ROBINSON & COLE LLP
Employee Benefits & Compensation

Cash Balance Plan Legislation Proposed

The Department of Treasury has issued a legislative proposal for cash balance plans. Most significantly, the proposal concludes that the cash balance plan design is not inherently age discriminatory.

The proposal changes the rules that apply when a traditional defined benefit plan is converted to a cash balance plan. Under the proposal, a plan would have to provide that all participants would continue to receive benefit accruals for five years after the conversion that are at least as valuable as the benefits they would have earned under the prior traditional defined benefit plan formula. "Wear away" of retirement benefits would be prohibited. The cash balance plan benefit would have to be provided on top of the old plan's benefit. The proposal also modifies the interest crediting rules. The so-called "whipsaw" of benefits would be eliminated.

If a plan sponsor fails to comply with the conversion requirements, the Department of Treasury has proposed that an excise tax be imposed as the penalty for noncompliance rather than plan disqualification.

The proposed legislation would be prospective and would not impact prior cash balance plan accruals or conversions. Although the new legislation that has been proposed is welcomed by plan sponsors, unless Congress embraces the legislation, it will not impact cash balance plan sponsors.

Since this year is an election year and issues concerning cash balance plans have become very political, it is unlikely that any action will be taken by Congress this year.

DOL Provides Guidance On Automatic Rollovers

The 2001 Tax Act (EGTRRA) contained a rule requiring that mandatory qualified plan distributions of less than $5,000 be automatically rolled over to an IRA when a terminated employee has not elected a distribution method. The DOL has proposed guidance regarding these automatic rollovers. A fiduciary is not required to follow the safe harbor provided in the guidance, but if the safe harbor is met, the fiduciary will be protected from liability when selecting the financial institution and the funds into which the rollover will be made.

The proposed safe harbor contains six requirements:

• The distribution must be more than $1,000 and less than $5,000 (or the cash out amount provided under the plan, if less). Rollover contributions are not included for this purpose.

• The rollover must be made to an individual retirement account or an individual retirement

annuity that is sponsored by a bank, insurance company, financial institution or other authorized IRA trustee or custodian.

• The IRA must be invested in a product intended to preserve principal and provide a reasonable rate of return. Money market funds, interest bearing savings accounts, certificates of deposits and stable value funds are acceptable investments.

• The fees charged by the IRA provider may not exceed fees charged for other rollover IRAs and the fees cannot exceed the income earned on the rollover amount.

• A plan's rules regarding automatic rollovers must be included in the summary plan description or a summary of material modifications. Details must be provided regarding the investment type and the fees and expenses and must identify a contact for additional information regarding automatic rollovers.

• The selection of an IRA provider and the investment type must not result in a prohibited transaction.

Simultaneously with providing this guidance, the DOL proposed a prohibited transaction Class Class Exemption for financial institutions that sponsor plans for their employees enabling them to offer their own products for automatic rollovers from plans they sponsor.

The automatic rollover rules will be mandatory six months after the rules are finalized. At that time, plan documents will need to be amended to set forth the applicable rules. If a plan sponsor does not want to be burdened with the automatic rollover requirements, a plan can be amended to limit the mandatory cash out to amounts not in excess of $1,000.

IRS Issues Guidance on Charging 401(k) Plan Expenses To Employees

In 2003, the Department of Labor issued guidance relating to the allocation of reasonable administrative expenses to participants' accounts. Now the IRS has clarified in a Revenue Ruling that a plan sponsor can charge reasonable Section 401(k) plan administration expenses to former employees without violating the Internal Revenue Code's prohibition on making distributions without a participant's consent. The IRS stated that the allocation of administrative expenses to the individual account of a participant who does not consent to the allocation is not a significant detriment if the allocation is reasonable and does not violate the nondiscrimination rules.

Plan Sponsor Committee Members may have Breached their Fiduciary Duty by Distributing SPD that Encouraged Participants to "Carefully Review" Plan Sponsor's Fraudulent SEC Filings

Dynegy Inc. sponsored a 401(k) Plan that provided a matching contribution in the form of company stock. Although the stock rose in value, it was largely due to irregular accounting practices that resulted in the stock being over-valued.

After Dynegy restated its financial results, its stock fell and a class action lawsuit was filed

against the Plan Sponsor Committee. The Plan Sponsor Committee had distributed an SPD that contained a statement encouraging participants to carefully review Dynegy's most recent SEC filings. The lawsuit alleged that Committee members breached their fiduciary duties of loyalty and prudence by distributing an SPD that explicitly referenced the SEC filings that contained false and material misrepresentations.

The Plan Sponsor Committee members argued that they should not be responsible for information contained in the SEC filings and attempted to have the lawsuit dismissed. The court refused to dismiss the lawsuit and stated that the participants should be given the opportunity to prove at trial that the Committee members knew or should have known that it was not prudent to rely on the SEC filings at the time the SPD was distributed.

IRS Rules That Medicare Entitlement is not a Second Qualifying COBRA Event

Employers who sponsor group health plans must provide COBRA continuation coverage to covered employees, spouses and dependents if health coverage will be lost as a result of certain qualifying events, such as an employee's termination of employment, divorce or Medicare entitlement. COBRA's multiple qualifying event rule provides for extended coverage if a second qualifying event occurs within 18 months after the initial qualifying event. For example, if an employee terminates employment, the 18 month continuation coverage requirement will be extended to 36 months if an employee and his or her spouse become divorced during the initial 18 month continuation period.

The IRS recently issued a Revenue Ruling holding that an employee's Medicare entitlement is not a second qualifying event for purposes of the COBRA multiple qualifying event rule. Under COBRA, Medicare entitlement is a qualifying event only if a qualified beneficiary will lose coverage as a result of the Medicare entitlement. Under the facts of the ruling, an employee terminated employment and the spouse elected COBRA coverage. During the 18 month COBRA period, the employee attained age 65 and became entitled to Medicare benefits. The IRS stated that the employee's entitlement to Medicare would not result in an extended COBRA period for the spouse. The IRS also stated that the spouse would only be entitled to the 36 month extended COBRA period if, in the absence of the initial qualifying event, the 36 month event would have resulted in a loss of coverage for the spouse. Since the spouse would not have lost coverage under the plan on account of the employee's Medicare entitlement if the employee had not terminated employment, the second event is not a qualifying event.

This is a new position taken by the IRS and is contrary to the practice of most employers. The model COBRA notice provided by the DOL states that the extended COBRA period will be available when a second qualifying event (including an employee enrolling in Medicare) occurs during the covered period. Employers may wish to review their current practice and model COBRA notice form if they choose to follow this new Ruling. Robinson & Cole LLP can assist you in your review.

Pending Legislation Affects Executive Compensation

There are currently two bills pending that could significantly impact executive deferred compensation. The legislation limits investment options available under nonqualified plans, prohibits offshore arrangements and eliminates the acceleration of payments.

The IRS has exhibited new interest and increased its enforcement in the executive compensation arena. Enforcement actions are focusing on the timing of deductions, the proper payment of FICA taxes, rabbi trusts, and asset protection schemes that limit the availability of assets to creditors.

IRS Issues Ruling on Post-Transaction Exemption from Coverage Testing

The IRS has issued a Revenue Ruling explaining the applicability of the Section 410(b) exemption from coverage testing following a merger, acquisition or other similar transaction. In the example used by the IRS to illustrate the applicability of the exemption, the stock of a corporation sponsoring two employee benefit plans is acquired by another corporation. Prior to the acquisition, the corporation met the coverage requirements of Section 410(b) with respect to its profit-sharing plan and its defined benefit plan, which was divided into two plans for purposes of performing coverage testing. The plans were not changed as a result of the acquisition. However, the benefit formula set forth in the defined benefit plan was changed approximately one year after the acquisition.

The IRS explained that the Section 410(b) exemption from coverage testing applied to the profit sharing and defined benefit plans as a result of the transaction. The exemption prevents the plans of the acquired company and the acquiring company from having to be tested together for purposes of the Code's coverage requirements until the plan year beginning after the first full plan year following the merger. However, the IRS noted that a change to the defined benefit plan's benefit formula after approximately one year would constitute a significant change in that plan and would void the coverage testing exemption only for that plan. The change would not affect the testing of the profit sharing plan. Accordingly, the defined benefit plan would have to be tested with the plans of the acquiring company for the plan year in which the formula changes take effect.

Finally, the IRS pointed out that the Section 410(b) exemption from testing is not applicable to the ACP or ADP tests. However, the Ruling does not indicate how the plans are tested and appears to allow some flexibility so long as the contributions are tested in one plan.

Electronic Premium Payments can be Made Directly to PBGC

The PBGC has introduced a new system, My Plan Administration Account (My PAA), designed to permit on-line filing of premiums to the PBGC. To establish an account with the PBGC, click here.

Plan Administration Errors Can Be Corrected Using Appropriate Procedures

If a plan administrator discovers that a plan has not been operated in compliance with the law or the governing plan document, the IRS encourages voluntary correction of the problem. In many cases, the IRS does not even need to be notified of the correction. However, certain procedures must be followed and IRS guidelines must be met in order to correctly correct the problem.

This is an archive of past issues. As a result, it may contain information that is not current.

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