Action Items

March, 2003

a newsletter for ACI's clients and their advisors

ERISA Section 404(c)

Myth vs. Reality

by Pat Byrnes

ERISA §404 essentially created the issue of fiduciary liability in retirement plans when it was passed into law in 1974. This controversial section of ERISA created two basic tenets, which serve as the background for the remainder of this article:

§404(a): Each retirement plan fiduciary is *personally liable* for *each investment alternative and each participant investment choice* made under a Qualified Retirement Plan; and

§404(c): A fiduciary can avoid personal liability for investment decisions made by participants if and only if the retirement plan meets the requirements of ERISA §404(c). The Department of Labor did not make the regulations for this section final until January 1, 1994 for calendar-year plans.

During the last decade, when the stock market enjoyed an almost-continual upward trend, nobody much cared about ERISA §404(c). There seemed to be little reason to follow a voluntary compliance process when, for the most part, every investment decision made by a participant made money.

As the expression goes, "Times have changed." ENRON-related retirement plan matters and the rapidly changing equity markets have ignited interest in fiduciary liability. With this attention, much misinformation has been floating around. Let's debug a few of the myths.

Myth: I have declared my Plan to be a §404(c) plan in my Summary Plan Description. Therefore, I have eliminated my personal liability for participant investment decisions.

Reality: This simple declaration that a plan intends to qualify under ERISA §404(c) is insufficient at best. At worst, it serves as a roadmap for participant lawsuits and DOL investigations. One must not only have the intent to comply; one must create the compliance process and rigorously follow it.

Myth: I offer my participants 65 name brand mutual fund choices. Therefore, I have avoided any liability for their investment decisions.

Reality: Under ERISA §404(a), the retirement plan fiduciaries are charged with the responsibility of properly selecting, monitoring, removing and replacing a diversified selection of investment alternatives *appropriate for participants*. Sixty-five investment alternatives, no matter how good or how diverse, may be inappropriate for certain populations of employees. A properly crafted Investment Policy (IP) sets forth the investment structure, the number and classes of funds, and the criteria for evaluating them. The IP will always bear in mind the sophistication level of plan participants.

Myth: ERISA §404(c) really only applies to big plans. If I offer no company stock in my plan, I am insulated from any personal liability.

See "§404(c)" on page 3

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Bush Proposal
Bad News for Small Business Retirement Plans

by Jeff Wallace

On February 3rd, the Bush administration released the fiscal year 2004 budget. Among the more controversial items proposed is a dramatic overhaul of the savings and retirement plan systems. Much has been written about this subject, and it appears that the Administration may now be distancing itself from the retirement plan proposal, which received a hostile response from both prominent republicans and democrats. Following is a summary of the proposed changes.

Consolidation of Retirement Plans

To provide consistency across plans with employee contributions, 403(b), 401(k) and governmental 457 plans would be consolidated into Employer Retirement Savings Accounts (ERSAs).

Elimination of Cross-Testing and Permitted Disparity

Cross-testing and permitted disparity would be eliminated in stand-alone defined contribution plans. If an employer sponsors *both* a defined contribution and defined benefit plan, cross-testing or permitted disparity may still be used.

Changes to Highly Compensated Employee Definition

The definition of Highly Compensated Employee (HCE) would change. Under the proposed rules, the compensation used to determine HCE will match the social security wage base. For 2003, this represents a reduction of $3,000 ($87,000 vs. $90,000). The rule that limited the number of HCEs to 20% of the total employees would also be eliminated. These changes could make it more difficult for some plans to pass non-discrimination tests.

Repeal of Top-Heavy Rules

Top-heavy rules would be repealed in defined contribution plans. This would be a positive change, particularly for small businesses.

Simplified Non-Discrimination Testing

Non-discrimination tests would be simplified, but not necessarily easier to pass.

Safe Harbor 401(k) Changes

The safe harbor ERSA matching contribution would be lowered to 50% of each employee's deferrals (up to 6% of compensation).

IRA Overhaul

Retirement Savings Accounts (RSAs) would replace IRAs (Roth & traditional). The RSA contribution limit would be $7,500 per year with no limits based upon compensation. They would operate in same manner as Roth IRAs (contributions not deductible, but earnings grow tax-deferred). Distributions are non-taxable if withdrawn after age 58.

Lifetime Savings Accounts (LSAs) would be introduced. Section 539 plans, Medical Savings Accounts and qualified state tuition programs would be converted into LSAs. Like RSAs, these plans would also permit individuals to contribute $7,500 per year. Distributions from LSAs would be non-taxable at any time for any reason. Because of their distribution flexibility, LSAs may appeal to individuals who may need to access their savings prior to retirement.

OBSERVATIONS

IRA Changes Have Limited Appeal

The President's proposed overhaul of IRAs would, in effect, offer few advantages to the average American worker. Significant increases in IRA/RSA/LSA limits would benefit only high-income households. According to the Employee Benefits Research Institute, in 1998 only 4.3% of taxpayers with incomes between $40,000 and $50,000 contributed to an IRA. Only a small segment of the US population has sufficient income to make non-deductible contributions to IRAs; yet this is the cornerstone of the President's proposal, and—as noted later—has a profoundly negative impact on the appeal of small business retirement plans.

Short-Term Gain and Long-Term Pain

From a fiscal perspective, the proposed changes create a badly needed short-term revenue surge for the government. As traditional IRAs are converted to RSAs and LSAs, individuals will be required to pay taxes on the converted account balances over a four-year period. These taxes will create the windfall noted above. Conversely, these changes also eliminate an important long-term revenue source that the government cannot easily replace (the forgone income taxes on distributions from traditional IRAs).

According to the budget, the transition from traditional IRAs to RSAs and LSAs will create revenue of $18.7 billion from 2003 through 2006. However, beginning in 2007, revenue becomes negative (-$650 million). This deficit nearly triples in 2008, reaching -$1.8 billion and is expected to continue growing at a staggering rate.

What Happened to My Deduction?

RSAs and LSAs lack one important component of existing IRAs: Contributions are not deductible. This is particularly problematic for baby boomers who, in most cases, need current deductions more than tax-free retirement distributions.

Most Troubling: The Repeal of Cross-Testing

The proposed repeal of cross-testing in stand-alone defined contribution plans is confusing for two reasons: First, the IRS spent several years drafting new regulations relating to cross-testing. The goal of these regulations was to ensure adequate benefits were provided to rank-and-file participants in cross-tested plans. This was accomplished by creating so-called "Gateways" through which plans must pass in order to take advantage of cross-testing. Now the Bush Administration pro-

poses eliminating this approach in the interest of "simplicity" (cross-testing, while very effective, is not a particularly simple methodology). Yet it is this approach that makes retirement plans cost-effective for many small businesses, which leads to the second point…

An employer's ability to use cross-testing is probably the most critical driver of small-business retirement plans. It permits business owners, who are generally older than most other employees and have deferred their retirement savings in order to build their businesses, to accumulate retirement savings at a rapid rate, while providing "guaranteed" benefits to non-highly compensated participants. Under the new gateway regulations, everyone wins in a cross-tested plan.

Without cross-testing, business owners will lose the ability to accumulate retirement savings quickly. Profit sharing contributions would only be permitted on a pro-rata basis; if the business owner receives a 25% contribution, all other eligible employees would also receive a 25% contribution. As a result, business owners will likely channel all of their savings into RSAs and LSAs, which don't require employer contributions. In the end, the employer needs to settle for non-deductible contributions that are lower than the current 401(k)/profit sharing plan limit, and employees are left without any employer-funded retirement benefits. Everyone loses.

Status of the Proposal

With war looming on the horizon, the Bush Administration appears to be focusing their efforts on the more-popular job creation element of the budget, rather than the retirement plan element. When Democrats and prominent Republicans, including Speaker of the House Dennis Hastert and Rep. Rob Portman, chairman of the GOP leadership team, voiced their concern to Administration officials over the wisdom of the retirement plan proposal, the wind was taken out of the Administration's sails. The subsequent overwhelmingly negative response from sponsors of small retirement plans, as well as the private pension industry, further eroded the Administration's support. However, in Washington, anything can happen!

We'll keep you posted.

§404(c) *continued from page 1*

Reality: While it is true that corporate stock in the ENRON plan caused both a DOL investigation and participant class-action lawsuits, this large-plan experience will become fodder for future DOL investigations. In all likelihood, many individual and class action suits against plan fiduciaries, even if no corporate stock is included in the plan, will ensue.

Myth: I have not declared that my plan is intended to qualify under ERISA §404(c), but I am following a process that is identical to the processes laid out in ERISA §404(c); therefore, I'm exempt from personal liability.

Reality: The DOL's Amicus brief in the ENRON case made it clear that unless a plan declares its intent to be compliant with ERISA §404(c), the fiduciaries will not be relieved of liability for participant choices.

Myth: It's impossible to comply with ERISA §404(c).

Reality: Many of the ERISA 404(c) requirements can be complied with in a fairly straightforward fashion. Some may be more difficult for some plan sponsors. The real answer in a pragmatic world is to follow a process that will lead to compliance. It may be very difficult for a judge to hold fiduciaries liable when they have established processes and procedures which are annually reviewed and updated. Procedural prudence will, no doubt, prevail in the long run.

As with all procedures, "perfection" is elusive. Procedural prudence will, however, not only create a better plan and investment structure—it will also result in better communication and awareness among plan participants than would a plan that ignores these processes and simply "wings it."

ACI has created a program to educate fiduciaries of their responsibilities and to help them establish and maintain internal processes to gain protection under ERISA §404(a) and §404(c). Contact one of our consultants or a plan administrator with questions regarding these services.

Deemed IRAs in Qualified Plans

by Craig Handa, Consulting Actuary

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) added to the Internal Revenue Code the concept of "Deemed IRAs" in qualified plans for plan years beginning after December 31, 2002. The purpose of this provision is to encourage employers to provide an additional way for employees to save for retirement. A Deemed IRA is a separate account set up in a qualified plan that functions exactly like either a traditional IRA or Roth IRA as long as the contributions are voluntary and the requirements of the Internal Revenue Code for traditional IRAs or Roth IRAs are met.

The employer sets up either a traditional IRA or Roth IRA on behalf of its employees without impacting the qualified plan of the employer. The employer assumes the burden of setting up the IRA that was previously the employee's responsibility. The Deemed IRA contributions can be made through payroll deductions.

To implement Deemed IRAs in your qualified plan, you must first adopt a sample "good faith" amendment provided by the IRS and then amend your plan document to include additional required language. Although the plan documentation requirements are not particularly problematic, the administrative effort required by employers will likely prove to be cumbersome and costly. Nevertheless, if providing your employees with additional retirement savings opportunities is a high priority, Deemed IRAs may be worth the cost.

Retirement Plans and Military Service

by Laura Mitchell, Consulting Actuary

With the possibility of war looming on the horizon, many employers are confronting the reality of having employees called up for military service. Now is the time to make sure you understand your retirement plan provisions as they apply to military service and how to handle participants who are on military leave.

All pension plans are required to conform to the Uniformed Services Employment and Reemployment Rights Act (USERRA) as part of the GUST restatement (USERRA is the "U" in GUST.) If your plan has been restated for GUST, it includes these provisions. If your plan is in the process of being restated, it will soon include these provisions.

USERRA's Impact on Your Plan

USERRA prescribes nondiscrimination provisions relating to military service. The pension provisions of USERRA require that as long as military service in not longer than five years and the person who performed military service "reports to, or submits an application for reemployment," the person's military service is deemed to be service under the plan. Here's what this means to you:

- An employee's entry date must not be delayed because of military service.
- An employee continues to vest and accrue benefits (including employer contributions in defined contribution plans) while in military service.
- An employee is permitted to make additional elective deferrals, known as "make-up contributions," for the period he/she was performing military service.

Example

The XYZ Company sponsors a 401(k)/profit sharing plan. Plan provisions include:

- An employee must be 21 and have one year of service before entering the plan;
- An employee can enter the plan on January 1 or July 1 following completion of the eligibility requirements;
- Participants are permitted to defer up to 10% of compensation to the 401(k) plan;
- The plan matches 50 cents for each dollar the participant defers;
- Profit sharing contributions are made for participants who are employed on the last day of the plan year, December 31, and who have worked 1,000 hours during the year;
- Participants are 33.33% vested after one year of service, 66.67% vested after two years of service and 100% vested after three years of service. Service is credited from date of hire.

Jane was hired by XYZ Company as a full-time employee on March 1, 2001, earning $36,000 per year. She began performing military service on February 1, 2002 and returned to work on July 1, 2003.

Until Jane returned to work, the Company did not need to put money into the plan for Jane. When Jane returned on July 1, 2003—for benefits purposes—she is essentially treated as if she had been employed full-time for the employer earning $36,000 per year. What happens in the plan is as follows:

- Jane's entry date into the plan was July 1, 2002. XYZ allowed Jane to contribute make-up 401(k) deferrals. Jane has the lesser of five years or three times the length of her military service to contribute these deferrals into the plan (in this case, she has until October 1, 2007 to contribute these deferrals). As Jane contributes her make-up deferrals, XYZ matches them.
- Jane receives a profit sharing contribution for the plan year that ended on December 31, 2002 based on her rate of earnings for the year. XYZ contributed 5% of compensation to the profit sharing plan, so Jane received a contribution of $1,800 (5% of $36,000). Jane is 66.67% vested in the match and the profit sharing contribution at July 1, 2003.
- If Jane continues full time employment with XYZ, on December 31, 2003, she will be 100% vested and entitled to a profit sharing contribution based on $18,000 for the first half of the year and whatever she earn during the second half of the year.

What Happens To Participant Loans?

Another military services item that is not part of USERRA relates to plan loans. Plans may suspend the obligation of a participant to repay a loan during the period a participant is performing military service. Unlike regular loan suspensions, loan suspensions due to military service may exceed one year. The loan repayments must resume when the participant completes military service. The payment amount and frequency of payment must not be less than under the original terms of the loan and the loan must be fully repaid by the end of the original term plus the period of military service.

Final Comments

There are complexities for determining how USERRA and the loan rules apply. Be sure to let your ACI administrator know if you have any employees performing military service.

Visit our website at
www.acibenefits.com

For an ACI brochure, contact Lace Greene at lace.greene@acibenefits.com

Sarbanes-Oxley and Blackout Period

What You Need to Know

by Tobi Cogswell, Consulting Administrator

As a result of the ENRON blackout debacle, the accounting reform bill signed into law last year included a blackout notice requirement. The bill provides that retirement plan participants and beneficiaries be given at least 30 days advance notice of any period of more than three consecutive business days where there is a suspension, restriction or limitation on the ability to direct or diversify investments or to obtain a loan or distribution.

On January 24, 2003 the Department of Labor (DOL) issued final regulations pertaining to this bill, as well as final regulations outlining the procedures for the imposition of penalties if the notice rules are violated.

The notice requirement applies to blackout periods commencing on or after January 26, 2003. Penalties for failure to provide a timely notice when required are $100 per day, per participant, beginning with the date the notice was given and ending on the last day of the blackout period. The DOL, however, has stated that penalties will actually be imposed on a case-by-case basis.

What does this mean to you?

As a plan sponsor, you must pay close attention to any circumstance which might limit your participants' account access. This will primarily be the case with plans where the assets are "participant-directed" under a bank, brokerage house or insurance company umbrella. For example, if you change recordkeepers, there likely will be a period of time from when the assets are liquidated and moved to when they are invested and available to be accessed by participants. This is a blackout period. There are also times when a merger or acquisition may result in a blackout period. The blackout notice is required on rights that are temporarily suspended, limited or restricted and does not refer to permanent elimination of certain rights (for example, permanent restrictions to a particular investment option).

The notice must be written in a manner that can be understood by the average plan participant. It must include:

1. The reasons for the blackout period;
2. The investments and other rights affected;
3. The expected beginning date and length of the blackout period;
4. A statement that the participant or beneficiary should evaluate the appropriateness of their current investment decisions in light of their inability to direct or diversify assets.

If the notice is not distributed 30 days prior to the beginning of the blackout period, it must include an explanation as to why

See "Sarbanes-Oxley" on page 6

Buzzphrase Interpretation:

Consumer-Driven Health Care

by Jeff Wallace

Consultants sometimes create obscure phrases to describe a relatively simple concept. Case in point: Consumer-Driven Health Care. This phrase refers to the rapidly-growing practice of employers sharing rising health care costs with employees. In essence, this approach holds employees increasingly accountable for managing their own health care expenditures. Given the meteoric rise in health care costs—and some employees' indiscriminate use of health plans—it was inevitable that this type of approach would emerge. As profit margins continue to erode, all expenses are coming under scrutiny. For many employers, sharing benefits costs is one of several necessary steps that must be taken in order to sustain their businesses.

Implementing Consumer-Driven Health Care: Health Reimbursement Arrangements

The most common vehicle for introducing consumer-driven health care in a business is a form of welfare benefit plan called a Health Reimbursement Arrangement (HRA). On the surface, these plans look like cafeteria plans, except there's one big difference: The employer makes all contributions. The employer saves money, though, by combining the HRA with a new group health plan that includes higher deductibles and co-payments than the previous plan. This approach should drive down the premium costs on the new plan. The employer then contributes to an HRA an amount intended to partially cover the increased deductible and co-payment costs. The theory driving HRAs is that the savings associated with the reduced insurance premiums outweighs the contributions to the HRA. Real-world experience has proven this to be true in many settings.

HRA Advantages

- Flexibility: HRAs provide for a higher degree of flexibility in their design than nearly any other form of benefit plan. As noted above, HRAs can be structured to cover only a portion of the increased employee costs associated with a high-deductible health plan, or they can provide comprehensive coverage for these costs. HRAs can also be designed to cover only a limited array of services, like dental and vision coverage, for example. As noted below, there are also some exciting design opportunities for owner-employees of small businesses.
- No "Use It or Lose It" Provision: Employers can design HRAs to permit participants to carry unused funds forward to subsequent years.
- Health care expenses that are eligible for reimbursement through an HRA are identical to those eligible through a

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Sarbanes-Oxley *continued from page 5*

the plan was unable to give 30 days notice.

How do you Handle Date Changes?

If the blackout is not over by the time stated in the original notice, a new notice must be distributed. The length of the blackout period can be stated as either:

1. The expected beginning date and ending date of the blackout period;
2. The calendar week during which the blackout period is expected to begin and end.

If option #2 is utilized, however, information as to whether the blackout period has begun or ended must be made readily available, without charge, to affected participants and beneficiaries via a toll-free number or access to a specific web site. The notice must describe how to access this information. Given this requirement, most plan sponsors will want to provide specific beginning and ending dates.

What should you do?

The DOL notes that the "blackout period" definition generally does not include "a regularly scheduled period" if such period is incorporated into the plan and disclosed on a timely basis to employees. To the extent that you can incorporate any specific operating procedures into your plan and Summary Plan Description, do it. An example would be a plan that does not process investment changes until after a quarterly valuation has been completed. There may also be ways to incorporate limitations on distributions from plans that have quarterly valuations.

Please contact your ACI plan administrator if you have any questions about the blackout notice requirements of the Sarbanes-Oxley Act.

Health Care *continued from page 5*

Section 125 Health FSA. This simplifies the administration of HRAs.

- Unlike a Health FSA, only a portion of the annual HRA limit is added to each participant account on a monthly or per-payroll basis. This eliminates the possibility of an employee using the entire HRA account balance early in the year, then resigning and leaving the employer on the hook for the "non-accrued" portion of the FSA election.
- Smaller businesses with owner-employees may design an HRA to provide retiree coverage only, with the understanding that—in most instances—only owners will work for the business until retirement. Upon reaching retirement age, the HRA funds can be used to pay for a variety of expenses, including long-term care insurance.

ACI can assist you in the design, documentation and ongoing administration of a Health Reimbursement Arrangement and/or a Cafeteria Plan. Please contact Stacy Bass or Jeff Wallace with questions or for information regarding our services.

ACI In the News

SPEECHES

The 2003 Los Angeles Benefits Conference was held on January 30 and 31 in Universal City. Pat Byrnes, a founding co-chair of the Conference, was a panelist and moderator at this year's event, which drew over 400 retirement plan professionals and government representatives. The LABC continues to be one of the largest events of its type in the western U.S. and provides attendees with an unparalleled opportunity to discuss important issues with high-ranking representatives from the Treasury Department and the Department of Labor.

PRESENTATIONS

Each year, ACI prepares a number of presentations related to employee benefits and compensation issues. Many of the presentations are eligible for continuing education credit and have been presented at various professional conferences.

For a complete list of ACI's 2003 Presentation Topics, contact Lace Greene at (310) 316-1334, ext. 120, or at *lace.greene@acibenefits.com*.

ACI CLIENT EDUCATION SCHEDULE

The following seminars are being held at ACI's office in Torrance from 9:00AM to 12:00PM. You may RSVP by contacting Lace Greene.

401(k) Basic Training: An Introduction to 401(k) Plan Operation

May 13 July 16 September 18