

The Default Investment Decision

SITUATION: Our 401(k) plan has had the same default investment for several years. We want to make sure it is still a suitable choice for our plan.

QUESTION: What should we consider when choosing a default investment?

ANSWER: First, you should decide if you want a default investment that meets the pension law's requirements for a "qualified default investment alternative," or QDIA. Using a QDIA in conjunction with automatic enrollment can help you secure liability protection for the investment of employees' account assets when they have been given the opportunity to direct their investments but have failed to do so.

Under U.S. Department of Labor regulations, a QDIA must be a mutual fund or managed by an investment manager, plan trustee, or plan sponsor who is a named fiduciary and generally cannot invest employee contributions in employer securities. Options include:

- Lifecycle funds, targeted retirement date funds, and similar products that take into account the individual's age or retirement date
- Balanced funds and similar products with a mix of investments that take into account the characteristics of the group of employees as a whole, rather than each individual
- Professionally managed accounts and similar investment services that allocate contri-

butions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date

- Capital preservations products, but only for the first 120 days of plan participation

Many plan sponsors have selected target date funds as their plan's QDIA. Recently, the U.S. Government Accountability Office (GAO) solicited feedback regarding why sponsors select target date funds over other QDIAs. Sponsors completing the GAO's questionnaire said that they generally looked for asset diversification, ease of participant understanding, limited fiduciary liability, and fit with participant characteristics when selecting a default investment.

In its report, the GAO notes that some plan sponsors forgo the fiduciary relief associated with using QDIAs and instead select a non-QDIA default investment, such as a money market fund or a stable value fund. The GAO notes that sponsors may do this for a variety of reasons. For example, a sponsor may have few employees and decide to require participants to make an investment election.

Clearly, there are many factors to consider in choosing a suitable default investment. If you would like assistance, please contact us.

2 2016 Plan Limitations

2 Passing the ADP Test

3 Could Your Plan's Internal Controls Be Stronger?

4 Recent Developments In Benefit Plans



2016 Plan Limitations

The IRS has announced that there are no cost-of-living adjustments to the following key retirement plan limitations for 2016:

- Elective deferrals to 401(k), 403(b), and most 457 plans: \$18,000
- Catch-up contributions to 401(k), 403(b), and most 457 plans: \$6,000
- Annual additions to a defined contribution plan account: \$53,000
- SIMPLE plan deferrals: \$12,500
- SIMPLE plan catch-up contributions: \$3,000
- Maximum annual benefit from a defined benefit plan: \$210,000
- Annual compensation used to determine qualified plan benefits or contributions: \$265,000
- Compensation used to determine whether officers are key employees for top-heavy plan purposes: \$170,000
- Dollar limit used in the definition of highly compensated employee: \$120,000
- IRA contributions: \$5,500
- IRA catch-up contributions: \$1,000

Passing the ADP Test

To retain their tax-favored status, 401(k) plans have to demonstrate that they don't discriminate in favor of highly compensated employees. Actual deferral percentage (ADP) nondiscrimination testing is an annual ritual for 401(k) plans that do not have a safe harbor design or a qualified automatic contribution arrangement and that are not SIMPLE 401(k) plans.

The ADP test compares the average rate at which highly compensated employees defer salary with the average deferral rate for nonhighly compensated employees. The difference between the averages for the highly paid and lower paid employees must be within certain limits:

- The ADP of the group of eligible highly compensated employees is not more than 125% of the ADP of the eligible nonhighly compensated employees *or*
- The ADP of the eligible highly compensated employees is not more than two percentage points greater than — and no more than two times — the ADP of the eligible nonhighly compensated employees

If an ADP test does not meet the requirements, there are several correction methods. For example, excess contributions can be returned to the highly compensated employees after year-end.

How Plans Pass the ADP Test	
	% of Plans
Excess Contributions Returned to Participants After Plan Year Ended	16.7%
Elections of Highly Paid Participants Limited by Plan Design	8.9%
Elections of Highly Paid Participants Limited When Contributions Reached the Maximum Allowed by the Test	3.8%
Excess 401(k) Amounts Deposited into a Nonqualified Arrangement	0.6%
Other	2.8%
Passed Because of Safe Harbor Plan Design	38.8%
Non-safe Harbor, Passed with No Corrective Action	35.4%

Source: 57th Annual Survey of Profit Sharing and 401(k) Plans, Plan Sponsor Council of America, 2014 (reflecting 2013 plan experience)

Actual deferral percentage (ADP) nondiscrimination testing is an annual ritual



Could Your Plan's Internal Controls Be Stronger?

When it comes to operating a retirement plan, there are a lot of moving parts. A strong system of internal controls can help keep a plan operating smoothly and in compliance with the law.

What are internal controls? The IRS describes internal controls as policies and procedures designed to detect and prevent errors in a retirement plan.

How are internal controls beneficial? They can help a plan sponsor avoid mistakes that could jeopardize the plan's tax-favored status. If an insignificant operational error is discovered, the sponsor may be able to correct it using the IRS's Self-Correction Program (part of the Employee Plans Compliance Resolution System) without contacting the IRS or paying any fees. However, the self-correction option is available only if the plan has established practices and procedures that are reasonably designed to promote and facilitate compliance with the law.

When the IRS selects a plan for audit, the agent conducting the audit begins by evaluating the effectiveness of the plan's internal controls. Whether the agent performs a focused or expanded audit is determined by the strength of the plan's internal controls.

Should a plan have procedures for reviewing the plan document? It should. A regular review of the plan document allows the sponsor to determine whether the plan needs updating. According to the IRS, during audits, employers often can't find documentation to prove that their plans were timely amended for current law. When this happens, the matter must be resolved using an audit closing agreement with the IRS. It is much less expensive to file for correction of a plan document failure using the IRS's Voluntary Correction Program, but this program is not available to plans under audit. Reviewing the plan document annually can reveal if any amendments are needed.

What internal controls should a plan have with respect to plan operations? The appropriate practices and procedures will depend on the organization sponsoring the plan, the plan type, and the plan's particular features. Knowing and following the terms of the plan is critical. Two items the IRS recommends

looking at are whether employee loans and distributions were made according to plan rules and whether eligible employees were included in the plan in a timely manner.

If a third party administrator performs annual testing for the plan, it's important to keep the lines of communication open regarding all employees eligible to make elective deferrals, including employees who terminated during the year. The plan sponsor should have procedures in place to ensure that the proper payroll information is provided and used in the testing calculations. Certain information regarding family relationships, officer status, and companies under common control may need to be provided to ensure that the testing can be completed properly.

What are some examples of internal control procedures? The IRS lists several on its website:

- Comparing salary deferral election forms with the actual amounts deducted from employees' paychecks
- Verifying the types of compensation used for allocations, deferrals, and testing
- Checking that plan service providers received accurate compensation and ownership records
- Monitoring annual contribution and compensation limits (see page two for the 2016 limits)
- Confirming that years of service were accurately determined for purposes of eligibility and vesting
- Verifying marital status and spousal consent for plan distributions
- Ensuring that participants received required minimum distributions

Having strong internal controls around employee eligibility, plan contributions, plan distributions, plan testing, and plan administration is key to avoiding costly penalties and potential plan disqualification. Plan sponsors should consider the benefits of being proactive by conducting a compliance self-audit each year.

The general information in this publication is not intended to be nor should it be treated as tax, legal, investment, accounting, or other professional advice. Before making any decision or taking any action, you should consult a qualified professional advisor who has been provided with all pertinent facts relevant to your particular situation.

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RECENT DEVELOPMENTS In Benefit Plans

Health Care Costs in Retirement.

According to the latest estimates from the Employee Benefit Research Institute, a 65-year-old man retiring in 2015 needs \$68,000 in savings and a 65-year-old woman needs \$89,000 to have a 50% chance of having enough money saved to cover health expenses in retirement. These projections assume median drug expenses throughout retirement. For a 90% chance of having enough savings, a man needs \$124,000 and a woman needs \$140,000. The analysis does not factor in long-term care expenses.

Loan Defaults. Failure to repay outstanding plan loans upon termination of employment costs 401(k) plan participants some \$6 billion of retirement savings annually, according to the Pension Research Council at the University of Pennsylvania's Wharton School of Business. In addition to the leakage in savings resulting from defaulting on their loans, participants incur income taxes and a potential 10% early withdrawal penalty on the defaulted loan amounts included in their incomes. The researchers estimate that about

one in 10 loans is not repaid.

Benchmarking Survey. On average, 75% of employees participate in their employer-sponsored defined contribution plans, according to an annual benchmarking survey by Deloitte. The average account balance grew to \$99,011 in 2015, up close to 4% from the prior period (2013-2014). Two thirds of the surveyed plans (66%) impose no service requirements for entry into the plan, and 49% have no age requirement for plan entry.