FORD & HARRISON LLP

Benefits Review

Employee Plans Compliance Resolution System Updated

A retirement plan that is intended to satisfy the requirements of Internal Revenue Code ("Code") Section 401(a), may discover that it has inadvertently failed to meet one or more of those requirements. The potential result of such a failure is the disqualification of the plan. If the plan is disqualified, participants could be forced to include in their incomes the value of their vested benefits, and companies may lose deductions taken in prior years for contributions to the plan, among other consequences. To guard against the risk of disqualification, employers should take advantage of the Employee Plans Compliance Resolution System ("EPCRS").

EPCRS is a program established by the Internal Revenue Service that offers employers the ability to correct certain types of failures that would otherwise subject the plan to disqualification. It can be used not only by qualified retirement plans, but also by tax-sheltered annuities under Code Section 403(b), by qualified annuity plans under Code Section 403(a), by simplified employee pension plans ("SEPs") under Code Section 408(k), and by simple retirement accounts under Code Section 408(p) ("SIMPLE IRA plans").

Depending upon the type of plan involved, the seriousness of the failure, and the satisfaction of other

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CMS Issues Updated Model Notices

As a result of provisions contained in the Medicare Prescription Drug, Improvement, and Modernization Act ("MMA"), Medicare-eligible individuals can now elect to enroll for prescription drug coverage under Medicare Part D. Persons who enroll for Medicare Part D must pay a monthly premium in order to receive this coverage. Individuals who do not enroll in Part D when first eligible, but who later enroll, will be required to pay more for their coverage than other enrollees pay. The higher premium will not apply if the reason the individual did not enroll when first eligible was because he or she had other prescription drug coverage that was just as good as the coverage provided by Medicare Part D, as long as enrollment occurs within 63 days of the date the other coverage is lost.

Employers who offer group health coverage to Medicare-eligible individuals must provide notices to those individuals that describe whether the plan's prescription drug coverage is just as good as the coverage available under Part D. Coverage that is as good as Medicare Part D coverage is known as "Creditable Coverage." This notice is required so that Medicare-eligible individuals can make informed decisions as to whether or not to enroll in Part D when first eligible.

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Fiduciary Compliance Program Revised

Under the Employee Retirement Income Security Act of 1974 ("ERISA"), persons who have discretionary authority over the administration of an employee benefit plan, or any control or authority over the assets of the plan, may be considered fiduciaries. ERISA imposes a very high standard of conduct on plan fiduciaries, requiring them to act in accordance with the governing plan documents and in the best interests of participants. ERISA also prohibits a fiduciary from engaging in certain transactions that may involve conflicts of interests. A fiduciary who breaches his responsibilities can be held personally liable for losses incurred by the plan.

Occasionally, fiduciaries may discover that the provisions of ERISA have not been satisfied, or may find that they have inadvertently engaged in a prohibited transaction. For example, participant contributions may not have been forwarded to a trust in a timely manner, or the plan may have impermissibly loaned money to a related party. The Department of Labor has created the Voluntary Fiduciary Correction Program ("VFCP") as a means by which fiduciaries can voluntarily correct specified ERISA violations. Without the VFCP, plan fiduciaries can be subject to investigation and possible civil penalties.

In an update that is effective May 19, 2006, the Department of Labor ("DOL") has simplified and expanded the types of transactions which can be resolved under the VFCP. The updated VFCP contains streamlined documentation requirements, clarifies eligibility rules, provides a model application form, clarifies what constitutes "under investigation" allowing more entities to qualify, and provides relief from civil penalties for health and welfare plans. The update shows how to apply the 19 categories of covered transactions, acceptable methods for correcting violations, and examples of potential violations and corrective actions.

Under the VFCP, ERISA fiduciaries may apply for relief from enforcement actions if neither the plan nor the applicant is under investigation and if the application contains no evidence of potential criminal violations. But fiduciaries using the VFCP must make sure to fully and accurately correct violations. If an application is rejected because it is incomplete or unacceptable, the applicant may still be subject to enforcement actions, including civil monetary penalties.

ERISA imposes a very high standard of conduct on plan fiduciaries, requiring them to act in accordance with the governing plan documents and in the best interests of participants.

Violations can be fully corrected in three easy steps:

First, the applicant needs to identify the violations and determine whether they are covered transactions. The VFCP describes 19 categories of covered transactions (such as prohibited purchases, sales and exchanges, improper loans, delinquent participant contributions, and payment of improper plan expenses) and corresponding correction methods.

Second, the fiduciary must follow the process specified in the VFCP for correcting the particular violations. In general, applicants must place the plan, and all participants and beneficiaries, in the condition they would have been in had the violation not occurred. This may involve calculating and restoring any lost principal plus the greater of lost earnings or profits resulting from the use of the principal, and distributing supplemental benefits to participants and beneficiaries. For assistance, an online calculator automatically calculates correction amounts. Plans must then file amended returns to reflect corrected transactions and/or valuations.

Third, the fiduciary has to file the model application form and documentation showing the corrective action with the appropriate regional office. The application typically includes copies of relevant portions of plan documents, calculations of restored amounts, and various other specific documents. A "no action" letter will be given to applicants who properly correct violations.

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IRS Releases Sample Amendments For Roth 401(k) Plans

Since January 1, 2006, employers who sponsor a 401(k) plan have had the option of including a "Roth contribution" feature in the plan. Such a feature allows plan participants to designate that all or a portion of their deferral contributions to the plan will be taxed as if they had been made to a Roth individual retirement account ("Roth IRA"). The Internal Revenue Service has now released sample amendments that can be used to incorporate Roth into their 401(k) plans (see IRS Notice 2006-44, April 24, 2006).

Normally, 401(k) deferral contributions are not subject to income tax when they are made, but are only taxed at the time of distribution. Any investment returns on the deferral contributions are also taxed at the time of distribution. A Roth IRA works in reverse fashion—the contributions are taxed up front, but eligible distributions are completely tax-free. A distribution will generally be eligible for tax-free treatment if the Roth 401(k) account has been in existence for at least five years, and the distribution is either made following the accountholder's death, disability or attainment of age 59-1/2.

By including a Roth contribution feature in its 401(k) plan, an employer will give participants extra flexibility to determine the best tax strategy to save for their retirements. More important, a Roth contribution feature in a 401(k) plan offers the opportunity to save much more than could be contributed to a Roth IRA, and, unlike a Roth IRA, is available to high-income individuals. Also, Roth contributions to a 401(k) plan can be much larger than contributions to a Roth IRA (the 2006 limit for contributions to a Roth IRA is $4,000, while the 2006 limit on Roth contributions to a 401(k) plan is $15,000). However, Roth contributions to a 401(k) plan are subject to the age 70-1/2 minimum distribution rules, whereas a Roth IRA is not required to make minimum distributions.

The sample Roth contribution amendments released by the IRS can be used by employers who sponsor both individually drafted 401(k) plans and pre-approved 401(k) plans (for example, prototype or volume submitter plans). The sample amendments are drafted in a form to be included in a prototype plan (that is, there is language to be included in both the "adoption agreement" and the "basic plan document"), but can be adapted to any employer's particular plan design.

Employers wishing to incorporate a Roth contribution feature in their 401(k) plans must adopt the necessary amendment no later than the end of the plan year for which the Roth contribution feature will be effective. For example, calendar year 401(k) plans could include the feature for 2006 if the plans are amended by December 31, 2006.

For more information on Roth contributions to 401(k) plans, or the new IRS sample amendments, please contact David Pearson or any member of the Ford & Harrison Employee Benefits Group. ■

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conditions described in Revenue Procedure 2006-27, employers may be able to use EPCRS to correct many types of failures without an application to the IRS or the payment of any fee or sanction. In those situations where self-correction is not available, EPCRS may still be used, although an application to the IRS and the payment of a sanction will generally be required. Unless the failure is discovered by the IRS during an audit of the plan, the amount of the sanction is based upon the number of participants in the plan, and ranges from $750 (for plans with 20 or fewer participants) up to $25,000 (for plans with over 10,000 participants). Separate fees apply for specific types of failures, and for failures involving SEPs and SIMPLE IRA plans.

The types of plan failures that can be corrected under EPCRS are numerous, and include such things as (i) exceeding IRS-imposed limits on plan contributions, (ii) failing a discrimination test, (iii) impermissibly excluding an eligible employee from participation in the plan, (iv) failing to make minimum required distributions, (v) failing to obtain spousal consent to a plan distribution, (vi) applying an incorrect vesting percentage to an employee's account balance, (vii) providing loans to participants that do not satisfy the plan's limits on loans, or (viii) failing to timely amend a plan for changes in the law.

Employers who discover that their plans do not satisfy one or more of the rules that apply to their plans should consider taking advantage of the protections available under EPCRS. For more information regarding EPCRS, please contact Margaret R. Bernardin or any member of the Ford & Harrison Employee Benefits Group. ■

Handling Mutual Fund Settlement Proceeds

In several enforcement matters brought before the Securities and Exchange Commission ("SEC"), the SEC has awarded settlement funds to mutual fund investors who have been harmed by alleged late trading and market timing activities. As mutual fund investors, employee benefit plans will be eligible to receive a share of the settlement proceeds. In Field Assistance Bulletin 2006-01, the Department of Labor ("DOL") has provided guidance to persons who will be involved in the distribution of the settlement proceeds as to their fiduciary duties under the Employee Retirement Income Security Act of 1974 ("ERISA").

When do settlement proceeds subject a party to ERISA's fiduciary requirements?

Persons appointed by the SEC to distribute the settlement proceeds to investors will not be subject to ERISA's fiduciary provisions, because the proceeds are not ERISA plan assets until actually distributed. However, persons who receive the proceeds (either the plan itself or an intermediary such as a broker-dealer, underwriter, or record keeper), will generally be subject to ERISA's fiduciary provisions. An intermediary may be able to avoid fiduciary status if its receipt of the proceeds occurs with the approval and direction of an appropriate plan fiduciary. In addition, an intermediary that is not otherwise a plan fiduciary may elect not to receive settlement proceeds on behalf of its employee benefit plan clients, although it may still incur fiduciary liability if that decision adversely affects a plan's right to receive the proceeds.

What fiduciary duties does ERISA impose?

Fiduciaries must prudently select a method to allocate proceeds among the affected plans or its participants and beneficiaries. At a minimum, fiduciaries must pick an allocation method that apportions proceeds in relation to the impact the late trading and market timing activities had on the particular plan or participants. In choosing an allocation method, fiduciaries may weigh the costs and benefits to the plan or participants of the selected allocation method and need not select a method that exactly reflects transactional activity, so long as a rational basis exists for the selected method and it is reasonable, fair, and objective. If the distribution plan itself makes available or requires as a condition to receipt of a distribution that the proceeds be allocated in a particular way, fiduciaries will satisfy ERISA by using the specified methodology, but must prudently implement the allocation method.

Fiduciaries must hold the settlement proceeds in trust pending allocation to plans or participants, and may also need to invest the proceeds pending allocation.

Compliance with ERISA's fiduciary rules generally will require that fiduciaries accept a distribution of proceeds. However, fiduciaries may refuse to accept a distribution of settlement proceeds if the cost of receiving and distributing the funds exceeds their value to the plan's participants and if there is no other permissible use for the proceeds (such as payment of plan administrative expenses).

An intermediary cannot receive compensation from plan assets for the services it provides in receiving, allocating, and/or distributing settlement proceeds, other than direct expenses incurred by it, unless an independent plan fiduciary has approved.

How can settlement proceeds be used?

In general, proceeds should be allocated to plans, and to participants in the plans, based on the impact the late trading and market timing activities had on them, subject to cost and benefit considerations. However, a plan fiduciary may reasonably conclude that allocating the proceeds to participants is not cost effective and may instead use the funds for other permissible plan purposes, such as the payment of reasonable administrative expenses. But because the settlement proceeds are ERISA plan assets, they may not be used to benefit employers, fiduciaries or other parties in interest.

If an intermediary receives proceeds on behalf of a terminated plan, it should make reasonable efforts to deliver the assets to a responsible plan fiduciary. If the intermediary is unable to locate a responsible plan fiduciary, the DOL has stated the intermediary may reallocate the proceeds among its other clients, but again, under no circumstances, can it retain the assets for its own use.

If you have any questions regarding the disposition of settlement proceeds, please contact Mike Munoz or any member of the Ford & Harrison Employee Benefits Group. ■

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The first set of notices to Medicare-eligible individuals was to have been provided no later than November 15, 2005. Notices must also be provided by employers at the following times:

1. Prior to November 15th of each calendar year.
2. Prior to the date an individual becomes eligible to enroll for Part D.
3. Prior to the date a Medicare-eligible individual first becomes eligible for coverage under the employer's group health plan.
4. Whenever the prescription coverage under the employer's plan changes in such a way that it is no longer, or becomes, Creditable Coverage.
5. Upon request by a beneficiary.

The Centers for Medicare & Medicaid Services ("CMS") has issued updated model notices that employers can use to satisfy their notice obligations. These updated model notices can be used on or after May 15, 2006. For more information regarding Medicare Part D or the employer's notice obligations, please contact Margaret R. Bernardin or any member of the Ford & Harrison Employee Benefits Group. ■

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In addition to updating the VFCP, the DOL also expanded the class exemption that provides applicants conditional relief from payment of excise taxes for certain VFCP covered transactions.

If you have any questions regarding the VFCP or would like assistance in taking advantage of that program, please contact Mike Munoz or any member of the Ford & Harrison Employee Benefits Group. ■

BENEFITS REVIEW

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