

KRAVITZ Retirement Plan News

Focus on target date funds

The Department of Labor's Employee Benefits Security Administration (EBSA) recently joined forces with the Securities and Exchange Commission (SEC) to publish an investor bulletin regarding target date funds (also known as life cycle funds). The guidance aims to give plan participants and other investors a better understanding of target date funds: what they are, how they operate, and how to evaluate them.

Plan sponsors will also benefit from this guidance. It can help them meet their fiduciary "prudent person" responsibilities by providing a better understanding of fund operations and a clearer picture of the risks involved.

Overview

Target date funds are long-term

investments typically offered in retirement plans (although they are also available to investors outside retirement plans). Target date funds include a mix of investments, including equities, bonds, and other investments, designed to reduce overall risk. As a fund gets closer to its target date, the investment mix is changed, becoming more and more risk averse (i.e., more and more conservative).

This is fitting since a participant nearing retirement will soon need to withdraw money to live on and will have less and less time to recover from any losses that could occur in a volatile market. Ideally, the target date fund concept is a simple way to make professional portfolio management available to participants for the life of the retirement plan.

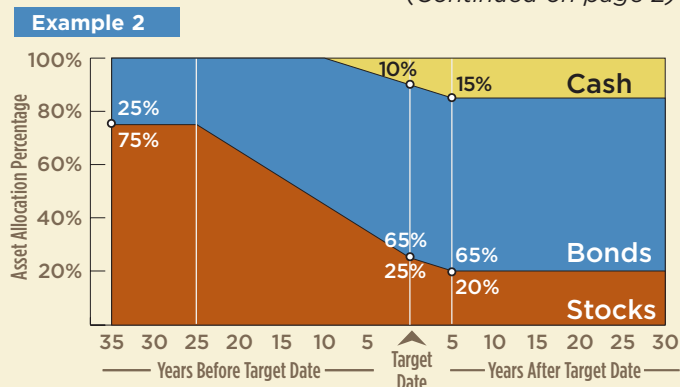
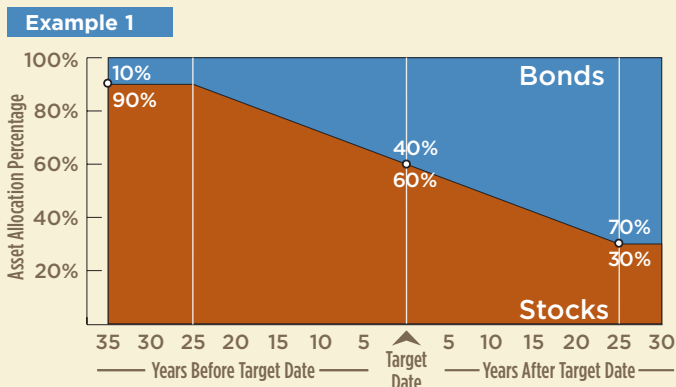
Same target date, very different funds

The EBSA/SEC bulletin stresses, however, that *participants should not rely*

on the fund's target date as the sole criterion for selecting the investment because funds with the exact same target date may have entirely different investment strategies, risks, returns, and fees. Rather, individuals – and, we add, plan sponsors – are urged to evaluate the fund's underlying characteristics to determine whether it meets participants' needs. Further, the plan sponsor, in his or her role as plan fiduciary, must review the fund using the due diligence approach a prudent person would use and evaluate it in light of the goals stated in the plan's investment policy statement. If the fund meets the fiduciary's criteria and is approved as a plan investment, the individual participant will still need to consider whether it meets his or her needs.

The bulletin provides an example (see charts) of the extreme differences that can exist between two target date funds

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Source: <http://www.dol.gov/ebsa/pdf/TDFInvestorBulletin.pdf>



Is it time for a self-audit?

The IRS wants to learn more about 401(k) noncompliance so it can more effectively target plans for examination and bring them into compliance. In May, the Service mailed questionnaires to 1,200 401(k) plan employers randomly selected from the 2007 Form 5500 filings. It also issued a special edition of its *Employee Plans News* to provide an overview of the extensive questionnaire (www.irs.gov/pub/irs-tege/se0510.pdf).

Dear employer

The employers chosen to participate received a letter from the IRS with a password and personal identification number (PIN). The Internet-based questionnaire consists of 69 questions, many of which have multiple parts. The questions are about the 2008 plan year, although data must also be gathered from the 2006 and 2007 plan years. Employers were instructed to return the questionnaire within 90 days. The IRS stated that if an employer did not respond, the result would be further enforcement action, which will likely include an IRS examination of the plan.

What's next?

At recent conferences, IRS representatives have stated that when answers indicate that a plan is not in compliance, the plan will be subject to follow-up. The good news is that if an employer discovered a problem while responding to this questionnaire, the employer could still take advantage of self-correction or voluntary compliance programs to remedy the problem under EPCRS *before* the IRS follows up. The IRS indicated that future recipients will not have this option.

Once results are analyzed, they will be used as part of the examinations program. Plans under examination are not eligible to take advantage of voluntary correction. If significant errors are found, the plans are forced into closing agreements with much higher sanctions.

The next wave of questionnaires (or other IRS examination projects) will be applied to a far larger base of 401(k) plans and, as already stated, will not provide time for employers to self-correct or enter the voluntary correction program.

A step ahead

Given these latest initiatives, this might be a great time for plans to consider conducting self-audits *before* the IRS arrives (in one way or another) for a real audit. The IRS has been promoting the idea of internal self-audit through the 401(k) Fix-It Guide, which can be found on its website at www.irs.gov/ep. Another good self-audit tool would be for employers to go through the 401(k) questionnaire with their plan professionals since there are a number of questions that may indicate noncompliance. The questionnaire (IRS Form 14146) is on the Internet at www.irs.gov/pub/irs-tege/epcu_401k_questionnaire.pdf.

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with an identical target date. When these two hypothetical funds reach their target date, the fund in Example 1 has an asset allocation of 60% stocks and 40% bonds. The fund in Example 2 holds 25% stocks, 65% bonds, and 10% cash investments, which is an investment mix one is likely to expect when the target date arrives. The investment mix in Example 1 leaves the investor heavily exposed to a market downturn right up to the fund's target date. This fund does not reach its most conservative mix of 30% stocks and 70% bonds until 25 years after its target date!

The market downturn of 2008/2009 had a surprisingly harsh impact on many of the target date funds that were being used as participants' retirement plan investment options. Many participants who were close to retirement were shocked that their target date funds lost so much value; they believed they were shielded from substantial loss by investing in a target date fund like the one in Example 2. It wasn't until the market downturn occurred that they learned — the hard way — that they were invested in a target date fund like the one in Example 1. They didn't expect a major loss so near the fund's target date (and their retirement), since they believed the fund should be providing a conservative, less risky mix of investments.

Tips for evaluating a target date fund

The bulletin provides a number of tips to help plan participants evaluate a target date fund before choosing it as an investment. In addition to the fund's target date, the bulletin advises participants to review the fund prospectus to find out the following:

- When does the most conservative mix of investments occur?
- What is the fund's risk level?
- How has the fund performed in the past?
- How does the asset allocation change over the life of the fund?
- What fees apply?

Guidance for fiduciaries

Since plan fiduciaries are responsible for the prudent selection of plan investments, the DOL will also be releasing guidance to assist them. A fiduciary compliance checklist will be published to help with the evaluation and selection of target date funds.



Diversification of employer securities

The Pension Protection Act of 2006 (PPA) created a divestiture requirement for non-ESOP defined contribution plans with publicly traded employer securities. Effective for plan years beginning on or after January 1, 2007, such plans must permit participants to divest their holdings in employer securities and reinvest the proceeds in other plan investments.

Employers initially relied on Notice 2006-107 for guidance; then proposed regulations were issued in 2008. On May 19, 2010, the IRS published final regulations that were substantially the same as the proposed regulations. In addition, they contain some clarifications and some new guidance, which is highlighted in this article.

Definition of applicable individual

Basically, the rules say that “applicable individuals” must be permitted to direct the portion of their account that consists of employer securities into alternative investments. An applicable individual is a plan participant or any beneficiary who is entitled to exercise the rights of a participant.

Contributions and timing

When the diversification requirements apply is determined by the type of contributions invested in employer securities. In the case of amounts attributable to elective deferrals and employee after-tax contributions that are invested in employer securities, the applicable individual will have an immediate right to direct that such amounts be invested in alternative investments.

An applicable individual who is a participant may move employer contributions invested in employer securities after completing at least three years of vesting service. A beneficiary of a deceased participant has the right to direct that such amounts be invested in alternative investments.

Investment alternatives

The diversification rules require that a

plan offer at least three other investment options. These investments must have materially different risk and return characteristics. This is based on the ERISA 404(c) guidance about shifting liability for investments to the participant making the investment choice. Any other investment options offered by the plan must also be available to applicable individuals.

A notice must be provided to each applicable individual 30 days before his or her divestiture rights begin.

Participants must have “periodic, reasonable opportunities occurring no less frequently than quarterly” to divest their account of employer security holdings and reinvest these assets in alternative plan investments. Changes related to employer securities must be permitted with the same frequency and implemented within the same time frame as afforded to other investments (unless circumstances require different treatment). Thus, the quarterly rule does not apply if the plan permits participants to make investment changes daily.

Restrictions not permitted

A plan may not impose restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other plan assets (other than those imposed by securities laws). For example, a plan provision that says a participant who divests himself of employer securities will receive a lower rate of employer contributions than a participant who remains invested in employer securities is not permitted. However, a plan could impose participant fees to invest in other investment options available in the plan, even if fees are not imposed on employer securities.

Final regulation clarifications

- Upon freezing an employer security fund, a plan may allow for dividends to be reinvested in that fund and the fund will still be considered “frozen.”



- Transfers from a QDIA can be made more frequently than transfers from an employer security fund.
- Transfers into or out of a stable value fund may be made more frequently than transfers involving other funds.
- Diversification requirements generally do not apply if the employer security is held in a broader fund of an investment company registered as “a regulated investment company as described in IRC Section 851(a)” (known by participants as mutual funds), certain common or collective trust funds or pooled investment funds, or certain funds designated by the IRS. (This exemption is subject to the next two bullet points.)
- An investment fund that fails to meet the 10% limit rule* or fails to be independent of the employer will have 90 days to offer diversification rights to that investment.
- The 10% limit will be based on the total value of the fund's investments as of the end of the preceding plan year.

Effective date

The final regulations are effective for plan years beginning on or after January 1, 2011. Until then, a plan may rely on Notice 2006-107, the proposed regulations, or the final regulations to satisfy the requirements of IRC Section 401(a)(35).

* The 10% limit requires that a plan not hold more than 10% of qualifying employer securities. However, this rule does not apply to individual account plans such as profit sharing and/or 401(k) plans.



RECENT developments

▶ **ACT recommendations**

The IRS recently received the report of the Advisory Committee on Tax Exempt and Government Entities (ACT) that included recommendations for changing the requirements for interim plan amendments. The recommendations were made after considering comments submitted by various members of the benefits community that were highly critical of the current interim amendment process. Some of the major complaints regarding the current rules cited uncoordinated deadlines for the various amendments, lack of guidance by the IRS, and the administrative burden and expense placed on plan sponsors and benefits practitioners. The report also contained recommendations for streamlining the determination letter process and improving customer service, and it included a review of the fee structure for certain failures that

are corrected under the Voluntary Correction Program. As these recommendations are acted upon, we will provide more details.

▶ **Change in disclosure requirement for plan loans**

Effective July 1, 2010, plans that restrict loan amounts to a participant's vested account balance and comply with the Internal Revenue Code loan provisions [Section 72(p)] will be exempt from having to provide truth-in-lending disclosures to plan participants. Plans that offer loans in excess of a participant's vested balance will not be exempt from having to provide these disclosures. (The truth-in-lending requirements only applied to plans that granted more than 25 loans, or 5 loans secured by a dwelling, in the preceding year.)

▶ **EGTRRA deadline extended for disaster areas**

The IRS extended the deadline for restating EGTRRA preapproved

defined contribution plans for plan sponsors located in certain areas affected by natural disasters. For disaster areas within eight states, the original deadline of April 30, 2010, has been extended to July 30, 2010. See Notice 2010-48 for additional conditions that must be met in order to be eligible for relief. This extension is one of many that have been granted by the IRS to victims of natural disasters since Hurricane Katrina devastated the Gulf Coast.

▶ **Correction:**

The Recent Developments section of an earlier issue incorrectly stated that the 2009 "Form 5500-EZ is the last form to be placed on EFAST2." The 2009 Form 5500-EZ will not be placed on EFAST2; it is to be filed as a paper copy. We apologize for any confusion.

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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