



FBA NEWS NOTES

Summer 2005

NEWS AND INFORMATION ON EMPLOYEE BENEFIT PLANS

Final 401(k) and 401(m) Regulations

[Treas. Reg. Secs. 1.401(k)-0 through 1.401(k)-6 and 1.401(m)-0 through 1.401(m)-5, 69 Fed. Reg. 78143 (Dec. 29, 2004)]

Copy of press release: <http://www.treasury.gov/press/releases/js2171.htm>

On December 29, 2004, Treasury released the final 401(k) and 401(m) regulations. The final regulations revise and restate statutory changes and incorporate administrative guidance issued by the IRS since 1994. The regulations apply to plan years that begin on or after January 1, 2006. Plan sponsors are permitted to apply the final regulations to any plan year that ends after December 29, 2004, provided that all of the rules of the final regulations are used and not just selected portions.

Plan sponsors will want to carefully review the final regulations to determine which of the many changes affect their plans. This notice will highlight some of the more notable changes and clarifications provided by these regulations.

Contributions

Ongoing Deferral Elections - The final regulations retain the proposed requirement that a plan provide participants with an "effective opportunity" to make or change deferral elections at least once each plan year.

Automatic Enrollment - Revenue Ruling 2000-8, specified the criteria a CODA must satisfy to automatically reduce an employee's compensation. The IRS illustrated the automatic enrollment provision with examples that referred to an automatic deferral rate of 3%. These final regulations clarify that this default election of 3% was merely illustrative. The regulations do not specify an amount for automatic deferrals.

Pre-Funding - The final regulations retain the rule that a CODA cannot accept pre-funded salary deferrals or pre-funded matching contributions. This ruling is designed to prevent employers from accelerating tax deductions by making plan contributions in an earlier taxable year. In general, the final regulations provide that all contributions under a CODA must be made after the employee has made the relevant deferral election, after the services have been performed, and, for purposes of salary deferrals, only if the amounts deferred would otherwise be paid in cash to the employee.

If the primary purpose is not the acceleration of deductions, the regulations allow for three limited exceptions with regards to contributions to a CODA before an employee has performed the service. These exceptions are: (1) occasional early contributions to accommodate a bona fide administrative situation (e.g., the temporary absence of the bookkeeper that is responsible for transmitting contributions to the trust); (2) forfeitures that are allocated as matching contributions; and (3) matching allocations of

shares from an ESOP loan suspense account when the contribution is for a required payment that is due under the loan terms. The final regulations clarify that this prohibition on pre-funding does not prevent partners from deferring amounts throughout the year from their draws, provided contribution limits are not exceeded.

This ruling actually reverses the position the IRS took in Notice 2002-48, in which it ruled that pre-funded elective deferrals and corresponding matching contributions were deductible. As a result, advanced deferrals or contributions can not be taken into account under the ADP or ACP test and cannot be treated as elective deferrals or matching contributions for any purpose under the plan.

Plan Aggregation and Disaggregation

Each portion of a plan must either meet a safe harbor or be tested to ensure that the plan does not discriminate in favor of HCEs. For testing purposes, certain portions of the plan must be aggregated or disaggregated. Before these regulations, if a plan contained both an employee stock ownership plan ("ESOP") and a CODA, the ESOP and CODA portions had to be disaggregated and tested separately. The new regulations revise this rule to provide that the ESOP and CODA portions of the plan may be permissively aggregated for the ADP and ACP tests, but not for the 410(b) minimum coverage test.

Another modification adds a rule prohibiting an employer from aggregating plans that have inconsistent testing methods. A plan must state which testing alternative it will use (i.e. the ADP & ACP, or Safe Harbor testing provisions). If there is an optional testing choice (current year, prior year or first year rule), the plan must also state those choices. Note - A safe harbor plan can not provide that the ADP test will be used if the plan doesn't satisfy the safe harbor requirements.

Hardship Distributions

The final regulations added two new "deemed" immediate and heavy financial needs to the list of "safe harbor" events permitting a hardship distribution. The two additions are 1) burial or funeral expenses for the employee's deceased parent, spouse, children or dependents; and 2) expenses for repair of damage to the employee's principal residence that qualifies as a deductible casualty expense, such as those resulting from hurricane or flood damage (without regard to the 10% "floor" for deductibility).

The definition of dependent for medical expenses under the hardship withdrawal rules as been expanded to include non-custodial children (certain criteria under code section 152(e) must be satisfied).

Distributions Upon Plan Termination

The final regulations continue to permit 401(k) plans to distribute deferral contributions at plan termination, but only if the employer does not maintain or establish an alternative plan. Alternative plans do not include ESOPs, Simplified Employee Pension Plans (SEPs), SIMPLE IRAs, 403(b) arrangements, and Code section 457 plans.

Plan to Plan Transfers

A plan receiving a plan-to-plan transfer that includes elective contributions, qualified non-elective contributions (QNECs), or qualified matching contributions (QMACs) must incorporate the transferring plans restrictions on withdrawals applicable to such contributions.

ADP & ACP Testing

Testing of Minimum Age & Service Period Requirement – The final rules confirm that ADP & ACP testing options are available to plans that allow employees to participate before the age of 21 or complete one year of service. These plans may use either the original “otherwise excludible” disaggregation rule, or the Small Business Jobs Protection Act (SBJPA) early participation rule.

The SBJPA rule allows for the plan to be disaggregated into two plans, and the ADP and ACP tests are performed separately for each component plan. One plan benefits the employees who have met the age and service period requirement, and the other plan benefiting all other employees.

HCEs in Multiple Plans – The final regulations have modified the manner in which actual deferral ratio (ADR) is determined for highly-compensated employees (HCEs) who participates in multiple 401(k) arrangements of the same employer. In this situation, the ADR is determined by aggregating the HCE’s elective deferrals made within the plan year of the plan being tested. A similar rule applies for determining the actual contribution ratio (ACR) of an HCE participating in multiple 401(m) plans of the same employer.

These rules also provide a special rule for connecting excess contributions for HCEs who participate in multiple 401(k) plans provided by the same employer. For testing, all deferrals are aggregated for ranking HCEs by the dollar amount of their contributions. The HCE with the highest dollar amount of contributions is apportioned excess contributions first. However, only elective deferrals made to the plan being corrected may be distributed. A similar rule applies for ACP test corrections.

Bottom-Up Leveling Prohibited – The final regulations are designed, in particular, to prohibit so-called “bottom-up” QNECs or QMACs that provide additional contributions at a high percentage of compensation to participants with the lowest compensation in order to boost the overall deferral rate of non-highly compensated employees (“NHCEs”). In the past, this approach enabled employers to pass the non-discrimination tests with a smaller total QNEC or QMAC than would be required if the contribution were allocated to a broad based group of NHCEs.

The final regulations impose new limitations on the plan sponsor’s ability to pass the ADP or ACP testing.

- A targeted QNEC can not exceed the greater of (a) 5% of an NHCE’s compensation (10% if the QNEC is in accordance with prevailing wage rules, like the Davis-Bacon Act), or (2) times the plan’s “representative contribution rate.” The plan’s representative contribution rate is defined as the

lowest contribution rate of qualified contributions among the group of NHCEs that is at least half of all eligible NHCEs, or, if greater, all NHCEs employed as of the last day of the plan year.

- A targeted QMAC can not exceed the greater of (a) 5% of an NHCE’s compensation (10% if the QMAC is in accordance with prevailing wage rules, like the Davis-Bacon Act), or (b) 100% of elective deferrals, or (c) 2 times the plan’s “representative matching rate” multiplied by the employee’s elective deferrals for the year.

Gap Period Income - If a plan fails the ADP or ACP test, it can distribute excess contributions made by HCEs as an alternative to providing corrective QNECs to NHCEs. The excess contributions need to be adjusted for earnings that accrue after the plan year in which the deferrals were made and before contribution. Because testing typically takes place after the end of the plan year in which deferrals are made, distributions of the excess contributions are normally made in the plan year following the year of deferral. The period between the last day of the deferral year and the date the distributions are made is called the “gap period.” Prior to the effective date of the regulations, plan sponsors could choose whether the excess contributions were adjusted for investment returns during the gap period. The regulations now specify that distributions of excess contributions must be adjusted for gap period income if the employee would have been credited with allocable gain or loss for that period if his or her total account were to be distributed.

Further, the regulations clarify that the value of distributed excess contributions is included in the taxpayer’s taxable income on the date the elective deferrals would have been received by the employee had he or she not elected to defer such amounts (i.e., in the year of deferral).

Note that the regulations provide two exceptions to the required gap period earnings adjustments. First, the plan sponsor can determine the attributable earnings up to seven days before the date of the distribution. This exception is to provide plan sponsors with a cutoff date for the purpose of determining the amount of the distribution. Second, if a plan sponsor uses the safe harbor method of calculating earnings, a corrective distribution that is made on or before the 15th day of a month is treated as made on the last day of the previous month for purposes of calculating the number of months that have elapsed.

Safe Harbor Plans

Safe harbor 401(k) plans can avoid performing the Actual Deferral Percentage (“ADP”) test and the Actual Contribution Percentage (“ACP”) test if they contain a safe harbor qualified non-elective employer contribution (“QNEC”) or a safe harbor qualified matching contribution (“QMAC”) formula. A safe harbor 401(k) plan must specifically state the amount of the contribution and whether it is a QNEC or QMAC. In the case of the QMAC, the IRS had not previously issued guidance on whether the age 50 catch-up contributions were required to be matched. Under the new regulations, if a plan permits employees to make age 50 catch-up contributions under a safe harbor 401(k) plan that uses the QMAC, to meet the safe harbor matching contribution requirements, the plan must match the catch-up contributions.

Some safe harbor 401(k) plans provide a reversion clause under which the plan will test if, for a particular plan year, such plans do not meet the safe harbor requirements. According to the Treasury

Department, the purpose of the safe harbor is to provide participants with a minimum amount of benefits in exchange for easier compliance, and a reversion provision is inconsistent with the intent of the safe harbor provisions.

Therefore, the regulations state that a plan cannot provide that an ADP or ACP test will be performed if the plan does not satisfy the safe harbor provisions. In addition, the regulations specify that a plan may not be amended to revert to a testing plan if, at the beginning of the plan year, it contains a safe harbor contribution formula.

Safe Harbor plans may not have a matching rate for NHCEs, which is less than the matching rate for HCEs. This requirement applies to all matching contributions provided, safe harbor formula or not. Thus, using last day or 1,000 hour provisions on any match in a safe-harbor plan may create problems for the plan sponsor.

A full 12-Month plan year is required for safe harbor plans, except for the first year and certain short-plan year exceptions. Short plan years are permitted under the following circumstances:

- In the year the plan terminates:
 - provided the termination is in connection with a merger or acquisition involving the employer, or the employer incurs a substantial hardship as described in IRC section 412(d), or
 - provided the employer makes safe harbor matching contributions for the short plan year and provides a notice of the change to employees and passes the ADP and ACP tests.
- A short plan year is permitted if the short plan year is preceded and followed by a full 12-month safe harbor plan year.

Failure to distribute the annual safe harbor notice does not allow a plan to return to the usual ADP/ACP testing methods. The notice must be provided within a reasonable period, which is generally 30 to 90 days, before the beginning of the plan year.

Other Clarifications

Changed to Leased Employee Status - A change in status of an employee to a leased employee who still performs services for the same recipient employer is not a severance from employment and thus is not a distributable event.

Elective Deferrals for Self-Employed Individuals – Self-employed individuals have been given explicit authority to fund elective deferrals during the plan year based on their advance salary or draw, as long as the total amount deferred does not exceed statutory limits. However, this change does not relieve an individual from the “profit” requirement for such contributions.

Non-vested Participants: The final regulations clarify that elective contributions under a qualified CODA are only disregarded with respect to the application of vesting schedule requirements for employer contributions. For example, since 401(k) contributions are always 100% fully vested, 401(k) plan participants will not be considered “non-vested” when applying certain break in service rules for eligibility and vesting purposes.

In addition, these new rules require that elective deferrals are taken into account for purposes of determining whether a participant is non-vested for purposes of the special vesting break-in-service rules for defined contribution plans.

If you have questions about how these regulations affect your plan, please contact your contact your FBA Plan Administrator for assistance. ♦

Definition of Controlled Group

The American Jobs Creation Act of 2004 (AJCA) modifies the definition of a controlled group of corporations to provide that a brother-sister controlled group means two or more corporations if five or fewer persons who are individuals, estates, or trusts own (or constructively own) more than 50 percent of the total voting power or value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation.

This provision, which pertains to tax years beginning after Oct. 22, 2004, applies only for purposes of section 1561 (currently relating to corporate tax brackets) the accumulated earnings credit, and the minimum tax. It does not affect other Internal Revenue Code sections or other provisions that refer to the section 1563 brother-sister corporation controlled group test for other purposes. For those purposes, the existing definition of a brother-sister controlled group remains in effect. ♦

Proposed Rules on Abandoned 401(k) Plans

[DOL Prop. Reg. Secs. 2520.103-13, 2550.404a-3, and 2578.1, 70 Fed. Reg. 12046 (Mar. 10, 2005); Proposed Class Exemption for Services Provided in Connection With the Termination of Abandoned Individual Account Plans, 70 Fed. Reg. 12074 (Mar. 10, 2005)]

According to the DOL, each year approximately 1,650 401(k) plans with \$868 million in assets are abandoned. Typically, these are small plans from which participants are unable to receive distributions because there is no responsible plan sponsor or plan administrator available to authorize the distributions (due to, for example, bankruptcy, acquisition, imprisonment, or death). In response, the DOL has issued three proposed regulations (and a proposed prohibited transaction class exemption) that would, when finalized, facilitate the termination of, and distribution of benefits from, abandoned individual account plans (including 401(k) plans). The regulations are proposed to be effective 60 days after they are issued in final form.

The first of the proposed regulations would establish a regulatory framework under which financial institutions (and certain other entities) that hold the assets of abandoned plans could terminate them and wind up the affairs of these plans with limited fiduciary liability. A plan generally would be considered “abandoned” when (1) no contributions to, or distributions from, the plan have been made for a 12-consecutive-month period; and (2) the plan sponsor no longer exists, cannot be located, or is unable to maintain the plan. A “qualified termination administrator” (QTA) would determine whether the plan is abandoned. The QTA is defined as an entity that holds the abandoned plan’s assets and is eligible to be a trustee or issuer of an individual retirement plan (e.g., a bank, trust company, mutual fund family, or insurance company). The proposed regulation would establish the following procedures that QTAs must follow for the winding-up and distribution process.

Finding of Abandonment. The QTA would be required to make reasonable efforts to locate or communicate with the plan sponsor at the last-known address of the plan sponsor (or the corporate agent for service of legal process). The proposed regulation provides a model notice that would be deemed to satisfy reasonable efforts.

Deemed Termination. If the QTA makes a finding of abandonment, the plan generally would be deemed terminated on the 90th day following the date that the QTA furnishes a notice of abandonment to the Employee Benefits Security Administration (EBSA). The proposed regulation further provides that the abandoned plan would be deemed amended to the extent necessary to implement the termination.

Winding Up. The QTA would need to take the following steps to wind up the plan's affairs: (1) locate and update plan records; (2) calculate the account balances; (3) notify participants and beneficiaries of the plan termination and of their distribution rights and options; (4) make distributions; and (5) file a simplified final Form 5500 and a final notice with EBSA. The QTA would be permitted to engage service providers, as necessary, for the winding up and to pay reasonable expenses from the plan. The proposed regulation includes model notices that the QTA could use, but would not be required to use, to satisfy each of the notice requirements.

The second proposed regulation would provide a fiduciary safe harbor for QTAs to make distributions to IRAs on behalf of participants who fail to make distribution elections under the abandonment procedure. This safe harbor also would be available to plan sponsors and other fiduciaries that terminate their 401(k) plans (without regard to whether the plan is abandoned) and have participants who fail to make distribution elections. The requirements for satisfying the fiduciary safe harbor include IRA provider, investment, and notice requirements similar to those for the fiduciary safe harbor for automatic rollovers of mandatory distributions (see our article in the Fall 2004 newsletter). The proposed regulation provides a model notice to satisfy the required notice to participants regarding the plan termination.

The third proposed regulation would provide a simplified method for the QTA to file a final Form 5500 as an attachment to the final EBSA notice that is required under the abandonment procedure. The QTA would not be required to file any other unfiled Form 5500s, but the plan sponsor or other plan fiduciaries would remain liable for all unfiled Form 5500s.

Along with the proposed regulation, the DOL released a proposed prohibited transaction class exemption that would cover transactions where the QTA selects and pays itself to provide services and investment products in connection with the termination of an abandoned plan.

The DOL/EBSA currently deals with abandoned plans on a case-by-case basis, which often requires court approval. The proposed regulations, when implemented, "would eliminate the need for costlier court approvals and allow workers to regain access to their benefits sooner," by providing needed guidance to the institutions that are left holding the plan assets of abandoned plans but that currently have no authority to terminate them and make distributions.

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Final Regulations Remove 90-Day Notice Requirement for Eliminating Optional Forms of Distribution

Treas. Reg. Sec. 1.411(d)-4, 70 Fed. Reg. 3475 (Jan. 25, 2005)]

The IRS has issued final regulations that remove the requirement that a participant be given 90 days advance notice of an amendment to a defined contribution plan that eliminates or restricts a participant's ability to receive a distribution in a particular optional form of payment. As background, Code Section 411(d)(6) contains an "anti-cutback" rule that generally prevents a plan sponsor from decreasing an accrued benefit (including an optional form of distribution) through a plan amendment. However, regulations issued under 411(d)(6) generally allow a defined contribution plan (including a 401(k) plan) to be amended to eliminate or restrict a participant's ability to receive a distribution in a particular optional form if, after the amendment is effective, the remaining forms of payment include a single-sum distribution form that is otherwise identical to the form of payment that is being eliminated or restricted.

Plan sponsors will be glad to see these final regulations, which provide more flexibility in amending plans to eliminate optional forms of distribution. Plan administration can often be simplified by reducing the number of distribution options that must be offered and explained to participants. Note that an amendment that eliminates or restricts the availability of an optional form of distribution cannot apply to distributions that have already begun. And plan administrators are still required to notify participants of plan amendments under ERISA's normal SMM and SPD notice requirements. ♦

Requirements for Fidelity Bonds

What is the ERISA Fidelity Bond? ERISA Section 412 requires that every plan fiduciary and every person who "handles funds or other property" of a plan be bonded. Certain types of fiduciary organizations, including FDIC-insured banks, trust companies, and others, who are subject to equivalent state law bonding requirements, are exempt from ERISA's bonding requirement. There is no small plan or small amount exception to the fiduciary duty to obtain a bond.

Purpose of Bond - The purpose of ERISA's bonding requirement is to protect your 401(k) plan against loss due to fraud or dishonesty by plan fiduciaries and others who handle plan funds, whether directly or through cooperation with others (the only alternative is a complete annual audit by an independent accountant). A Fidelity Bond also shields the plan trustees from personal liability for lost contributions and legal costs that could arise if assets were to be misappropriated from the fund.

Funds Considered "Handled". A plan fiduciary or other person is considered to "handle" plan funds if the person has physical contact with cash, checks, or other similar property, power to transfer or negotiate plan property for a price, power to disburse funds, sign checks, or produce negotiable instruments from plan assets, or has decision making authority over any individual described above.

Type of Bond. The bond can be in the form of an individual bond covering a named individual, a name schedule bond covering more than one named individual, a position schedule bond covering individuals who hold specified positions, or a blanket bond covering all of the insured plan's fiduciaries and others who handle funds. The

bond must be obtained from an approved corporate surety company. (A list of approved surety companies is published in Treasury's Circular 570, available at <http://www.fms.treas.gov/c570/c570.html>.) And the bond cannot be obtained from a surety company in which the plan (or a party-in-interest to the plan) has any direct or indirect control or significant financial interest.

Amount of Bond and Plan Assets Subject to Bond. The bond amount will be based on the amount of assets that are handled by the plan for the preceding plan year. For the first year, the bond amount will be based on the estimated amount of assets that will be handled by the plan for the year. At the very least, the bond must equal 10% of the value of the total plan assets, with a minimum bond value of \$1,000 and no more than \$500,000. For example, if the plan's trust balance at the close of the prior year were \$4 million, then the required bond amount would be 10% of that, or \$400,000. If the total trust balance were \$6 million, then 10% of the assets would be \$600,000, but because of the cap on the maximum required bond, the required bond amount would be \$500,000. The amount of the bond is reported each year on the plan's Form 550, Schedule H for large plans, and Schedule I for small plans. Additional bonding requirements may apply to small pension plans that wish to qualify for a waiver of ERISA's audit requirements for the Form 5500 filing.

Plan assets that "qualify" for a 10% bond include employer securities; participant loans; assets held by financial institutions (i.e. banks, insurance companies, broker-dealers, or other organization authorized to hold IRA assets), mutual funds; investment and annuity contracts issued by an insurance company; and self-directed individual account plans in which the participant gets a statement of assets at least once a year. All other assets are considered non-qualifying plan assets.

Assets held outside a financial institution carry a higher risk of potential loss and are required to carry a higher level of protection. If more than 5% of the plan assets are in limited partnerships, artwork, collectibles, mortgages, real estate, or securities of "closely-held" companies AND are held outside of regulated financial institutions (i.e. a bank, an insurance company, a registered broker-dealer, or other organization authorized to act as trustee for individual hold IRA assets under IRC Code §408, the plan sponsors need to do one of two things. (1) make certain that the bond amount is equal to 100% of the value of these "non-qualified" assets, or (2) arrange for an annual full-scope audit, where the CPA physically confirms the existence of the assets at the start and end of the plan year. Since the risk for misuse presented by assets held outside a financial institution is so high, most insurance companies choose not to write bonds for non-qualified plan assets and limit their bond writing to qualified assets only.

Duration of Bond. Normally the Fidelity Bond is purchased for a three year duration.

Minimum Suggested Bond Amount. Fidelity Bonds are normally purchased for a three year duration, therefore, to cover anticipated plan assets at the end of the three year period, we suggest that the bond be purchased for an amount which is equal to 50% of the initial plan year assets.

What are the Penalties if a Bond is Not Maintained or Provided? Not maintaining or providing a sufficient ERISA fidelity bond can red flag the DOL that they need to take a closer look at the plan. In addition, in cases where a plan has more than 5% in non-qualified assets, a serious underwriting risk may arise if the non-qualified assets are not properly listed on the bond application. If the non-qualified assets are not listed on the bond, the underwriter

would have cause to deny coverage if there was a loss due to misappropriation or misuse by a plan fiduciary. Under those circumstances, the loss may be denied and the trustees could be liable for the losses to the plan.

Any violation may be subject of a civil action brought by a participant or a beneficiary or the Secretary of Labor to enforce the requirement or to obtain other appropriate relief. And, in the case of any breach of any fiduciary responsibility, the Secretary of Labor may assess a civil penalty in an amount equal to 20% of the amount recovered with respect to the breach or violation of any fiduciary obligation.

In a move to increase compliance, the DOL's Employee Benefit Security Administration (EBSA) and the IRS have lowered penalties to \$1,500 or less per plan year under the revised If your plan has gone without a bond in the past

One final note: Fiduciary liability insurance and the bond required under ERISA Section 412 are not the same thing. Fiduciary liability insurance provides broad coverage for employees and others who perform fiduciary functions for the plan but generally excludes fraud and dishonest practices. In contrast, the required bond protects the plan (not the employer or the fiduciaries) from losses caused by the fraud or dishonesty of those named in the bond. ♦

DOL Revises Voluntary Fiduciary Correction (VFC) Program

For a copy of the Notice:
<http://a257.g.akamaitech.net/7/257/2422/01jan20051800/edocket.access.gpo.gov/2005/pdf/05-6627.pdf>

The DOL's The Voluntary Fiduciary Correction Program allows fiduciaries to voluntarily correct specific violations of the Employee Retirement Income Security Act (ERISA). Applicants must full correct any violations, restore to the plan any losses or profits with interest, and distribute any supplemental benefits owed to eligible participants and beneficiaries. A "no action" letter is given to plan officials who properly correct violations. This program is only available if the plan is not under investigation by the DOL..

Amendments. Here are three additional transactions that can be corrected under the VFC Program.

The first new transaction covers circumstances where a plan is holding an illiquid plan asset (such as undeveloped real estate) and a plan fiduciary has determined that it is not in the plan's best interest to continue holding the asset, but the only available purchaser of the asset is a party in interest (e.g., a plan fiduciary). The approved correction method would permit a plan to sell the illiquid asset to the party in interest, rather than to continue to hold it. (Note that the original VFC Program included PTE 2002-51, which provides a limited exemption from the excise taxes imposed under the Code for certain transactions corrected in the VFC Program. The DOL also has proposed an amendment to PTE 2002-51, effective when finalized, to include a sale of illiquid assets pursuant to the VFC Program among the transactions exempted from excise taxes. The exemption would include both the original transaction and the correction transaction.)

The second new transaction covered by the Program involves participant loans that violate certain plan restrictions on the amount or duration of a loan (as incorporated from the Code). The approved correction methods would permit repayment and reformation to correct these types of loan errors. According to the

Program overview, the IRS has expressed its intent to develop a coordinating correction under EPCRS to alleviate certain tax consequences.

The third new transaction covers delinquent participant loan repayments. DOL Advisory Opinion 2002-02A set forth specific time frames for repayment of participant loans to plans. The DOL had previously issued guidance stating that, under the VFC Program, fiduciaries could correct a failure to forward participant loan repayments in the manner set forth in the Advisory Opinion. Consistent with this prior guidance, the DOL here expands the Program to explicitly include correction of delinquent loan repayments.

Simplification of the VFC Program. In addition to the three new transactions, the Notice streamlines the correction process by making available a model application form (available at <http://www.dol.gov/ebsa/calculator/vfcapplicationrevised.html>), which the DOL "encourages" applicants to use, and reduces the supporting documentation that is required to be filed with an application. It also simplifies the calculation of the correction amount that must be restored to the plan eliminating, among other things, the need to calculate "restoration of profits" in many circumstances. The Notice announces a new online calculator (available at <http://www.dol.gov/ebsa/calculator/main.html>) that can be used to calculate lost earnings and interest.

New Definition of "Under Investigation." Eligibility to participate in the VFC Program is conditioned on neither the plan nor the applicant being "under investigation." The Program previously provided that a person was "under investigation" only if the person were subject to an investigation under ERISA by the DOL or under any criminal statute affecting the plan. Under the new definition, a person also will be considered "under investigation" if another federal agency (e.g., the IRS or SEC) is conducting a criminal or civil investigation involving the plan, applicant, or plan fiduciary. The definition of "under investigation" also now includes notice of a federal agency's intent to conduct an investigation, even if the investigation or examination has not started. ♦

Plan Designs w/Top Heavy Requirements

Top heavy is a term used to describe qualified retirement plans that favor "key employees" over non-key employees (as determined by certain formulas). For instance, a defined contribution retirement plan (DC plan) is "top heavy" when the aggregate value of key employee plan accounts exceeds 60% of the aggregate value of all plan accounts. For a defined benefit pension plan (DB plan), top-heavy status is determined by a similar formula using the "present value of accrued benefits" instead of plan account values.

Who are the key employees? A key employee is someone who, at any time during the prior plan year, was:

- A more than 5% owner of the employer. (Family attribution rules apply.)
- An officer with annual compensation greater than \$130,000 in 2004, or \$135,000 in 2005.
- A more than 1% owner with annual compensation greater than \$150,000. (Family attribution rules apply.)

If a DC plan is top heavy, then top-heavy contributions, generally up to 3% of compensation, must be made for all non-key employees. For a top-heavy DB plan, top-heavy accruals are required —

generally an additional benefit accrual of 2% — for all non-key employees who complete 1,000 hours of service during the year (even if separated from employment).

Plus, if the plan is not using a top-heavy vesting schedule, it will be required to accelerate its vesting schedule. There are a number of plan design strategies that can help satisfy top-heavy requirements while providing more "bang for the buck" for the employer.

Employer maintains a DC and a DB plan that cover the same employees. An employer with both a DC and a DB plan may make top-heavy allocations to both plans separately or make a single allocation to just one of the plans. In many cases, the most cost-efficient method is to make an accrual contribution to the DB plan. Why? If the work force is relatively young, then the current value of contributions may be less than a DC plan contribution allocation. In addition, accruals to a DB plan are capped at 10 years. Many times, the DB plan's normal benefit accrual will satisfy the top-heavy allocation.

Employer maintains a money purchase plan (MPP) and another DC plan that cover the same employees. An employer with a top-heavy profit sharing or 401(k) plan and an MPP must make a top-heavy contribution to only one of the plans. Making the contribution to the MPP provides the more cost effective solution. For example, if the MPP is already required to provide a fixed contribution formula of at least 3%, the top-heavy 3% allocation is automatically satisfied. The profit sharing or 401(k) plan document must be amended to indicate that the top-heavy contribution will be made to the MPP. If the plans have different eligibility provisions, employees who aren't eligible to participate in the MPP but are eligible to participate in the other DC plan must receive a minimum contribution through that plan.

Top-heavy 401(k) plan issues. Elective deferrals made by key employees are considered employer contributions for top-heavy purposes. If a key employee makes a deferral to a top-heavy plan, then the plan must make a minimum top-heavy contribution, even if there are no other employer contributions. (The key employee may not disgorge the elective deferral to avoid this situation.) Top-heavy 401(k) plans have several options. For example, employer contributions — including matching, profit sharing, qualified, or safe harbor contributions — may be used to satisfy the 3% top-heavy contribution.

A 401(k) plan may be designed as a safe harbor 401(k) plan and will be exempt from the top-heavy rules as long as only elective deferrals and contributions that satisfy the safe harbor are allocated in a given year. If the employer makes additional non-elective contributions, the safe harbor plan would not be exempt, although employer contributions may count toward satisfying the top-heavy contribution.

Note: SIMPLE 401(k) plans and SIMPLE IRAs are exempt from the top-heavy testing. ♦

Guidance on Allocation of Plan Expenses

[Field Assistance Bulletin 2003-3 (May 19, 2003)]
For a copy: http://www.dol.gov/ebsa/regs/fab_2003-3.html
[Rev. Rul. 2004-10 (Jan. 29, 2004)]
For a copy: <http://www.irs.gov/pub/irs-drop/r-04-10.pdf>

Field Assistance Bulletin 2003-3 (FAB 2003-3) indicates that plan sponsors and fiduciaries have considerable discretion, either

as a matter of plan provision or plan administration, to determine how to allocate expenses among participants and beneficiaries. In all circumstances, however, the plan expenses must be proper plan expenses and must be reasonable with respect to the services provided.

The FAB concludes that the method of allocating plan expenses as set forth in the plan document effectively becomes a part of the benefit entitlements under the plan and fiduciaries generally are required to follow these provisions even if that method favors a class of participants. If, however, the plan document is "silent or ambiguous," plan fiduciaries must act prudently and solely in the interests of participants in selecting the method of allocation. Prudence requires the fiduciary to weigh the competing interests of various classes of plan participants and the effects of each allocation method on those interests. For example, an allocation method that disfavors one class of participants still may satisfy the "solely in the interests of participants" requirement if there is a reasonable basis for selecting that method. In addition, the FAB indicates that a plan fiduciary who also is a plan participant must take care not to select an allocation method that more than incidentally benefits the fiduciary's own account and risks raising conflict of interest issues.

The FAB discussion focuses on two allocation principles: (i) individual versus general plan expense; and (ii) pro rata versus per capita.

Individual versus General Plan Expense. The FAB notes that, except for the "few instances in which ERISA specifically addresses the imposition of expenses on individual participants, ERISA places few constraints on whether expenses are allocated to individuals." The principles that apply when determining how to allocate expenses (that is, pro rata versus per capita) would also apply to a decision about whether to allocate expenses to an individual's account rather than to the plan as a whole.

According to the FAB, ERISA does not prohibit a plan from allocating these specific administrative expenses to the account of an individual participant, rather than the plan as whole:

- i. Administrative Expenses Attendant to Hardship Distributions.
- ii. Expenses for Calculation of Benefits Payable under Different Distribution Options. This would include joint and survivor annuity, lump sum, single life annuity, etc...
- iii. Benefit Distributions. May be done for those receiving periodic distributions and may include check writing expenses. This ruling does not address lump-sum payment, but it can be inferred that they are eligible for similar treatment.
- iv. *Pro Rata or Per Capita Expenses Only for Vested Accounts of Terminated Participants.
- v. QDRO and QMSCO Determinations. Expenses incurred in a determination as to whether a domestic relations order is a Qualified Domestic Relations Order (QDRO). (This is a direct reversal of the DOL's earlier position in Advisory Opinion No. 94-32A.) In addition expenses incurred in determining a Qualified Medical Child Support Order (QMCSO) also may be charged to the affected participant.

*According to IRS Revenue Ruling 2004-10, the IRS explains that charging such expenses on a pro rata or "another reasonable basis" to the accounts of former employees does not impose a significant detriment under Code Section 411(a)(11) because analogous fees are

imposed in the marketplace for a comparable investment outside a plan, such as an IRA. The conclusion with respect to former employees is the same whether or not expenses are charged to the accounts of current employees or whether the terminated participants had the option to take a distribution or rollover.

The DOL's Employee Benefit Security Administration (EBSA) regulations require that all fees and charges that may affect the benefit entitlements of participants and beneficiaries must be disclosed in the summary plan description or summary of material modifications before they can be implemented.

Pro Rata versus Per Capita. The FAB indicates that while a pro rata method of allocating expenses among participant accounts (that is, expenses allocated on the basis of assets in the each individual account) would appear to be the more equitable method of allocation, it is not the only permissible method. The per capita method (that is, expenses are allocated on an equal dollar or percentage basis to each individual account, regardless of the value of the individual account's assets) may be a reasonable method for certain fixed plan administration expenses such as recordkeeping, legal, auditing, annual reporting, claims processing, and similar expenses. But if the expense is a fee based on the assets in the account balance such as, for example, investment management fees, a per capita allocation method would not be reasonable.

IRS Revenue Ruling 2004-10 cautions, however, that not every allocation method is reasonable. For example, a pro rata allocation of the expenses of active employees to all accounts (including the accounts of former employees), while allocating the expenses of the former employees only to the former employees' accounts, would not be a reasonable method. And the ruling further cautions that the allocation method must not discriminate in favor of the highly compensated, both with respect to availability and timing of amendments.

This FAB appears to grant significant flexibility to plan sponsors in designing how their plans will handle certain types of expenses. But note that the FAB specifically expresses no view about whether a particular allocation of expenses might violate the Code or any other federal statute. Thus, we caution employers to consult with their attorneys before implementing new procedures as a result of this FAB. In particular, we are concerned about the broad language suggesting that allocations that disfavor a particular class of participants would be acceptable if a "rational basis" for that decision exists. A plan allocating expenses differently for different groups of participants would need to assess its allocation provision to make sure it does not violate Code Section 401(a)(4), which requires a plan to make available benefits, ancillary benefits, and "other rights and features" on a basis that does not discriminate in favor of highly compensated employees.

However now that the IRS has provided guidance that generally is consistent with the DOL's guidance, sponsors who wish to consider charging expenses to the accounts of former employees have the tools they need to create (with their advisors) appropriate plan amendments. ♦

*This summary is intended for information and educational purposes only and does not constitute financial, tax, or legal advice. Further, this information is general in nature and is not intended to address the particular needs of any specific plan. Please contact your financial, tax, or legal advisor for information about your specific situation.

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