see ¶263 in the *Handbook* for more information).
- The amount of the hardship withdrawal must be reported on the Form 1099-R issued to the employee (see ¶536).
- Plans are not required to offer hardship withdrawal provisions. Even if they do provide for such withdrawals, plans may choose to drop the provision.

Finding out More

For further guidance on establishing a plan loan program, see ¶460 of the *Guide to Assigning & Loaning Benefit Plan Money.*

Subject Index, Vol. 22

This index covers the *Assigning & Loaning Benefit Plan Money* newsletter Vol. 22, Nos. 1-2. It is arranged by subject. The numbers following each entry refer to the volume, issue and page numbers of the newsletter in which information on that topic appears. For example, the designation "22:2/6" indicates Vol. 22, No. 2, Page 6.