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Newsletter – Volume 1, No. 4 - March 28, 2005

## Newsletter – Volume 1, No. 5 – April 25, 2005

### *Highlights*

1. EBSA Makes Changes to Fiduciary Correction Program and Proposed Amendment to the Related Class Exemption
2. IRS Issues Clarification for HSA Contribution Rules for Married Employees
3. IRS Guidance on *Heinz* Case Suspension of Benefits Issues to Avoid Plan Disqualification
4. Supreme Court Confirms Bankruptcy Exemption for IRAs

### **EBSA Makes Changes to Fiduciary Correction Program and Proposed Amendment to the Related Class Exemption**

EBSA has expanded and simplified its Voluntary Fiduciary Correction Program (VFC). EBSA has added three additional types of transactions that are eligible for correction under the program, provided an on-line calculator that can be used to calculate the amount that needs to be restored to the employee benefit plan, and has stream-lined documentation and clarification of the eligibility requirements for the VFC.

### *Background*

VFC was established as a temporary program in 2000 and made permanent in March 2002. When the VFC program was made permanent in 2002, it was expanded to include a class exemption (Prohibited Transaction Exemption (PTE) 2002-51) which provides excise tax relief for four specific VFC program transactions.

The VFC permits plan fiduciaries and others to self-correct fiduciary breaches and report the correction to EBSA. If the plan fiduciaries follow the requirements of the VFC in correcting fiduciary breaches then they can avoid potential civil actions and the assessment of civil penalties under ERISA. The VFC program describes:

1. The application process for relief.
2. The list of transactions that are covered by the program.
3. Acceptable methods for correcting the violations.
4. Examples of potential violations and corrective actions.



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VFC applicants must fully correct any violations, restore any losses or profits with interest to the plan, and distribute any supplemental benefits owed to eligible participants and beneficiaries. If the applicant meets all the conditions of the VFC program, EBSA issues a no action letter and they are not subject to civil monetary penalties.

PTE 2002-51 provides that the following four types of transactions covered by the VFC program are not subject to the excise tax on prohibited transactions if the conditions of the class exemption are met:

1. delinquent remission of participant contributions and participant loan repayments;
2. loans by a plan to a party in interest;
3. purchase, sale, and exchange of assets between a plan and a party in interest; and
4. sale and leaseback of real property between a plan and a party in interest.

### *New Transactions*

The VFC program was expanded to include the following new transactions as eligible for correction:

1. illiquid plan assets sold to interested parties
2. delinquent participant loan repayments
3. participant loans that violate certain plan restrictions on such loans.

### *Sale of Illiquid Assets*

The revised VFC program allows an employee benefit plan to sell an illiquid asset to a party in interest where the plan fiduciary has determined that continued holding of such asset is not in the best interest of the plan participants and beneficiaries. Examples of the types of illiquid assets that might be sold include restricted and thinly traded stock, limited partnership interests, real estate or collectibles. This sale can only occur after the plan fiduciary has made reasonable efforts to dispose of the asset and has determined that the only available purchaser is the party in interest.

Specifically, the revised VFC program covers the following three situations:

1. a plan holds an asset previously purchased from a party in interest with respect to the plan at no greater than fair market value at that time in an acquisition to which no prohibited transaction exemption applied;
2. the plan holds an asset previously purchased from a person who was not a party in interest with respect to the plan in an acquisition in which a plan fiduciary failed to appropriately discharge his fiduciary duties; and



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3. the plan holds an asset that was purchased from a person who was not a party in interest with respect to the plan in an acquisition in which a plan fiduciary appropriately discharged his fiduciary duties.

If in any of these situations, after the acquisition of the asset, the plan fiduciary concludes that the continued holding of the asset is not in the best interest of the plan; the plan fiduciary may correct the transaction under the revised VFC program. To correct the transaction, the revised VFC program requires the fiduciary to classify the asset as illiquid by determining that:

1. the asset has failed to appreciate, failed to provide a reasonable rate of return, or has caused a loss to the plan;
2. the sale of the asset is in the best interest of the plan; and
3. following reasonable efforts to sell the asset to a non-party in interest, the asset cannot be immediately sold for its original price, or its current fair market value, if greater.

Under the VFC program, the illiquid asset can be sold to a party in interest, provided that the plan receives the higher of:

- the fair market value of the asset on the date of the correction, or
- its original purchase price, plus incidental costs.

The correction provides relief for both the original purchase of the asset, if that acquisition would have been a prohibited transaction, and the sale of the illiquid asset by the plan to a party in interest, which would itself be a prohibited transaction but for the VFC program class exemption, whose conditions the plan official also must satisfy. The sale of an illiquid asset cannot occur until the proposed class exemption is finalized.

### ***Participant Loans that Do Not Meet the Conditions of the Statutory Exemption***

The revised VFC program also covers the following violations that relate to participant loans:

1. a plan extends a loan to a participant who is either a party in interest with respect to the plan based solely on his status as an employee; and
2. a plan extends a loan where either the amount or duration of the loan exceeds the limitations of Code section 72(p) as incorporated into the plan documents.

In order to correct a participant loan that exceeded the amount limitation, the VFC program requires that:

1. the participant pays back to the plan the excess amount of the loan;



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2. plan officials reform the loan to amortize the remaining principal balance as of the date of the correction over the remaining duration of the original loan, making any required adjustments to the monthly payment amount; and
3. plan officials otherwise continue to enforce all other terms of the original loan agreement.

To correct a participant loan that exceeded the duration limitation under the VFC program, plan officials must reamortize the loan to complete repayment within the maximum period permitted under the plan loan provisions.

### *Delinquent Participant Loan Payments*

This revision to the VFC program conforms the program's provisions with EBSA's previous guidance on delinquent participant loan payments, including:

- ERISA Advisory Opinion Letter No. 2002-02A relating to the time frames for repayment of participants' loans to pension plans;
- Guidance in a question and answer format under the VFC program stating that applicants could correct the failure to forward participant loan repayments to a plan in a timely fashion under the VFC program in the manner set forth in ERISA Advisory Opinion Letter 2002-02A; and
- The VFC program class exemption which contained explicit language to cover the failure to transmit participant loan payments to a pension plan within a reasonable time after withholding or receipt by the employer.

### *Simplified Calculation of the Correction Amount*

The revised VFC program provides a simplified method of calculating the correction amount that must be restored to the plan. The general rule is that the amount restored to the plan is either the losses incurred by the plan as a result of the fiduciary breach or the profits that were gained from the improper use of plan assets. The correction amount consists of two components:

- The principal amount (i.e., the amount of plan assets that would have been available to the plan if the breach had not occurred), and
- Lost earnings or restoration of profits. In reality, the most frequent restoration is based on lost earnings rather than a restoration of profits.

Under the revised VFC program, the plan officials are able to calculate the lost earnings (and interest, if any), and the restoration of profits components of the correction amount using the factors provided in Revenue Procedure 95-17, 1995-1 CB 556. In addition, the factors are also displayed on EBSA's website in a tabular format and incorporate daily compounding of an interest rate over a period of time. An applicant can use either the on-line calculator or perform the necessary calculations manually. In either case,



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information sufficient to verify the correctness of the amounts to be paid to the plan must be included as part of the VFC program application.

The revised VFC program defines the restoration of profits to incorporate two amounts:

- The amount of profits made on the use of the principal amount, and
- If the profit is restored to the plan on a date later than when the profit was realized, the amount of interest earned on the profit from the date the profit was realized to the date the profit is restored to the plan.

Plan officials are required to calculate the restoration of profits amount only when the principal amount was used by a fiduciary, plan sponsor, or other plan official for a specific purpose so that a profit resulting from the breach is determinable. The revised VFC program provides that the plan official is required to restore profits to the plan as a component of the correction amount only if the restoration of profits amount exceeds the lost earnings amount plus interest, if any.

### *On-line Calculator*

As part of the revised VFC program, EBSA has provided an on-line calculator on its website. The on-line calculator can be used by applicants to calculate lost earnings and interest, if any, and the interest amount for the restoration of profits. Before using the on-line calculator the applicant must have the appropriate elements that are necessary to calculate the lost earnings and interest, if any. For example, the appropriate elements for calculating lost earnings are the principal amount involved in the fiduciary breach, the loss date, recovery date, and if final payment occurs after the recovery date, the date the final payment is made. The on-line calculator automatically references the underpayment rates over the relevant time period, selects the applicable factors under Revenue Procedure 95-17 and applies the factors to provide the applicant with either the amount of lost earnings and interest, if any, that must be paid to the plan or the interest amount on the profit that must be paid to the plan.

### *Reduced Documentation*

The documentation requirements for two items are reduced under the revised VFC program. The two items are as follows:

1. The requirement that applicants provide certain information relating to the plan's fidelity bond has been eliminated.
2. the documentation required to correct delinquent participant contributions or loan payments can be summary documentation instead of detailed records for transactions that involve either amounts below \$50,000 or amounts greater than \$50,000 that were remitted within 180 calendar days after receipt by the employer.



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### *VFC Program Modifications*

Eligibility to participate in the revised VFC program is conditioned on neither the plan nor the applicant being under investigation. EBSA has expanded the definition of “under investigation” to include civil or criminal examinations or investigations by other federal agencies. In addition, if a plan or an applicant has received a notice of a federal agency’s intent to conduct an examination or investigation they are considered to be “under investigation” for purposes of the revised VFC program. However, the applicant or plan sponsor will be considered “under investigation” only if the investigation or examination at issue is in connection with an act or transaction involving the plan. For example, the examination of a bank by one of the banking regulators would only cause the bank to be ineligible for the VFC program if the banking examination related to an act or transaction involving the bank’s plan.

The revised VFC program contains a simplified penalty of perjury statement and conforms the representations to the revised VFC program’s eligibility criteria. However, the applicant must declare that the application and all supporting documents, based on knowledge and belief, are true, correct, and complete.

### *Other changes*

1. A new model application form was attached to the EBSA notice as Appendix E. The model form outlines the information and supplemental documentation that an applicant must include with a correct and complete application. The model application also contains a mandatory checklist that must be included with all applications.
2. A new provision was added that permits EBSA to make written requests for any supplemental documentation necessary for a complete examination and review of an application under the VFC program. This provision also permits EBSA to suspend a review of the application and to consider other appropriate action if an applicant fails to respond with the requested documentation within the specified timeframe.
3. EBSA can reject an incomplete application and consider appropriate action, including the assessment of a penalty under ERISA section 502(i). However, any penalty assessed would only apply to any additional recovery amount paid to the plan as a result of a court order or a settlement agreement with the DOL.
4. Other persons and governmental agencies, including the IRS are not precluded from exercising any rights they may have with respect to transactions that are the subject of the application even though full correction is made under the VFC program. However, IRS has indicated full correction under the VFC program for a breach that constitutes a prohibited transaction under Code section 4975 generally will constitute correction for purposes of Code section 4975 and



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correction of an operational plan qualification failure generally will constitute correction for purposes of the IRS voluntary compliance program.

## **IRS Issues Clarification for HSA Contribution Rules for Married Employees**

In Revenue Ruling 2005-25, 2005-18 IRB the IRS explains how the health savings account (HSA) eligibility and contribution rules apply to a married individual who has a high deductible health plan (HDHP) coverage if his spouse also has non-HDHP family coverage. The conclusion reached by the IRS in this ruling is that the married individual may contribute to an HSA as long as he is not covered by his spouse's non-HDHP.

### ***Basic rules for HSAs***

Individuals are eligible to set-up HSAs if they are covered under HDHPs and not covered under any non-HDHPs (except for certain permitted limited insurance or coverage). Eligible individuals may, subject to statutory limits, contribute to HSAs, and so may employers and other persons on behalf of eligible individuals. An account holder may claim an above the line tax deduction for contributions to his HSA (even if someone else, e.g., family member, makes the contributions). Employer contributions to HSAs are excludable from the employee's income and distributions for qualifying medical expenses are tax-free.

In order for a health plan to qualify as a HDHP for 2005, the plan must have an annual deductible of at least \$1,000 for individual coverage (\$2,000 for family coverage), and maximum out-of-pocket expenses of \$5,100 for individual coverage (\$10,200 for family coverage). The maximum annual contribution to an HSA is the sum of the limits determined separately for each month, based on status, eligibility, and health plan coverage as of the first day of the month.

In 2005, the maximum monthly contribution for eligible individuals with self-only coverage under an HDHP is 1/12 of the lesser of:

- The annual deductible under the HDHP (minimum of \$1,000) or
- \$2,650.

For family coverage, the maximum monthly contribution is 1/12 of the lesser of:

- The annual deductible under the HDHP (minimum of \$2,000), or
- \$5,250.

For individuals and their spouses covered under an HDHP between the ages of 55 and 65, the HSA contribution limit is increased by \$600 in calendar year 2005. It should be noted that HSA contributions cannot be made for individuals enrolled in Medicare or who can be claimed as a dependent on another taxpayer's return.



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### *HSA's for Married Individuals*

The HSA rules generally provide that if either spouse has family coverage both are treated as having only such family coverage. In addition, if each spouse has family coverage under different health plans; both are treated as having family coverage under the health plan with the lowest deductible. However, if one spouse has HDHP family coverage and the other spouse has non-HDHP self-only coverage, the spouse with the HDHP family coverage is eligible to contribute to an HSA up to the amount of the annual contribution limit. The spouse with non-HDHP self-only coverage is not eligible to contribute to an HSA even though the general rule treats both spouses as having family coverage.

### *New Ruling*

The recently issued Revenue Ruling uses three different scenarios to clarify that an otherwise qualifying eligible individual may make HSA contributions even if his spouse has non-HDHP family coverage, as long as the individual is not covered by the spouse's non-HDHP. The contribution amount is determined by whether he has self-only or family HDHP coverage.

#### *Scenario 1*

Harry and Wanda are married and both are age 35. Throughout 2005, Harry has self-only coverage under a HDHP with a \$2,000 annual deductible. He has no other health coverage, he is not enrolled in Medicare, and he can not be claimed as a dependent on another taxpayer's return. Wanda has non-HDHP family coverage for Wanda and Harry's two dependents, but Harry is excluded from Wanda's coverage.

Although Wanda has non-HDHP family coverage, Harry is not covered under her plan and so he is eligible to contribute up to \$2,000 to an HSA (which is the lesser of the \$2,000 HDHP deductible for self-only coverage, or \$2,650) for 2005. Wanda has non-HDHP family coverage and, therefore, is not an eligible individual.

#### *Scenario 2*

The facts are the same as Scenario 1, except that Harry has HDHP family coverage for himself and one of Harry's and Wanda's dependents, with an annual deductible of \$5,000. Wanda has non-HDHP family coverage for herself and their other dependent only, but not for Harry. Because the non-HDHP family coverage does not cover Harry, he may contribute up to \$5,000 to an HSA (which is the lesser of the \$5,000 family HDHP deductible, or \$5,250). Wanda has non-HDHP coverage and can not make an HSA contribution.



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### Scenario 3

The facts are the same as in Situation 1, except that Harry has HDHP family coverage for himself and Harry's and Wanda's two dependents with an annual deductible of \$5,000. Wanda is not covered under Harry's health plan and has no other health plan coverage. Harry may contribute up to \$5,000 to an HSA (which is the lesser of the \$5,000 family HDHP deductible, or \$5,250).

### **IRS Guidance on *Heinz* Case Suspension of Benefits Issues to Avoid Plan Disqualification**

The IRS released Revenue Procedure 2005-23 which provides guidance to plans affected by the U.S. Supreme Court decision regarding plan amendments that add or expand a suspension of benefits provision. In the *Heinz* case (*Central Laborers' Pension Fund v. Heinz*, 124 S.Ct. 2230 (June 7, 2004)), the Supreme Court held that a plan amendment that expanded the reasons for suspension of benefit payments retirees had already accrued could not be enforced because it violated the anti-cutback rules under the Internal Revenue Code (the "Code") and ERISA. This revenue procedure provides guidance to plan sponsors that adopted similar amendments prior to the Court's June 7<sup>th</sup> decision.

### **Background**

The case against *Heinz* was brought by two inactive participants in the Central Laborers' Pension Fund (the "Fund"), a multiemployer plan. Both of the participants had retired and commenced receiving benefit payments from the Fund when they returned to work at *Heinz* as construction supervisors. When they retired the position of construction supervisor was not covered by the Fund and reemployment in that position would not have resulted in a suspension of benefit payments from the Fund upon reemployment. After they retired the Fund was amended to expand the definition of disqualifying employment (i.e., employment that would result in a suspension of benefit payments) to include any employment in the construction industry in the geographic area covered by the Fund. The benefit payments to the two retirees were stopped. In its ruling the Supreme Court stated that a condition may not be imposed after a benefit has accrued and that payments should continue to the two participants. However, the Supreme Court stated that the Code gives the IRS Commissioner discretion whether to apply the Court's decisions retroactively and added that this situation was "an appropriate occasion for exercise of that discretion."



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### *Guidance*

The guidance provided in Revenue Procedure 2005-23 states that tax qualified pension plans can apply similar amendments until June 7, 2004 at the latest if the following requirements are met:

- The plan sponsor adopts a reforming amendment which provides that, beginning on June 7, 2004 (or an earlier date if the plan sponsor so chooses), the provisions of the original amendment that suspends benefits do not apply with respect to benefits that had accrued as of the original amendment date.
- The plan provides payment of retroactive benefits (beginning as of June 7<sup>th</sup> or the earlier date selected by the plan sponsor) to any affected plan participant with respect to benefits that had accrued as of the original amendment date. Retroactive payments must include any appropriate interest and actuarial increases.
- Affected plan participants include participants who did not apply to commence benefits but have qualified for payment under the plan if they had not engaged in employment that resulted in a suspension of benefits under the original amendment.
- Participants must receive at least 6 months' notice of their option to retroactively elect commencement of the payment of benefits. Reasonable efforts must be taken to notify all affected participants, including the use of the IRS letter forwarding service or the Social Security Administration employer reporting service if the participant is not located after a mailing to the last known address.
- The plan must comply with the reforming amendment by January 1, 2006 with respect to benefits payable through December 31, 2005, and must maintain compliance for all periods on or after that date. Plan amendments must be done by the last day of the EGTRRA remedial amendment period for the plan.

There are two alternatives for the plan amendment. The first is to adopt a reforming amendment that would continue to apply the suspension of benefits provision that was in effect immediately prior to the original amendment with respect to all accrued benefits (accruing both before and after the original amendment). The second is to limit the original amendment to only those participants who commenced participation in the plan after the original amendment date.

The effective date of the revenue procedure is April 18, 2005.



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## **New Bankruptcy Law means Good News for Retirement Plans and Participants**

On April 12, 2005 President Bush signed a new bankruptcy law which provides broad protections for benefits under tax-exempt retirement accounts. Specifically, the new law provides that:

1. States cannot opt out of the federal exemptions list relating to “tax-exempt retirement” funds. All retirement funds that are exempt from tax under Code sections 401, 403, 408, 408A, 414, 457 or 501(a) will be outside the reach of an individual’s creditors. Under the new law the debtor must demonstrate that the retirement benefits constitute payments on account of illness, disability, death, age or length of service but the additional requirement that the moneys are “reasonably necessary” for the support of the debtor or the debtor’s dependents does not have to be met. In addition, the debtor must also be able to prove the tax exempt status of the account. This requirement can be met by providing a copy of the determination letter or other reasonable means.
2. The new law places a statutory cap for IRA accounts under Code sections 408 and 408A of \$1 million. This cap is determined without regard to rollover amounts. This cap does not apply to SEP nor SIMPLE retirement accounts. The bankruptcy court may also waive the cap.
3. Under existing bankruptcy law, there is a federal exemption list. Debtors may exempt from their bankruptcy estate either (1) the federal exemption list or (2) property exempt under non-bankruptcy federal law (e.g., ERISA), state and local law, and jointly owned property that is exempt under non-bankruptcy law. Under the existing law, most states had opted out of the federal exemption list so the only exemptions available to debtors were those mentioned in (2) above.

The passage of this law resolves conflicts among the circuit courts that have existed for many years regarding a debtors ability to exempt IRA assets from their bankruptcy estate. The new bankruptcy law follows the Supreme Court’s decision in *Rousey v. Jacoway*.