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Retirement PLAN news

HEART Act clarifications

The IRS recently provided guidance (IRS Notice 2010-15) on the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act), which affects qualified plan rules for individuals called into qualified military service (QMS). The guidance clarifies certain HEART provisions and reinforces others.

The HEART Act created a new tax code section (IRC Section 401(a)(37)). It provides that survivors of a plan participant who dies on QMS will be entitled to any additional benefits — other than benefit accruals relating to the participant's period of qualified military service — that would have been provided had the participant resumed employment and then terminated on account of death. Benefits include service credit, ancillary life insurance benefits, and other survivor benefits that are contingent upon a participant's death and vesting.

Vesting service

HEART requires that participants killed on QMS be treated as having returned to employment the day before their death and that vesting be provided accordingly; just as if the individual had died while he or she was employed. In almost all defined contribution (DC) plans, this will result in 100% vesting. However, that may not be the case in defined benefit (DB) plans, which often do not fully vest upon death. Although credit will be given as if the employee had died while employed for the purpose of vesting percentages, the plan is not required to include the participant's period of QMS when determining the amount of death benefits for either a DB or a DC plan. However, the plan may opt to do so.

If a participant is not entitled to reemployment rights under USERRA, then the survivor benefits under the HEART Act do not apply.

The Notice also clarifies that the plan does not have to provide 100% vesting for service members who become disabled on QMS, although it may choose to do so.

Differential wage payments

Under the HEART Act, differential pay is considered compensation. Any individual receiving differential wage payments will be treated as an employee of the employer making the payment. Thus, if an employee on QMS is already a plan participant, his or her differential wage payments are considered compensation for qualified plan purposes, such

as employer allocations and elective deferrals. (Note: Differential pay was an option in the final 415 regulations plan amendment and, thus, has already been either included or excluded in the plan's definition of compensation.)

Contributions resulting from differential wage payments may be included in nondiscrimination testing. However, this is not permitted — nor desired — if the amounts will cause the testing to fail. If these amounts are included in testing, they must be included for all employees receiving differential wage payments.

Qualified reservist distributions

The qualified reservist distribution (QRD) was created by the Pension Protection Act of 2006 (PPA) and made permanent by the HEART Act. It is a

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Exception to the early withdrawal penalty

Qualified plan distributions paid to participants who are younger than age 59½ are generally subject to a 10% excise tax. There are several exceptions to the age-59½ rule, however, most notably the exception for distributions paid to *terminated* participants age 55 or older.

Under Code Section 72(t)(2)(A)(v), payments made to qualified plan participants who have separated from service with their employer *during or after* the year they reach age 55 are exempt from the 10% early withdrawal penalty. Here are some practical examples:

Example 1: Participant severs employment after age 55

John terminates employment on March 15, 2010, and elects to receive a lump-sum distribution of his 401(k) balance. He is age 57. John's distribution will not be subject to a 10% excise tax because he separated from service after attaining age 55.

Example 2: Participant severs employment before age 55; requests distribution after age 55

Henry separates from service in 2007 at age 52. He reaches age 55 on February 28, 2010, and calls his employer to request a distribution. Henry asks if the 10% early distribution penalty applies now that he is 55 years old and is disappointed to learn that it does. Why? Because the 10% penalty is waived only for those participants who separate from service in the year they attain age 55 or thereafter. The fact that Henry did not receive the actual distribution until after age 55 is irrelevant. (He must wait until after age 59½ to avoid the penalty.)

Example 3: Participant severs employment at age 55

Rebecca leaves her job on March 19, 2010, but will not be 55 years old until December 8, 2010. She withdraws her entire 401(k) balance on October 26, 2010. She had not yet attained age 55 at the time of severance nor at the time of the distribution. Will the 10% penalty apply?

No. The IRS clarified (Notice 87-13 Q&A 20) that distributions paid to a qualified plan participant who severs service during or after the year in which he/she reaches age 55 are exempt from the 10% early withdrawal penalty.

Example 4: Participant severs employment after age 55 and directly rolls over account to an individual retirement account (IRA)

Bret retires at age 56 and directly rolls over his entire 401(k) balance into a traditional IRA to avoid the 20% mandatory federal income-tax withholding. Bret will have to wait until he reaches age 59½ to withdraw funds from the IRA without penalty because the rule waiving the 10% penalty after separation of service at age 55 or after applies only to qualified plans and not to IRAs.

HEART Act clarifications

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distribution from an IRA or of deferrals from a 401(k) or 403(b) plan to a member of a military reserve unit that was ordered or called to active duty for a period in excess of 179 days (or for an indefinite period). The QRD must be made between the date of the order or call to active duty and the date the active duty period ends. There is no 10% penalty on QRDs for participants under age 59½.

A QRD or any portion of a QRD may be repaid up until two years after the day the active duty period ends. Whether the QRD is from a 401(k), 403(b), or IRA, repayment may only be made to an IRA as after-tax amounts. Thus, there is no deduction for the repayment (unless it is made within the normal 60-day period allowed for rollovers). Since this is a rollover, it has no impact on the annual IRA contribution limit.

Deemed severance distribution

For distribution purposes, an individual called into active duty is deemed to be severed from employment after 30 days of active duty and may request a distribution of deferrals after that 30-day period. Deferrals are suspended for six months after such a distribution. Deemed severance distributions are eligible rollover distributions subject to the 20% mandatory income-tax withholding. A plan is not required to allow deemed severance distributions. If an individual has a real severance from employment and then returns to the job within six months of taking a distribution of deferrals, he or she can begin making elective deferrals immediately.

If an individual on active duty is eligible for both a deemed severance distribution and a QRD (after 179 days on active duty), the distribution will be treated as a QRD. Thus, there will be no six-month suspension of deferrals or 10% premature distribution penalty.

Remedial amendment period

Plans must be amended for the HEART Act by the last day of the first plan year beginning on or after January 1, 2010. (The deadline for amending governmental plans is January 1, 2012.)

Blackout period and notice

Forms 5500 and 5500-SF have a two-part question about plan compliance with the blackout notice rules. The first part asks if an individual account plan had a blackout period. If the answer is yes, the follow-up question asks whether a blackout notice was provided or if one of the exceptions applied.

The IRS is monitoring compliance with blackout period and notice rules. Here is a review.

Definition of blackout period

A blackout period is defined as a period of more than three business days during which a participant is "temporarily suspended, limited, or restricted" from any one of the following activities:

- Directing or diversifying assets credited to his or her account,
- Obtaining a distribution, or
- Obtaining a loan.

Not every instance of suspended or restricted access is considered a blackout. Here are a few events that are not:

- QDRO (qualified domestic relations order) restrictions on an individual's account
- Restrictions or third-party actions on an individual's account, such as a tax levy or beneficiary dispute of a deceased participant's account
- "Regularly scheduled" restrictions, such as a regularly scheduled freeze on an investment, if it has been disclosed beforehand in an SPD, SMM, enrollment form, or investment material
- Permanent restrictions, such as eliminating loan provisions from a plan or eliminating participant direction of investments
- Restrictions on investment education services

Blackout notice general rules

A blackout notice must be written so the average plan participant can understand it. It must be provided to participants between 30 and 60 calendar days before the last date on which one of the three previously mentioned transactions may be exercised. For example, if the last day participants can make a transaction is June 20 and the blackout period is for 10 days, the blackout notice must be provided between April 21 and May 21.

The notice must include the length of the blackout period and provide beginning and ending dates. The notice may indicate the calendar weeks in which the blackout period begins and ends provided that a toll-free number and/or free website is included so participants can obtain the exact start and end dates. Contact information may be the name, address, and phone number of an individual, or it can be a department name, such as human resources.

The notice must specify only the rights being suspended. For example, if only plan loans are being suspended, then the notice should only address loans.

Some additional points:

- If the dates of the blackout period change after the notice is sent, a second notice must be provided to reflect the change.
- Different restrictions may be included in the same notice. For example, the same notice may be used to announce a 25-day blackout for withdrawals and a 20-day blackout for investment changes.
- Single participant plans are exempt from the blackout notice rules.
- Directors and executive officers are prohibited from trading in employer stock during a blackout period imposed on participants in individual account plans. It is important to note that the restriction applies to stock owned outside of the plan subject to the blackout.

Exceptions to the 30-day notice requirement

In the following cases, notices must be given "as soon as reasonably possible." The 30-day time period may be shortened if:

- Postponing the blackout period would violate ERISA's exclusive purpose rule or prudence rule,
- The blackout period begins due to events that were unforeseeable or circumstances that were beyond the control of the plan administrator, or
- The blackout period occurs solely in connection with a merger, acquisition, divestiture, or similar transaction involving the plan sponsor.

If providing a notice is completely impossible, then none is required.

Blackout notice penalties

A daily penalty of $100 will be imposed for each participant/beneficiary who does not receive a blackout notice. The penalty is imposed on a *per-day late, per-violation* basis. For example, if a plan has 200 participants and the blackout notice is five days late, the penalty would be 200 × 5 × $100, or $100,000. The plan administrator is liable for the penalty; it may not be shifted to the plan.

RECENT developments

Late deferrals

The Department of Labor (DOL) has stated that an overwhelming number of filings in the Voluntary Fiduciary Compliance Program (VFCP) involve late deposits of elective deferrals and loan repayments. Self-correction for these errors is very possible. Between the calculator on the DOL website that allows plans to compute earnings due to the plan on late deposits and the recently finalized rules for the seven-business-day safe harbor for depositing deferrals/loan repayments for small plans,* the correction process has been greatly simplified. Hopefully, a future VFCP update will include criteria permitting self-correction methods for late deferrals and/or loan repayments.

For a number of years, Form 5500 has asked plan sponsors to disclose if any deferrals were deposited late during the year. The 2009 Form 5500 also asks if late deposits were corrected, thus allowing plan sponsors to indicate that the plan has been made whole. This should prevent a common scenario where a plan sponsor reports a late deposit and makes the correction, only to then receive a letter from the IRS and/or the DOL about the need to make a correction.

* Note that if a small plan misses the safe harbor, interest and penalties are calculated from the benchmarked deposit date (usually three to five business days) and not from the end of the seven-day safe harbor period.

EBSA fiscal year 2009 results

The Employee Benefits Security Administration (EBSA) closed 3,669 civil investigations in FY 2009. In over 72% of those cases, the agency found violations and obtained corrections. Criminal offenses involving employee benefit plans led to the indictment of 115 individuals. The agency also recovered $124.5 million for workers and their families by resolving individual complaints through informal resolution procedures. In addition, EBSA handled 365,457 inquiries from the public and conducted more than 1,500 education and outreach events for workers, employers, plan officials, and Congressional members.

Results were also achieved through the agency's compliance assistance programs. The popular Voluntary Fiduciary Correction Program (VFCP) received 1,692 applications from employers, plan officials, service providers, and other fiduciaries to self-correct ERISA violations. The Form 5500 Delinquent Filer Voluntary Compliance Program (DFVCP), which helps plan administrators comply with ERISA's filing requirements, received 26,603 filings.

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