

QUALIFIED PLANS 2008-8

Thursday, August 28, 2008

Page 1

HIGHLIGHTS

1. *DOL Guidance on Participant Investment Advice Arrangements*
2. *DOL Policy on Fiduciary Receipt of Business Entertainment*
3. *Highlights of Updated IRS Plan Correction Guidance*
4. *IRS Rules That Transfer of Qualified Plan to Unrelated Entity May Violate the Exclusive Benefit Rule*
5. *IRS Adopts Final Rules For Mortality Tables For PPA Funding Requirements*

1. **DOL Guidance on Participant Investment Advice Arrangements**

Last week, the Department of Labor ("DOL") published three major guidance items in connection with the statutory exemption (the "Statutory Exemption") adopted pursuant to the Pension Protection Act of 2006 (the "PPA") for the provision of non-discretionary investment advice to qualified plan participants and IRA beneficiaries pursuant to an "eligible investment advice arrangement":

- A proposed regulation implementing ERISA sections 408(b)(14) (the "statutory exemption") and 408(g) (the definition of "eligible investment advice arrangement"). 73 Fed. Reg. 48986 (Aug. 22, 2008) (the "Regulation").
- A proposed prohibited transaction class exemption providing relief for certain transactions outside the scope of the statutory relief (the "PTE"). 73 Fed. Reg. 49924 (Aug. 22, 2008).
- A Report to Congress, mandated by the PPA, discussing the availability of computer model investment advice programs in the IRA marketplace. The Report concludes that computer model investment advice programs are

available for IRAs under some circumstances, but DOL nonetheless believes that it is appropriate to provide additional relief in the form of the PTE.

We think that the major focus of attention will be on the PTE. The exemptive relief under the PTE is quite broad, especially under the part of the exemption for computer modeling. For example, the exemption covers off-model advice, and does not restrict or require a leveling of fees at the individual or company level. Thus, while a number of issues will need to be addressed – particularly concerning the types of information that need to be considered under a model as well as the certification and audit requirements – we think this exemption may become a major part of the 401(k) investment market place in the future. We note in this regard that plan sponsors also benefit from DOL relief in choosing among available advice arrangements in accordance with the DOL guidelines in Field Assistance Bulletin 2007-01 ([Qualified Plans 2007-2](#)).

The DOL proposals have already garnered criticism from Capitol Hill. Within hours of their release, Rep. George Miller (D-CA), the Chairman of the House Education and Labor Committee, issued a press release asking DOL to withdraw both the Regulations and the PTE as benefiting financial institutions at the expense of plan participants. While not likely to prevent adoption, this statement may foreshadow future legislative proposals,

particularly if Senator Obama (D-IL) is elected in November.

A. Background

Under ERISA, a plan fiduciary engages in a prohibited act of self-dealing if the fiduciary "causes" a plan to engage in a transaction that can affect the amount or timing of fees or other compensation paid to the fiduciary or anyone in whom the fiduciary has an "interest" that can affect the fiduciary's judgment. Accordingly, in the absence of an exemption, a fiduciary cannot "recommend" that a participant make a particular investment if doing so can cause the fiduciary or any of its affiliates to earn additional compensation (in the form of commissions, Rule 12b-1 fees, shareholder services fees, etc.). However, the Statutory Exemption exempts, among other things, "the direct or indirect receipt of compensation by the fiduciary adviser or an affiliate thereof (or any employee, agent, or registered representative of the fiduciary adviser or affiliate) in connection with the provision of [investment] advice or in connection with the acquisition or sale of a security or other property available as an investment under the plan pursuant to the investment advice," if the advice is provided pursuant to an "eligible investment advice arrangement."

Under the Statutory Exemption, eligible investment advice arrangements may be structured in one of two ways and, either way, are subject to a number of disclosure and other requirements. The first approach is the so-called "level fees" approach. Under this approach, the fiduciary adviser's fees may not vary depending on the basis of the investment option selected. The second type of eligible investment advice arrangement must utilize a computer model having certain characteristics. The model must be periodically "certified" by an "eligible investment expert" as meeting the requirements of the Statutory Exemption.

Other conditions of the Statutory Exemption require that

- the eligible investment advice arrangement be expressly authorized by a plan fiduciary other than the person providing the advice program (e.g., by the plan sponsor or IRA account holder);
- the fiduciary adviser obtain an annual audit from an independent expert demonstrating compliance with the conditions of the Statutory Exemption;

- comprehensive disclosures be given periodically to participants or beneficiaries; and
- transactions be on arms' length terms and for reasonable compensation.

B. The Regulation

Fee Leveling. The Regulation addresses in detail the foregoing requirements of the Statutory Exemption. As expected, with respect to "fee leveling," the Regulation appears to be fairly consistent with guidance that DOL issued last year in Field Assistance Bulletin 2007-01 (Feb. 2, 2007) (the "FAB"). In this respect, consistent with the FAB, the Regulation requirement of level fees is imposed at the level of the "fiduciary adviser," *i.e.*, the financial institution that contracts to provide the advice, or whose individual employees, agents or registered representatives provide the advice. As a result, the Statutory Exemption permits a fiduciary to make investment recommendations that result in additional compensation to an *affiliate*.

The Regulation goes beyond the FAB to clarify that the level fee requirement applies separately to the fiduciary adviser and to the individual employee, agent or registered representative who actually gives the advice, *i.e.*, even if the compensation paid by the plan to the financial institution otherwise is level (such as a wrap fee), the financial institution *may not* pay the individual a commission, bonus, award or other compensation based on the specific investment options being recommended.

Computer Modeling. As an alternative to fee leveling, the Statutory Exemption permits the provision of investment advice pursuant to a computer model that meets certain detailed conditions. The Regulation discusses the conditions at some length. In addition, the Regulation requires that the model must be designed and operated to avoid investment recommendations that "inappropriately favor" (1) proprietary investments over non-proprietary investments, and (2) investment options that may generate greater revenue. However, the Regulation makes it clear that a financial institution is permitted to offer *only* proprietary investments as part of the design of its advice program.

The Regulation further clarifies that the computer model need only take into account "designated investment options," *i.e.*, specific investments designated by the plan, and can

disregard other investments offered through brokerage windows. It also permits the adviser to disregard any designated investment option that invests primarily in employer securities.

Pursuant to ERISA section 408(g)(11), in contexts where a financial institution hires a third party to develop its computer advice model (similar to DOL's "SunAmerica" advisory opinion), the Regulation permits one of the two entities to elect to be treated as the sole "fiduciary adviser" for purposes of the Statutory Exemption, thus relieving the other of liability as a fiduciary under the plan. The Regulation sets out the procedure for making the election.

Although the Regulation makes no provision for "off model" advice, this is covered by the separate PTE discussed below.

C. The PTE

The PTE essentially addresses areas of concern raised by numerous commenters, but which DOL found to be outside the scope of the Statutory Exemption. Though it follows the Statutory Exemption and the Regulation in general scope, the PTE expands the scope of relief in three major ways:

- In the case of IRAs only, it permits in some cases the substitution of "educational" materials in place of computer modeling.
- For both plans and IRAs using the computer model/educational approach, it permits an adviser to provide "individualized" or "off-model" advice after the computer model or educational materials have been provided, and to receive higher compensation as a result, i.e., fee leveling is not required, even for the individual employee/agent/rep.
- In the case of advisers who choose to use fee leveling instead of computer modeling, the PTE applies the "fee leveling" requirement only to compensation received by the individual employee, agent or registered representative, rather than at the level of the financial institution (fiduciary adviser), or at the entity level as in the Regulation.

IRA Educational Materials. To the extent that the number or type of investment alternatives available "reasonably precludes" the use of a computer model, the PTE permits the financial institution to furnish the accountholder with alternative information in the form of graphs, pie charts, worksheets, interactive software, etc., reflecting or calculated to permit the accountholder to produce an asset allocation model taking into account (at least) age and risk tolerance. The materials must include certain disclosures and themselves must not result in any "recommendation" of investment options that would result in greater fees or compensation to the individual employee, agent or registered rep, to the financial institution, or to any affiliate.

Computer Model Requirements. For qualified plans and IRAs other than those described above, the computer model must (1) meet all of the requirements of the Regulation, if developed by the financial institution itself, or (2) meet the requirements of the Regulation other than being certified, if developed by an unaffiliated financial expert.

Off-Model Advice. In contrast to the Regulation (and to the "SunAmerica" DOL advisory opinion), once the IRA educational materials or computer model advice has been provided, the PTE permits the individual employee, agent or registered representative to provide personalized recommendations (i.e., recommendations that deviate from the model or that recommend specific investments to implement an IRA asset allocation). Within 30 days of providing any specific advice, the advisor must provide a written explanation of the advice provided and the reasons why the recommendation is in the best interest of the participant/acountholder, including where the advice may result in greater compensation for the individual adviser or the financial institution.

Additional Conditions. For both the computer model/educational material and fee leveling alternatives, the PTE imposes additional conditions, including required disclosures and an annual compliance audit requirement similar to those set out in the Regulation.

D. Effective Dates

The Exemption, as proposed, would be effective 90 days after it is published in final form. The Regulation, as proposed, would be effective 60 days after it is published in final form, but DOL solicits comments on whether a different date should

be specified. (The 30-day gap presumably will be corrected.)

E. Preliminary Observations

The Regulation and the PTE are both in proposed form, and DOL has invited comments and suggestions for changes by October 6. Accordingly, it is possible that some further refinements will be made. As a general proposition, however, it appears likely that the PTE will have more utility than the Regulation for financial institutions seeking to offer personalized advice to plan participants and IRA accountholders. On the other hand, the Regulation may serve as a "safe harbor" for financial institutions who offer "plain vanilla" computer models that arguably do not constitute fiduciary advice at all, but who do not want to risk challenge.

In the IRA context, the PTE alternative permitting the use of educational materials is likely to become the option of choice, as it does not preclude the receipt of transaction-based compensation by the individual account representative.

2. DOL Policy on Fiduciary Receipt of Business Entertainment

The Department of Labor ("DOL") recently provided important guidance that, for the first time, sets forth its internal enforcement policy with respect to a fiduciary's receipt of meals, gifts and entertainment of de minimis value. This is welcome relief to plan fiduciaries and service providers concerned about DOL's previously stated "zero tolerance" entertainment policy. That said, the new guidance is not a panacea as it leaves several issues unresolved, and creates new requirements for plans and fiduciaries.

Background – ERISA (sec. 404) imposes general duties on plan fiduciaries, including the duty to act prudently. In addition, ERISA (sec. 406) prohibits certain transactions involving plans; in particular, under section 406(b)(3), a fiduciary is prohibited from receiving any consideration for his own personal account from any party dealing with a plan in connection with a transaction involving plan assets. Arguably, section 406(b) does not contain an exception for de minimis gifts or routine business entertainment.

Over the years, DOL has primarily focused its enforcement power on fairly egregious cases, such as a fiduciary's free use of a boat or vacation condominium from service providers. DOL has

always reserved its right to pursue even small, seemingly innocent payments, however. In recent years, a number of DOL initiatives have focused attention on the provision of meals, entertainment and gratuities to plan fiduciaries – including its overhaul of the reporting system for union officers (Form LM-30), service providers dealing with multiemployer plans (Form LM-10), and substantial revisions to the Form 5500 annual return for all employee benefit plans. In the last year, DOL officials made public statements suggesting a "zero tolerance" policy towards routine business meals and entertainment provided to a fiduciary. In addition, DOL's substantial revisions to the Form 5500 Annual Return/Report included instructions for Schedule C that most "non-monetary" compensation is reportable and expressly warns that "[G]ifts and gratuities of any amount paid to or received by plan fiduciaries may violate ERISA and give rise to civil liabilities and criminal penalties."

New Guidance – Uncertainty over DOL's position created confusion for plan fiduciaries and service providers. On August 1, DOL revised the Employee Benefits Security Administration's Enforcement Manual to provide its first explicit guidance on when a fiduciary's receipt of business meals, entertainment or gifts may be the subject of enforcement under ERISA section 406(b)(3). The Manual provides internal guidance to DOL investigators, but is a public document, available on the DOL website at www.dol.gov/ebsa/oemmanual/main.html.

Most significant is the Manual's suggestion that, for enforcement purposes, de minimis gifts and entertainment may not violate section 406(b)(3). DOL investigators should "treat as insubstantial and not as an apparent violation" a fiduciary's receipt of "gifts, gratuities, meals entertainment" and non-cash consideration (including certain reimbursed expenses for educational conferences) where the aggregate value of such items provided by a single source (including employees, affiliates and related parties) is less than \$250 per year. Consideration provided to fiduciaries' family members also falls within the rule (and counts toward the \$250 per fiduciary aggregate maximum). Notably, the Manual does not exempt such de minimis meals and entertainment; rather, they are not "an apparent violation" of section 406(b)(3), leaving open the possibility that, in some circumstances, DOL may find a violation where there is a "quid pro quo." Conversely, DOL has informally advised that it does not view the receipt of amounts above \$250 per year as "automatic" violations.

The revised Manual adopts a special rule for educational conferences. Reimbursement to a plan for attendance at a conference "should not be treated" as a violation of ERISA, provided a plan fiduciary makes specific written advance determinations that

- the plan's payment of the educational expenses is prudent and consistent with the plan's written policies or provisions,
- the conference is reasonably related to the attendee's duties, and
- the expense is reasonable in light of the benefit to the plan and is unlikely to compromise the attendee's ability to carry out his or her ERISA duties.

In the revised Manual, DOL places a new emphasis on plan policies or provisions to prevent abuses in the entertainment of plan fiduciaries. Thus, in determining whether any particular facts support a violation of section 406(b)(3), an investigator is instructed to determine whether the fiduciary or the plan maintained a reasonable written policy or plan provision governing the receipt of items or services from parties dealing with the plan, and whether the fiduciary adhered to that policy. Similarly, the determinations a fiduciary must make before attending an educational conference include whether the expense is consistent with a written plan policy or provision. Not all plans or fiduciaries currently have such policies, and these new requirements may catch them off guard. Moreover, it is unclear whether the Manual's reference to "reimbursement to the plan" for educational conferences allows a service provider to simply pay directly for the fiduciary's attendance at the conference.

Although the revisions to the Manual leave a number of questions unanswered, they are a definite improvement. Interested persons should review their written internal policies to address these matters in a manner consistent with the DOL guidelines.

3. Highlights of Updated IRS Plan Correction Guidance

The IRS has published updated guidance for the correction of errors in qualified plans, section 403(b) plans and employer-based IRA programs. New Rev. Proc. 2008-50 (Sept. 2 [IRS Bulletin](#)) generally follows the prior correction guidance in

Rev. Proc. 2006-27 ([Qualified Plans 2006-5](#)), and includes a number of helpful changes, many of which are described below.

This new guidance is generally effective January 1, 2009, although plan sponsors may choose to follow it beginning September 1, 2008. In anticipation of the next correction update, the IRS is already seeking comments on the correction of

- the failure to withhold amounts under 401(k) auto-enrollment arrangements,
- the failure to provide 401(k) safe harbor notices, and
- administrative issues relating to Roth contributions.

Expanded Use of Streamlined Application

– The new procedures expand the availability of the streamlined application in Appendix F of the current – and prior – guidance. In general, the streamlined application provides a "check-the-box" approach for the identification of the failure and correction method (*i.e.*, the correction must be made in a manner described in Appendix F). The prior guidance only permitted use of an Appendix F application for the failure to timely adopt an interim amendment. The new guidance makes this streamlined application available for many common qualification failures, including –

- the failure to amend a plan to reflect prior law, including ERISA, REA or GUST;
- the failure to timely adopt an amendment that reflects an optional change in law;
- the failure to administer loans in accordance with Code section 72(p), provided the failure does not affect any key employee or self-employed individual;
- the failure of a plan sponsor to satisfy the criteria to sponsor either a 403(b) or 401(k) plan;
- the failure to distribute amounts in excess of the annual deferral limits, currently \$15,500 (sec. 402(g));

- the failure to make required minimum distributions under Code section 401(a)(9);
- the failure to properly apply the Code section 401(a)(17) maximum compensation limit;
- making available hardship distributions and loans where the plan terms do not provide for them; and
- the early inclusion of otherwise eligible employees.

In light of the many new qualification failures that are eligible for the streamlined application, the fee structure has changed – the flat \$375 fee that currently applies will continue to apply only to interim amendment failures, but not to other types of failures. Generally, the fee for other types of failures will be based on the general fee structure for VCP applications.

New "Model" Format For Other Applications – The new guidance provides a "model" application for qualification failures that are not eligible for the streamlined approach of Appendix F, described above. This model application is found in Appendix D. The format closely follows the Appendix F format, except that it does not include a "check-the-box" approach for the identification of the failure and correction method. As with the Appendix F submission, if the IRS agrees with the correction as described, the IRS will simply sign the Enforcement Resolution that must be included at the end of the submission, and the application will serve as the Compliance Statement. The IRS encourages applicants to use this Appendix D format, and appears to envision that it will be available for all VCP applications, even group submissions. However, it is difficult to see how this format could be used for a group submission without some modification.

Plan Loan Failures – The new guidance clarifies that plan loan failures may now be corrected under VCP – even if the plan document does not include language to the effect that loans will meet the requirements of Code section 72(p). (Many plans have the rules in loan procedures, which arguably are not part of the plan document.) Loan correction under VCP is helpful because it can avoid the need to issue 1099-Rs to reflect prior tax year loan defaults and the need to treat repayments as after-tax contributions (since many plans don't have any).

The new guidance also expands the available correction methods so that, in addition to making a lump sum payment of missed loan payments or reamortizing the loan over the remaining original loan period, the loan may be corrected by reamortizing it over a 5-year period, measured from the original date of the loan. Although the IRS did not make the special loan correction methods available under self-correction, it has attempted to make VCP filings for loan failures easier and cheaper by reducing the filing fee by 50% if the failure does not affect more than 25% of the participants in any year, and by making available the streamlined application under Appendix F.

401(k) Plan Contribution and Similar Failures – IRS made several helpful changes in this area, including –

- When corrective contributions are made to the plan to address the failure to make correct elective deferrals and matching contributions, the plan need not rerun the ADP/ACP test after making the corrective contributions.
- The new guidance addresses the situation where an eligible employee filed a salary deferral election, but the plan failed to correctly implement it – a situation not expressly covered in the prior guidance. In this situation, the employer must make a QNEC equal to 50% of the amount elected by the employee.
- The correction methods for elective deferrals are extended to catch-up contributions and Roth contributions.
- The new guidance addresses the situation where an individual is excluded from the opportunity to make elective deferral contributions, including Roth contributions. In that case, the employer's corrective contribution cannot be treated as a Roth contribution. As under the prior guidance, the new guidance assumes that the correction will be made after the plan year to which the deferral election relates, and does not appear to envision correction during the year in which the failure occurs.
- The new guidance provides that the earnings rate derived from the DOL's

online calculator may be used to determine earnings in the plan correction context if it is not feasible to make a reasonable estimate of what the actual investment results would have been. On the downside, however, the new guidance clarifies that earnings must be calculated without regard to compliance deadlines that might otherwise be extended (e.g., April 15 for refunds of excess deferrals).

Increase in De Minimis Amount for Corrective Distributions – The plan correction guidance provides that no corrective distribution is necessary where a participant is owed a specified de minimis amount. The new guidance increases the de minimis amount from \$50 to \$75 as long as the reasonable direct costs of processing and delivering the distribution would exceed the amount of the distribution. The de minimis amount under which a plan need not attempt to recover an overpayment continues to be \$100.

Limited Excise Tax Relief For Certain Overpayments – A plan may distribute an amount not provided for under its terms (a simple miscalculation) or reflecting a contribution or benefit in excess of Code limitations (e.g., section 415). In such cases, the standard correction method involves seeking repayment from the participant (with the employer making up any shortfall), and also notifying an IRA that may have received the overpayment as part of a rollover that the excess may not be rolled over. The new version of EPCRS provides relief from the 10% early distribution tax (sec 72(t)) on the participant, and the 6% excise tax on excess contributions to IRAs (sec. 4973) in such cases, but only if, in general, (i) the correction is part of a VCP filing, (ii) the sponsor requests the relief and provides supporting information, and (iii) the overpayment is removed from the IRA and returned to the plan.

4. IRS Rules That Transfer of Qualified Plan to Unrelated Entity May Violate the Exclusive Benefit Rule

Some plan sponsors and financial institutions have been exploring whether a frozen tax-qualified pension plan could be transferred to an entity outside of the plan sponsor's controlled group with the new entity taking financial responsibility for the pension plan. The IRS and the Treasury Department recently issued Revenue Ruling 2008-

45 (Aug. 25 IRS Bulletin), which states that these transfers could violate the Internal Revenue Code's exclusive benefit rule and as such would not maintain the plan's tax qualified status after the transfer. The exclusive benefit rule (Code sec. 401(a)(2)) states that a tax-qualified plan of an employer must be for the exclusive benefit of its employees and their beneficiaries.

The Revenue Ruling describes the following transaction:

- an underfunded pension plan was transferred to a new subsidiary of the original plan sponsor;
- the subsidiary would have assets outside of the plan trust that would equal or exceed the amount of underfunding in the pension plan,
- the subsidiary would be sold to another entity that would administer the plan, and would invest the assets in the plan and the assets outside the plan held by the subsidiary;
- after the transfer, the employees that benefited under the transferred pension plan would remain with the original plan sponsor as would the business operations that employed the individuals whose benefits are provided under the plan; and
- the new entity would be solely liable for the pension plan and the old plan sponsor would have no continuing liability for the plan.

Rev. Rul. 2008-45 concerns whether, after the transaction occurred, the new plan is maintained for the exclusive benefit of employees. IRS pointed to the fact that the business operations and assets were not transferred to the new entity that now sponsors the plan and that there are no employees in this new entity. The ruling thus effectively adds a new requirement to the long-standing exclusive benefit rule that there be a business purpose surrounding the transfer of the pension plan and that the purpose of the transfer cannot be for the new entity to make a profit from the use of the assets transferred in the transaction.

Some observers are concerned that this ruling expands the exclusive benefit rule beyond how it has been interpreted by adding a requirement that

the transfer of a pension plan to a new controlled group must be done in conjunction with the transfer of business operations or assets to the new controlled group. They question whether, as a result of this ruling, there must be an examination of the business motives in any corporate transaction where pension plans are moved outside of a controlled group. While clearly erecting a roadblock to these proposed pension plan transfers, it is unclear whether other more routine transfers of pension plans will be affected.

The Bush Administration apparently believes that these types of transactions may be beneficial to the retirement system. At the same time that the Revenue Ruling was released, the Treasury Department also outlined (in an August 6 News Release) a legislative proposal which would permit such transfers as long as certain "fundamental requirements" relating to the transfer and the entity receiving the transferred plan – conditions intended to minimize risks to participants and the PBGG – are met. In this regard, one Democrat on the Ways and Means Committee with a strong interest in retirement issues, Rep. Earl Pomeroy (D-ND), has stated publicly that Democrats are highly skeptical of these types of transactions, and he does not believe that they will act on legislation that would approve them.

5. IRS Adopts Final Rules For Mortality Tables For PPA Funding Requirements

The IRS recently adopted final rules governing mortality tables to be used in calculating minimum funding requirements for 2008 and later plan years under the Pension Protection Act of 2006 ("PPA"). 73 Fed. Reg. 44632 (July 31, 2008). The final rules are substantially identical to the proposed rules released in May 2007 (Qualified Plans 2007-5), and reflect a detailed approach to this subject, including allowing the use of plan-specific tables with IRS approval.

The principal guidelines are as follows:

- The tables continue to be based on RP-2000 mortality, and are gender-distinct.
- The tables generally require the use of separate tables for annuitants and non-annuitants.
- Plan sponsors and actuaries can choose between static tables that are

updated annually for expected improvements in mortality, or adopt the use of "generational tables."

- Small plans (less than 500 lives, counting active and inactive participants as of the plan's valuation date) can use the static table blended for all participants (i.e., annuitants and non-annuitants).
- The rules lay out a methodology for large plans to obtain IRS approval of substitute gender-specific tables based on the actual and "credible mortality experience" (i.e., 1,000 deaths within a gender over a prescribed period) of the plan sponsor's population. If approved, a substitute table generally must be used for each plan in the controlled group. Special rules are provided for newly affiliated plans and certain plans in the controlled group without credible mortality experience.
- Mortality tables for disabled participants will be provided in future guidance.

These tables are generally required for all defined benefit plans including multiemployer and airline plans, as well as for rural cooperative and certain other plans that are allowed to continue using the pre-PPA minimum funding rules during a lengthy transition period. In general, the rules apply to 2008 and later plan years, but certain transition rules apply, and the new rules for substitute mortality tables generally first apply to 2009 plan years.

This memorandum is published as an information source for our clients. The articles appearing in it are current as of the date shown above, are not intended as legal advice, and may not be used to avoid penalties under the Internal Revenue Code or any other law.