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ERISA NEWSLETTER

TO: CLIENTS AND COLLEAGUES
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This Newsletter –

- introduces an important new fee disclosure proposal (page 1),
- sounds a warning of how company changes can significantly affect your ERISA plans (page 3),
- discusses new cafeteria plan opportunities and changes, (page 4)
- provides a reminder of the 2008 plan limitations (page 5), and
- shares some firm news (page 6).

For more information, please contact Jeffery Mandell or John Hughes.

DEPARTMENT OF LABOR INITIATIVE LIKELY TO DRAMATICALLY IMPACT ERISA PLANS

I considered an alternative title, such as *Proposed ERISA Rule Serves Some Purpose*, but decided that an *Onion* header might not yet be appropriate for this professionally-glossed publication. As revolutionary as it may seem, it is true that the Department of Labor has proposed a new regime of regulations which might effectively and dramatically improve employee benefit plans. Such topic was the focus of the seminar I recently co-hosted with Bill Campbell, regarding ERISA Fee Disclosure Developments.

The regulations, when finalized and as currently written, will require *all* entities that provide *any* services to retirement or health plans (such as investment and other financial institutions, recordkeepers, lawyers, accountants and third-party administrators, etc.) to provide certain *detailed* disclosures to plan sponsors (and in turn to plan participants). I like to describe the disclosures this way – “Who is getting paid how much for what?”

Very briefly stated, the rules will require entities that provide services to plans (all ERISA plans, retirement and health) to disclose –

- the direct and indirect fees the providers receive,
- the services the providers provide,
- the manner in which plans pay the fees and the providers receive payment,
- the provider's relationships with other plan providers, and
- relationships or other matters that may present conflicts of interest or otherwise affect the provider's performance of services for the plan (such as the choice or recommendation of investments).

A provider's failure to provide the disclosure creates an ERISA "prohibited transaction" because the fees the plan pays will be deemed to be "unreasonable." A prohibited transaction is not a good thing.

I believe the purpose of the new proposal is, in the end, to reduce the fees that plans pay, which in turn means to reduce the fees the participants pay for ERISA services. The disclosures are intended to arm plan fiduciaries with the information they need to discharge their duties to participants to properly select plan providers and pay only "reasonable" fees (which the law requires).

The Department of Labor appears to be gravely concerned with the amount of fees that plans pay (primarily investment fees) and the drag such fees have on investment performance. There is a general perception that providers, particularly financial institutions, are receiving considerable fees, reducing returns for the participants, and yet there is also a considerable lack of understanding of those fees and the provided services. The Department of Labor is not only concerned with the *amount* of fees, but also that the fees are neither understood nor understandable.

I believe it is fair to state that the employee benefits community, notably employers and fiduciaries, has not paid sufficient attention to the fees plans pay, nor to an understanding of the services the providers are supposed to be performing or are performing for the plan. If the proposed regulations, or a material variation of them, survive resistance and become final (I predict they will), this change may stand out as a rarity among the relentless, constant, most-often unwarranted onslaught of ERISA modifications. The change may actually help employers and employees – its benefits may outweigh its costs.

In the meantime, the proposed regulations should have a more immediate beneficent impact on the employee benefits community. This initiative should cause fiduciaries to focus attention on a critical aspect of ERISA which is often overlooked until litigation or government examination ensues. This aspect is "process." Title I of ERISA (the Department of Labor and not the Internal Revenue Code part of ERISA) requires that fiduciaries discharge their duties with care, prudence, deliberation and diligence, and this applies not only to the choice of investments but also to the choice of providers and the fees underlying the employer's choices. Title I of ERISA does not demand particular results (unlike Title II, the Internal Revenue Code), not nearly as much as it requires that the "process" be appropriate and prudent.

The regulations at this moment should encourage fiduciaries to at least take several small, not difficult steps – to engage the "process" – to ensure that they are fulfilling their fiduciary duties with respect to investments and other providers and plan services. Basic questions, perhaps not yet

addressed by employers, should be asked and answered, particularly with regard to investments. This process will not only help protect against charges of breaches and the resulting significant potential liability, but may also create savings for the plan and employer and otherwise do some good.

The discussion above is short in details. To better understand the Department of Labor's proposal, you may review our outline regarding fee disclosure by going to www.erisalawgroup.com.

BEWARE THAT COMPANY CHANGES CAN CAUSE HAVOC ON YOUR PLAN

All qualified retirement plans (and often group *health*, life insurance and *cafeteria* plans) must satisfy a variety of complex Internal Revenue Code nondiscrimination tests. The plan's recordkeeper performs those tests, often with the assistance of legal counsel. The number and type of tests for a particular plan often will differ, depending on legal considerations. For many plans, particularly smaller ones, and also particularly for professional or entrepreneurial closely-held employers, the tests are carefully adjusted each year to best achieve the objectives of the employer. Often the plan satisfies these complex IRS requirements by the slimmest of mathematical and legal margins to meet the employer's contribution objectives. The failure to satisfy one or more of these tests "disqualifies" the plan. Disqualification under any possible remedial approach is costly, cumbersome and sometimes draconian.

The point of this discourse is to inform you that if certain circumstances occur, then you should *without delay* advise your ERISA lawyer (and recordkeeper) as soon as the circumstance occurs; if necessary, adjustments to the plan and/or your expectations and/or testing can then be accomplished. If you wait to inform us, particularly until after the year concludes when you normally provide employee census information to the recordkeeper, it may be too late to make adjustments. The changed circumstance may not allow you to both satisfy your contribution obligations or expectations and satisfy the IRS tests.

The circumstances requiring this vigilance may include, without limitation, the following:

(a) if any individual is hired to work for the company in a capacity other than as an employee (i.e., as an independent contractor, temporary employee, leased employee),

(b) if there is a material change in your business, whatever it may be (e.g., merging with another employer, the termination of or hiring of an unusual number of employees),

(c) if your company experiences turnover of at least 20%,

(d) the hiring of an employee who is related by blood or marriage to any "highly compensated employee,"

(e) the employment or termination of employment of any highly compensated employee or family member,

(f) if your company works closely with one or more other companies to deliver your product or service to your customers or clients,

(g) if, in operation, one or more groups of employees are excluded from or not considered for plan participation,

(h) if any employee becomes, or ceases to be, an owner,

(i) if any owner of the company becomes an owner of any other company, or

(j) if any employee other than an owner receives annual compensation in excess of $100,000.

Not all of the circumstances listed above may materially affect your plan, particularly for a publicly-traded or large company. But, they may. Also, the above list is not exhaustive. *Any* circumstance affecting ownership, the number of your employees, a change in the way your business is managed, a change in the way your product or service is sold, or a change in the way your employees are managed, may adversely affect your plan. A quick call to us may alert you to expensive problems that otherwise would not even be considered, but which may be averted with proper planning.

PROPOSED CAFETERIA PLAN REGULATIONS AFFECT ALL SUCH PLANS

The Treasury Department's proposed Internal Revenue Code Section 125 (aka Cafeteria Plan) regulations will affect all cafeteria plans. (The garden-variety cafeteria plan allows employees to pay three kinds of expenses on a pre-tax basis – the employee's share of insurance premiums, out-of-pocket medical and dental expenses, and dependent care costs.)

The good, the bad and the ugly might aptly describe the rules. The regulations represent a retooling and complete rewrite of the hodgepodge of regulations that have governed these arrangements since the 1980s. They have a little bit of everything[1] in them:

- the good – orthodontia and certain other expenses may be reimbursed in their entirety in the year when paid, instead of having to prorate the reimbursement over the years during which the individual is in braces,

- the bad – tougher nondiscrimination rules may significantly limit small business owners from participating, and

- the ugly – failure to comply with <u>all</u> of the plan *written* requirements or all of the plan *operational* requirements disqualifies the <u>entire</u> plan for <u>all</u> participants; all salary deferral amounts for all participants are included in taxable income, along with the appropriate employer and employee FICA/FUTA withholding taxes, among other penalties.

[1] The "use-it or lose-it rule" is now named the "use-or-lose" rule. Anal writers, including authors of regulations, generally always strive to say the same thing with less (sometimes too less), even if it is as little as losing two "its."

Although the regulations are not yet effective, in some circumstances employers may (and should) rely upon them to selectively utilize certain improvements to their favor. Otherwise, if the plan is already currently in compliance with the existing effective regulations, the employer may delay compliance with the new rules until they become final. They are supposed to be finalized effective January 1, 2009, although there is talk about a further possible extension. If a plan is not, or may not be currently compliant, then the plan, summary plan description and related plan documents and operations should be reviewed and adjusted without delay.

The regulations are one of several initiatives of heightened government interest in cafeteria plans. The Internal Revenue Service has for a long time discovered significant noncompliance *with the most basic* of the Section 125 requirements. We understand that the IRS is now increasing its audit activities to encourage compliance. Given the severe tax penalties the IRS can (and has) imposed on noncompliant employers and their employees, the announced increased audit activity is noteworthy.

PLAN LIMITATIONS FOR 2008

Various retirement plan limits are subject to annual cost-of-living and/or statutory adjustments. Here are some of the more commonly applicable limits for 2008.

1. Maximum Contribution to 401(k), Profit Sharing and other Defined Contribution Plans. Increases from $45,000 to $46,000 for 2008. For most plans, the limit will apply for the plan year January 1 to December 31, 2008. *Warning. Participants of small employers may not be able to receive the $46,000 allocation.*

2. Pre-Tax 401(k), 403(b) or 457(b) Employee Contribution Limit. Remains unchanged at $15,500 for 2008.

3. Age 50 Catch-up Contribution. Remains unchanged at $5,000 in 2008.

4. Maximum Annual Recognized Compensation. Increases from $225,000 to $230,000 for 2008. To limit retirement plan accumulations for high paid employees, as well as to increase contributions for non-high paid employees, retirement plans generally may only recognize compensation up to this limit.

5. Highly Compensated Employee Threshold. Increases from $100,000 to $105,000 for 2008. Under ERISA's nondiscrimination rules, the employee population is divided into two groups – the highly compensated employees and the nonhighly compensated employees. A highly compensated employee generally is an employee who owns more than 5% of the employer sponsoring the plan or whose compensation in the preceding year exceeds the dollar threshold.

6. Defined Benefit Plan Limit. Increases from $180,000 to $185,000 for 2008. In a defined benefit plan, the law limits the annual pension payable to the participant upon retirement (as opposed to limiting the annual additions going into a defined contribution plan). If you desire to accumulate possibly significant retirement benefits over and above the $46,000 annual defined contribution limit, a defined benefit plan should be explored.

7. Social Security Tax Wage Base. Increases from $97,500 to $102,000 for 2008. This change in the wage base will affect the way in which employer contributions are allocated to participants in "integrated" plans.

FIRM NEWS

Jeffery Mandell has been named to BEST LAWYERS IN AMERICA 2008. Jeff has garnered this prestigious award for 13 years in a row, making him among a select group of attorneys nationwide. BEST LAWYERS is a peer-review of 18,500 U.S. attorneys on the legal abilities of attorneys.

Jeffery Mandell and John C. Hughes authored an article published in the *Journal of Pension Benefits*, Autumn 2007 edition, entitled "Update on PPA Participant Benefit Statements."

John C. Hughes has been appointed Program Chairperson of the Boise Chapter of the Western Pension & Benefits Conference (in addition to serving on the Board).

This bulletin is intended to provide general information only and does not provide legal advice. This bulletin does not discuss potential exceptions to the above rules. The application of ERISA laws can be complex. For information regarding the impact of these developments under your particular facts and circumstances, please call us.