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### *Highlights*

1. Retirement Plan Compliance a Top Priority Issue for IRS
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4. IRS Proposed Regulations Explain Roth IRA Option for 401(k) Plan Contributions

### Retirement Plan Compliance a Top Priority Issue for IRS

Steven Miller, IRS Commissioner of Tax Exempt and Government Entities (TE/GE), stated that compliance is an important topic and matter of concern for the IRS and Congress when he addressed the Los Angeles Benefit Conference. Thus, outreach and increased enforcement will be key components of IRS's future work.

Miller further stated that in order for the IRS to achieve its goal of promoting and protecting retirement benefits, the Employee Plans Office of TE/GE needs to rebalance its efforts to better establish a prominent IRS enforcement presence in the benefits community. Between 1999 and 2003, IRS reduced the number of employee plan reviews to less than one-half of what Miller believes a modest examination program should handle. In order to reverse this trend, Miller stated that the TE/GE office will conduct 11,000 employee plan examinations in 2005 and 12,500 in 2006.

He stated that the TE/GE office is currently hiring additional personnel to assist in employee plan examinations and employee plan compliance. The office has also established dedicated staffs for dealing with examinations and determinations. This new structure will provide increased stability and experience, further improving the quality, efficiency and consistency of examinations, said Miller.

The TE/GE office also will experience improvements to its infrastructure and its work processes through improved automation, permitting agents to communicate with internal systems within the IRS when working outside the IRS office. In addition, the TE/GE office expects to perform more focused examinations and to begin the examination process earlier in time.



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## **DOL Advisory Opinion Clarifies Rules for Amounts Reported on Schedule A**

Recently there has been significant focus on commissions and fees paid in connection with insurance policies. Many insurance brokers have settled charges over the past year regarding commissions and other payments with various governmental agencies. Many employee benefit plans purchase insurance to provide benefits to the plan's participants and beneficiaries.

In light of the focus on commissions paid to insurance agents and brokers, counsel for an insurer requested guidance on an insurance company's duty to report the commissions and fees paid to brokers, agents, and other persons on Schedule A. In his request, counsel alleged that some in the insurance industry have developed a pattern and practice of underreporting commission and fee payments to brokers and agents based on incorrect interpretations of the Schedule A, Schedule A instructions, and Advisory Opinion 86-17A issued April 28, 1986.

In ERISA Opinion Letter No. 2005-02A, 2005, issued on February 24, 2005, the Department of Labor (DOL) attempted to clarify its position on the reporting requirements for Schedule A. Schedule A is the attachment to Form 5500, Annual Report of Employee Benefit Plan, which is used for the reporting and disclosure of certain insurance information. In this opinion letter the DOL reiterated its position that:

- A separate Schedule A must be attached for each insurance contract used to provide benefits under the plan;
- Separate commission and fee information is required for the Schedule A even if the premiums are paid from the employer's general assets or the insurance policy is held in the name of the plan sponsor.
- Schedule A should reflect all direct or indirect fees and commissions that are attributable to a contract between an employee benefit plan and an insurance company, this includes:
  - Commissions and fees paid by an insurance company where the broker's or agent's or other person's eligibility for the payment is based in whole or in part on the value (e.g., policy amounts, premiums) of contracts or policies in place with or retained by an employee benefit plan, including for example, persistency or profitability bonuses
  - Nonmonetary forms of compensation, such as prizes, trips and cruises, gifts or gift certificates, club memberships, vehicle leases, and stock awards, must be reported if the entitlement to or the amount of the compensation was based in whole or in part on policy contracts in place with or retained by ERISA plans.



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- Reportable commissions and fees include amounts paid by an insurance company on the basis of the aggregate value (e.g., policy amounts, premiums) of contracts or policies placed or retained.
- The fact that a broker or agent signs on behalf of an insurance company would not be a basis for failing to report fees and commissions attributable to the contract or policy on Schedule A.
- Amounts paid to a general agent or manager must be reported on Schedule A if they are calculated under a formula based in whole or in part on the value of contracts or policies placed with or retained by ERISA plans even if such amounts were labeled override commissions, salaries, or bonuses. The exception for compensation paid by an insurer to a general agent or manager for managing an agency or for performing other administrative functions must be paid solely to the general agent or manager for those functions. In addition, the terms “general agent” or “manager” do not include brokers representing an insured.

The rules outlined in this Advisory Opinion will be helpful to plan administrators when they are preparing their 2004 annual reports for filing in the next few months.

### **IRS Issues Technical Advice Memorandum that the Purchase of Life Insurance by a VEBA Did Not Kill Employer Deduction for Contributions to VEBA**

A corporation maintained a group medical plan and a self-funded death benefit plan (Plan) for its employees, retirees, and their dependents. When the Financial Accounting Standards Board (FASB) adopted Statement of Financial Accounting Standards No. 106 (SFAS 106) which required that an employer’s financial statements report existing non-pension, post-retirement benefit obligations, the corporation established a VEBA to fund those benefits. The establishment of the VEBA allowed the corporation to offset its liability for post-retirement, non-pension obligations by the assets held in the VEBA.

SFAS 106 provides that non-pension, post-retirement obligations can be offset with the value of “plan assets.” In order for the amounts to constitute plan assets, the amounts need to be segregated and restricted to provide for the payment of post-retirement benefits. Plan assets include contributions by the employers and participants, if the plan is contributory, and amounts earned on invested funds, less benefits, taxes and other expenses incurred. Amounts held in a VEBA are considered plan assets and, therefore, satisfy the requirement of SFAS 106 in order to be an offset against the employer’s liabilities relating to post-retirement obligations.

The corporation that is the subject of the TAM decided that without offsetting assets, its financial statements would bear the full impact of SFAS 106. As such liabilities would



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significantly increase and earnings per share would significantly decrease. The corporation decided to implement a funding plan that would reduce the rate of increase in post-retirement liabilities and lessen the negative impact on earnings per share. Therefore, the corporation established a trust which together with the Plan constituted a VEBA.

The corporation was allowed a tax deduction for contributions made to the VEBA as long as the rules relating to funded welfare plans were followed. If the VEBA's assets exceed the specified funding limits then the VEBA's income is subject to unrelated business income tax (UBIT) and the tax deduction relating to the excess contributions would be disallowed.

Upon the advice of its consultant, the VEBA purchased life insurance policies on the lives of key employees. The beneficiary on the policies was the VEBA. The life insurance was the primary investment of the VEBA's reserves for the post retirement benefits. Life insurance was chosen as the primary investment because its cash values would accumulate on a tax deferred basis and would not be subject to UBIT. The tax deferred earnings would eventually be paid to the VEBA as tax free benefits. The corporation had been advised that the contributions to the VEBA would be deductible, subject to applicable statutory provisions.

Upon examination an IRS agent disallowed the deduction for contributions to the VEBA. The agent argued that the VEBA was a conduit for the corporation and since the corporation was not allowed a tax deduction for premiums on any life insurance policy if it is directly or indirectly a beneficiary under the policy. Because the proceeds of the life insurance policies would be used to fund an obligation of the corporation, the agent concluded that the corporation received the proceeds indirectly.

The matter was referred to IRS National Office for resolution since the taxpayer did not agree with the agent's conclusion. In reaching its conclusion the National Office stated that the VEBA was established for the purpose of providing medical and life insurance benefits for the corporation's active and retired employees, and that the Plan was an employee welfare benefit plan subject to the provisions of Title I of ERISA. Title I of ERISA imposes certain fiduciary duties on various parties associated with the Plan.

The National Office held that the corporation, its Board of Directors, and the Investment Committee, in exercising control over the VEBA and in directing the Trustee to purchase the life insurance policies, were acting in their fiduciary roles. Acting as fiduciaries, they could act and provide direction only in the best interests of the VEBA participants. If the VEBA were operated as a mere conduit for the corporation's benefit, the fiduciaries would violate their duties and obligations under ERISA. Thus, absent any showing of fiduciary violations, the National Office could find no agency, conduit, or other relationship that would equate the corporation's contributing amounts to the VEBA to the



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payment of premiums. Therefore, the corporation was allowed a tax deduction for contributions to the VEBA that were used to purchase life insurance policies.

## **IRS Proposed Regulations Explain Roth IRA Option for 401(k) Plan Contributions**

IRS issued proposed regulations that explain the post-2005 rule that permits 401(k) plans to allow participants to elect to have all or part of their elective deferrals treated as Roth IRA contributions. The proposed regulations would apply to plan years beginning on or after January 1, 2006.

Unlike the elective deferrals, the amounts designated as Roth contributions are currently includible in an individual's gross income. However, a "qualified distribution" of designated Roth contributions is excludible from income.

Under the proposed regulations, "designated Roth contributions" would be defined as elective contributions under a cash or deferred arrangement (CODA) that is:

1. irrevocably designated as "designated Roth contributions" by the employee when he/she makes the cash or deferred election;
2. treated by the employer as includible in the employee's income (amounts would be subject to applicable withholding taxes) when the employee would have received the contribution in cash (i.e., the employee had not made an election to defer the receipt of cash); and
3. maintained by the plan in a separate account.

The proposed regulations provide that the separate accounting requirement is met by:

1. contributions and withdrawals of designated Roth contributions must be credited and debited to a designated Roth contribution account maintained for the employee who made the designation;
2. the plan must maintain a record of the employee's investment in the contract (i.e., as yet undistributed designated Roth contributions) with respect to the designated Roth account; and
3. gains, losses, and other credits or charges (but not forfeitures) must be separately allocated on a reasonable and consistent basis to the designated Roth contribution account and other plan accounts.

The separate accounting requirement must be met until the designated Roth contribution account is completely distributed.



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A designated Roth contribution has to satisfy the requirements that apply to elective contributions made under a qualified CODA. Thus, the designated Roth contributions are subject to a number of the qualification rules that apply to employee salary deferrals. These rules include the nonforfeitability and distribution restrictions for salary deferrals; the actual deferral percentage (ADP) test; and the required minimum distribution rules.

The proposed regulations amend the rules relating to correction methods for failure to satisfy the ADP test to permit a highly compensated employee with elective contributions that include both pre-tax salary deferrals and designated Roth contributions to elect whether excess contributions are to be attributed to pre-tax salary deferrals to designated Roth contributions.

Under the proposed regulations, a distribution of excess contributions would not be includible in income to the extent it represents the timely return of designated Roth contributions. However, the income allocable to the corrective distribution of excess designated Roth contributions is includible in income.

One important item that is not addressed by the proposed regulations is guidance on the taxation of the distribution of designated Roth contributions. The IRS has stated that additional guidance will be issued including guidance on how an employee is to recover “his investment in the contract” associated with designated Roth contributions.

While adding a designated Roth contribution feature to a 401(k) plan provides a new savings alternative for employees, it will add new compliance and recordkeeping costs. The additional cost for adding this feature needs to be weighed against the number of employees who would elect to use the designated Roth contribution feature.