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Monthly Newsletter – Volume 3, No. 8 – September 6, 2007

Highlights of the Month

- 1. Internal Revenue Service Issues Final Regulations for §403(b) Programs**
- 2. Department of Labor Publishes Field Assistance Bulletin Addressing ERISA Exemption for §403(b) Programs**
- 3. Bill Introduced in Senate to Require Employers with Nonqualified Deferred Compensation Plans to Sponsor a Defined Benefit Pension Plan for Employees**
- 4. District Court Rules that ERISA Preempts "Play or Pay" Employer Health Benefit Mandate**
- 5. Internal Revenue Service Issues New Proposed Regulations for Cafeteria Plans**
- 6. Appeals Court Gives Cashed-Out Former Employee Right to Sue Administrator of §401(k) Plan for Fiduciary Mismanagement**
- 7. Company Files Suit Against Fidelity Management Trust Company for Breach of Fiduciary Duty Related to Expenses**

Internal Revenue Service Issues Final Regulations for §403(b) Programs

The Internal Revenue Service (IRS) has issued final regulations reflecting legislative changes made to §403(b) since the existing regulations were adopted in 1964. The final regulations also incorporate interpretive positions that the IRS has taken in other guidance on §403(b). The effective date for most provisions is for the plan year beginning on or after January 1, 2009, with church plans delayed one year. Some of the major provisions of the final regulations include:

- ❖ Requiring all §403(b) custodial accounts and annuity contracts be issued pursuant to a written plan that satisfies the applicable requirements. The document must contain all material terms and conditions for eligibility, benefits, applicable limitations, the contracts offered under the plan, and the time and form under which benefit distributions would be made. The document can contain other optional provisions. Certain documents, such as insurance contracts and custodial accounts, can be incorporated into the plan document by reference. If there are conflicts between such elements of plan documentation, the primary plan document's provisions will control. The plan is permitted to designate the administration of the §403(b) plan, including responsibility for compliance, to another person or the employer. This designation should be included in the written document.

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- ❖ §403(b) programs can no longer exclude the following classes of employees from making elective deferrals: employees covered by a collective bargaining agreement (union employees), employees who elect to participate in a governmental plan described in §414(d) instead of a §403(b) plan, visiting professors, and religious order employees who have taken a vow of poverty.
- ❖ Imposing new requirements on investment changes between §403(b) contracts under the same “plan.” Such exchanges are permitted only if certain requirements are met; the plan must provide for the exchange and the employer must enter into an information sharing agreement with the issuer of the new §403(b) contract. The information sharing agreement must specify that the employer will share information sufficient for the issuer of the §403(b) contract to satisfy applicable requirements, such as loan limits, hardship distribution requirements, etc. A nontaxable exchange or transfer of assets is still permitted for §403(b) plans, provided that 1) the transfer is a change of contracts (investments) within the same plan, 2) the transfer is from one plan to the plan of another employer, or 3) the transfer is to repay, or to purchase permissive service credits in a governmental defined benefit plan. Transfers based on Revenue Ruling 90-24 will no longer be permitted after September 24, 2007. Plan-to-plan transfers will be allowed as long the employee requesting the transfer is an employee or former employee of the employer who sponsors the receiving plan. Such a transfer differs from a direct rollover. In addition, both the distributing and receiving plan must permit the transfer. Neither the employees’ benefits nor the distribution restrictions can be diminished by the transfer. A transfer that fails to meet the terms of these regulations will be treated as a taxable distribution if a distribution-triggering event has occurred or as a taxable conversion to a nonqualified annuity if a distribution-triggering event has not occurred.
- ❖ Governmental and church §403(b) plans continue to be exempt from the Employee Retirement Income Security Act of 1974 (ERISA). Plans maintained by tax-exempt employers generally are subject to ERISA, unless a safe harbor exemption requiring limited employer involvement in the plan applies.
- ❖ Prohibiting the purchase of life and other insurance contracts in connection with a §403(b) plan and requiring that death benefits under the plan be incidental. Life insurance contracts issued before September 24, 2007, are grandfathered and premium payments may continue to be made.



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- ❖ Acknowledging that an employer may terminate a §403(b) plan; an employer may immediately replace a terminated §403(b) plan with a §401(k) plan or a §457(b) plan, as appropriate.

Department of Labor Publishes Field Assistance Bulletin Addressing ERISA Exemption for §403(b) Programs

In connection with final regulations, the Department of Labor (DOL) published Field Assistance Bulletin 2007-02, *ERISA Coverage of IRC §403(b) Tax-Sheltered Annuity Programs* (FAB 2007-02), which addresses whether tax-exempt employers will be able to comply with the final §403(b) regulations and remain within the safe harbor exemption from ERISA. The DOL guidance generally provides that a plan of a tax-exempt employer may satisfy the requirements of the final 403(b) regulations and remain exempt from ERISA.

The safe harbor provisions at §2510.3-2(f) state that a program for the purchase of annuity contracts or custodial accounts in accordance with provisions set forth in §403(b) and funded solely through salary reduction agreements or agreements to forego an increase in salary is not "established or maintained" by an employer under §3.2 of ERISA and therefore is not an employee pension benefit plan subject to Title I, provided that certain factors are present. These factors include: 1) participation by employees is voluntary; 2) all rights under the contract or account are enforceable solely by the employee or by an authorized representative of such employee; 3) the involvement of the employer is limited to certain specified activities (including but not limited to permitting annuity contractors to publicize their products, entering into salary reduction agreements, collecting and remitting amounts under such agreements to the contractor); and 4) the employer receive no direct or indirect consideration or compensation other than reasonable reimbursement to cover expenses incurred in performing the employer's duties pursuant to the salary reduction agreements.

Under FAB 2007-02, the DOL has issued guidance concerning the extent to which compliance with the IRS Final Regulations on § 403(b) programs would cause employers to exceed the limitations on employer involvement permitted under the safe harbor provisions of §2510.3-2(f). One requirement in the final regulations is that a program must be maintained pursuant to a written defined contribution plan that satisfies Internal Revenue Code requirements and contains all the material terms and conditions for benefits under the program. The DOL does not believe that by adopting such a written plan an employer establishes a Title I plan. An employer's development and adoption of a single document to coordinate administration among different contract issuers, and to address tax matters without reference to a particular contract, would not put the program out of compliance with the safe harbor. The documents should describe the employer's



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limited role and allocate discretionary determinations to the annuity provider(s), participant, or other third party selected by the provider or participant. Under FAB 2007-02, the DOL has stated that while periodically reviewing the documents making up the plan for conflicting provisions and compliance with the IRC falls within the safe harbor provision, negotiating with annuity providers or account custodians to change the terms of their products for other purposes, such as setting conditions for hardship withdrawals, would be a form of employer involvement that exceeds the safe harbor limits.

The DOL has stated that it believes the safe harbor allows an employer to conduct administrative reviews of the program structure and operations for tax compliance defects, including discrimination testing and contribution limits testing. The employer may design and propose corrections, develop improvements in the program's administrative processes to prevent recurrence of tax defects, and obtain the cooperation of independent entities involved in the program needed to correct tax defects.

In the DOL's opinion however, the employer cannot be consistent with safe harbor provisions and have responsibility for, or make discretionary determinations in, administering the program. For example, the employer could not be involved in discretionary determinations such as authorizing plan-to-plan transfers, processing distributions, making determinations regarding hardship withdrawals or qualified domestic relations orders, and eligibility for loans.

Bill Introduced in Senate to Require Employers with Nonqualified Deferred Compensation Plans to Sponsor a Defined Benefit Pension Plan for Employees

Senator Tom Harkin (D-IA), a member of the Senate's Health, Education, Labor, and Pensions Committee, has introduced a bill (S. 1725), the *Restoring Pension Promises to Workers Act*, that would require employers offering nonqualified deferred compensation plans to also sponsor and maintain one or more defined benefit pension plans for their employees. Under the bill, if an employer failed to satisfy this requirement, all compensation deferred under the nonqualified plan for the taxable year of the failure and all preceding taxable years would be immediately included in each covered employee's gross income. Other features of S. 1725 include a provision to prevent pension plans from recovering benefit overpayments that are not due to any fault on the part of the participant and would create a hardship on the part of the participant or beneficiary, and a three year statute for such recoveries; a provision to amend ERISA and the IRC to allow employees to continue earning service credits towards eligibility for early retirement after their employment has changed due to a corporate transaction; and a provision to create an Office of Pension Participant Advocacy within the DOL.



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District Court Rules that ERISA Preempts "Play or Pay" Employer Health Benefit Mandate

In July, the U.S. District Court of the Eastern District of New York ruled that ERISA preempts Suffolk County, New York's employer health benefits "play or pay" mandate. In *Retail Industry Leaders Association v. Suffolk County* [06 CV 00531 (E.D.N.Y., July 14, 2007)], the District Court adopted the analysis used by the Fourth Circuit Court of Appeals to strike down a similar Maryland law earlier in 2007. Suffolk County can appeal the District Court's decision to the Second Circuit Court of Appeals.

The Suffolk County law requires covered employers to make minimum employee health care expenditures equal to the "public health care cost rate" multiplied by the total number of hours worked by their employees in the county. The cost rate is the approximate cost to the county's public health system of providing health care to one uninsured employee as calculated by the county's Labor Department. All hours worked by a covered employer's non-managerial and non-supervisory employees would be used to calculate its required expenditures. If the employer's expenditures were less than the calculated amount, it is required to pay the difference to the county in the form of a civil penalty. An employer's health care expenditures include contributions to an employee's health savings account, reimbursements of health care expenses incurred by employees or their families; amounts expended to operate a workplace health clinic or health-related services in the workplace; and contributions to any health center or other community center. The county's law only applies to "covered employers" which generally are large retailers (i.e., operators of one or more retail stores in the county that sell groceries or other food for off-site consumption and meet one of the following requirements: 1) at least 25,000 square feet of selling space is used for sale of groceries or food for off-site consumption; 2) at least 3% of the selling space is used for sale of groceries or food for off-site consumption and the store contains at least 100,000 square feet of selling space; or 3) the retail store had annual revenues of \$1 billion or more in the last calendar year and groceries account for more than 20% of the employer's revenue.

Consistent with the Fourth Circuit Court of Appeals decision with respect to a similar situation in Maryland, the District Court found that the Suffolk County law effectively requires employers to spend a certain amount on health benefits for employees. The County argued that covered employers could comply with the law without reference to their ERISA plans but the District Court found the alternatives to be "unrealistic" and "difficult for covered employers to use"; the only reasonable option to comply with the law would be for covered employers to increase contributions to their ERISA plans and therefore, the County law is preempted by ERISA.



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Internal Revenue Service Issues New Proposed Regulations for Cafeteria Plans

The IRS has withdrawn proposed regulations issued in 1984, 1989, 1997 and 2000, as well as February 1986 temporary rules, and issued new Proposed Regulations governing the operation of cafeteria plans under §125. The new proposed regulations are generally intended to apply for years beginning on or after January 1, 2009, but can be relied on until the issuance of final regulations.

§125 defined a cafeteria plan as a written plan under which all participants are employees and all participants may choose among two or more benefits consisting of cash and qualified benefits, which, with some exclusion, are benefits that are not includible in an employee's income by reason of a provision in the IRC. A cafeteria plan cannot discriminate in favor of highly compensated individuals as to eligibility to participate or contributions and benefits. In addition, a cafeteria plan cannot provide for deferred compensation, except as specifically provided in the IRC. The newly issued proposed regulations emphasize that §125 is the only means by which an employer can offer its employees an election between nontaxable and taxable benefits without the election itself resulting in inclusion in gross income by the employee. A cafeteria plan must be maintained and operated in accordance with a written plan document. The proposed regulations have expanded the information required to be in such a document – it must specifically state that participation is limited to employees (spouses and dependents may benefit under the coverage elected by an employee through the cafeteria plan but cannot be provided an opportunity to elect or purchase benefits offered through the plan); must contain specific provisions to put paid time off, flexible spending accounts (FSA), and distributions from a health FSA in compliance with the rules applicable to such arrangements. The proposed regulations emphasize that an amendment to a cafeteria plan can only be effective for periods after the later of the adoption date or the effective date of the amendment. In addition, if the amendment adds a new benefit, only expenses incurred after the later of the adoption date or effective date of the amendment can be paid or reimbursed by the plan.

The proposed regulations list specific benefits that cannot be offered through a cafeteria plan – dependent life insurance coverage, long-term care insurance, educational assistance benefits, and transportation benefits. The method for imputing income for group term life insurance purchase through a cafeteria plan is changed by the proposed regulations and is immediately effective – the amount includable in income is the Table I cost of the excess coverage (i.e., in excess of \$50,000) less any after-tax contributions. All salary reduction and flex credits are excludable from income, even if used to purchase



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group term life coverage in excess of \$50,000. The new proposed regulations specifically provide for a cafeteria plan to have automatic elections for new employees or for current employees who fail to make an election during an annual enrollment period.

The proposed regulations incorporate by reference the nondiscriminatory classification test under §410(b) that applies to qualified retirement plans with a substitution of highly compensated individuals and non-highly compensated individuals for highly compensated employees and non-highly compensated employees. The regulations also specify that in order to satisfy the Contributions and Benefits test, highly compensated participants (HCPs) must not disproportionately elect qualified benefits while other participants (non-HCPs) elect to receive employer contributions and permissible taxable benefits. If the aggregate qualified benefits elected by HCPs, calculated as a percentage of compensation, exceed the aggregate qualified benefits elected by non-HCPs, calculated as a percentage of compensation, then the HCPs have disproportionately elected qualified benefits. If a plan fails any of the nondiscrimination tests, the adverse tax consequences affect only HCPs and key employees – the HCP or key employee is taxed on the value of the benefit with the greatest value that the employee could have elected to receive.

Appeals Court Gives Cashed-Out Former Employee Right to Sue Administrator of §401(k) Plan for Fiduciary Mismanagement

In an opinion issued by the 3rd Circuit Court of Appeals [(*Graden v. Conexant Systems Inc.*, 3d Cir., No 06-2337, July 31, 2007)], a former account holder and participant in a defined contributions pension plan was granted standing to sue the administrator of the plan for mismanagement of the plan's assets, even though he had cashed out the balance in his plan account upon termination of employment with Conexant Systems, Inc. (Conexant).

Howard Graden was an employee of Conexant until September 2002 and a participant in its retirement savings plan until October 2004. Graden's contributions into the plan were invested in the employer's common stock which was offered as an investment option in the plan. From March 2004 to October 2004 when Graden took a distribution of his account balance, the price of the stock dropped from \$7.42 per share to \$1.70 per share. Graden alleged in his suit that the stock price drop was the result of a risky, failed merger by the company. He also alleges that the company breached its fiduciary duty to him and to other plan participants by (1) offering the stock fund as an investment option despite the fact that it was not (and was known not to be) a prudent investment, and (2) making false and misleading statements about the merger that caused him to invest in the fund.



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The district court dismissed the case [United States District Court for the District of New Jersey (D.C. Civil Action No. 05-CV-00695)] due to lack of standing as Graden was no longer a participant for purposes of ERISA having cashed out his account balance in the plan. The ruling was appealed by Graden and the Court of Appeals solely considered the issue of standing. The Court noted that it was not disputed that the Conexant plan is a benefit plan covered by ERISA and it also assumed for purposes of the action that the defendants (Conexant, its officers and members of the committee that administered the plan) are fiduciaries of the plan. Graden brought the action under 29 U.S.C. §1132(a)(2) which accords various parties the right to sue ERISA plan fiduciaries for breach of duties. The Supreme Court has held that suits under §1132(a)(2) are derivative in nature – various parties are entitled to bring suit but they do so on behalf of the plan itself. ERISA defines a participant as "any employee or former employee . . . who is or may become eligible to receive a benefit of any type from an employee benefit plan." [29 U.S.C. § 1002(7)]. Applying this definition, the Supreme Court has held that the term covers a former employee with a colorable claim for "vested benefits." [*Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 118 (1989) (quoting *Saladino v. I.L.G.W.U. Nat'l Ret. Fund*, 754 F.2d 473, 476 (2d Cir. 1985))]. Graden argued that because Conexant's breaches improperly reduced the value of plan assets allocable to him, he is entitled to additional benefits that will become available once Conexant makes good the loss to the plan. The Court concluded that as an account-holder in the Conexant plan, he was entitled to the net value of his account as it should have been in the absence of any fiduciary mismanagement.

Company Files Suit Against Fidelity Management Trust Company for Breach of Fiduciary Duty Related to Expenses

A complaint against Fidelity Management Trust Company (Fidelity) was filed in the U.S. District Court – District of Massachusetts by Columbia Air Services (Columbia) alleging breach of fiduciary duty. Columbia is the sponsor and plan administrator for the Columbia Group of Companies 401(k) Retirement Savings Plan (Plan) and Fidelity is the Plan's trustee. Columbia brought the action against Fidelity on behalf of the Plan and all other sponsors, administrators and trustees on behalf of similarly situated plans pursuant to §502(a)(2) and §(3) of ERISA. Columbia alleges that Fidelity breached its duty as a fiduciary and engaged in prohibited transactions in violation of ERISA §406(b) when it received a share of fees paid to third parties in addition to the amount expressly agreed under the Plan as compensation for the services provided to the Plan. Columbia alleges that as a result, Fidelity was in effect overpaid for services it rendered to the Plan.

By execution of the adoption agreement, Fidelity agreed to serve as the trustee for the Plan – to open and maintain a trust account for the Plan and individual accounts for each



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participant in the Plan, to accept contributions on behalf of the participants, to invest and reinvest Plan assets and to hold securities owned by the Plan in accordance with the terms of the Plan. Under the terms specified in the Service Agreement between the Plan and Fidelity, Fidelity was to receive a fee for performing its duties as specified in the Agreement. Under the Agreement, no fee was paid to Fidelity for investment selection or management services. The Plan utilized a variety of mutual funds as investment options into which participants could direct their contributions and these funds charged fees arising out of the investment of plan assets. Columbia alleges that Fidelity was paid a share of these investment fees even though it performed no services for the Plan other than those specified in the Service Agreement. Columbia further alleges that Fidelity received this share of investment fees as a result of its exercise of duties under the Service Agreement and that as a result, the fees are Plan assets and that the Plan and its participants thereby overpaid for the services received. Columbia seeks to make this a class action suit pursuant to Rule 23 of the Federal Rules of Civil Procedure.