

Fiduciary Liability 101: How do I limit my fiduciary liability?

by Jeff Wallace

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In the last issue of *Action Items*, we answered the question of what are a retirement plan fiduciary's responsibilities. In this issue, we'll answer the question of how to limit fiduciary liability.

First of all, what exactly is the extent of your liability?

That will depend upon how much money is in your retirement plan. Theoretically, the extent of your liability is limited to the total plan assets, plus any earnings lost as a result of a fiduciary breach. In other words, if there's \$5 million in a plan for which you are a fiduciary, your liability is "limited" to \$5 million, plus earnings. This can be quite a shock for the person who realizes for the first time that he/she is a plan fiduciary.

How might a claim arise against you?

There are many different ways a claim might arise against a retirement plan fiduciary. Perhaps the most common scenario—and the one getting all the media attention—is a significant drop in employee retirement plan account balances as a result of a poor investment option in a plan. If, for example, your plan includes a mutual fund that loses most of its value, participants may choose to file a lawsuit against you in an effort to recoup their losses. If you do not have a prudent process in place for evaluating investment options, and can demonstrate that you followed this process in evaluating the mutual fund in question, you may be negotiating a large settlement in the near future.

See "404(c) 101" on page 5

PAT BYRNES RECEIVES IRS COMMISSIONER'S AWARD

Pat Byrnes recently received the *Internal Revenue Service Commissioner's Award* for his sustained effort to enhance voluntary compliance within the retirement system. This is the highest honor bestowed on a private citizen from the Department of the Treasury.

Over 12 years ago, the IRS asked Pat to help bring together the Service and the private sector benefits community with the goal of improving cooperation and the level of voluntary compliance in the pension plan arena. This served as the genesis for the Los Angeles Benefits Conference, which Pat has co-chaired since 1992.

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Abusive Tax Shelters Targeted by IRS

The Treasury recently issued four pieces of guidance focusing on §412(i) plans deemed abusive and several practices associated with life insurance in qualified plans. What's particularly important to note regarding this guidance is that much of it is retroactively applicable. Sponsors of existing plans deemed to be "abusive" will likely face stiff penalties, including possible disqualification.

The following table summarizes the abusive practices under scrutiny and the guidance issued by Treasury:

Issue	Abusive Practice	Treasury's Response
1. Can a policy be sold or distributed at its "cash value"?	Some arrangements are designed to process distributions or sales when cash values are artificially minimized. The prevailing theory among marketers of these plans is that the diminished cash value represents the taxable distribution.	When a plan distributes or sells a life insurance contract, it must be at the policy's fair market value, which may be greater than its cash value.
2. Can a surrender charge reduce a policy's fair market value by reducing its reserves?	Some arrangements are designed with large surrender charges that effectively reduce the fair market value of the policy by reducing its reserves during a specified period of time. The policy is expected to be sold or distributed during this period of time.	A policy's reserves are not always considered to be an accurate representation of its fair market value. An alternative method of determining fair market value will be applied where reserves are artificially reduced by large surrender charges that are never expected to be paid.
3. What is the Treasury's interim methodology for determining fair market value?	Refer to above.	Until further guidance is issued, cash value may be treated as fair market value, provided the cash value is no less than the result of the following equation: Premiums Paid + Interest, Dividends, etc. - Reasonable mortality charges & expenses
4. In designing insurance into a plan, must it be nondiscriminatory?	Some arrangements provide "enhanced" policies to highly compensated employees, which can be purchased from the plan at the time of distribution.	This approach violates existing non-discrimination rules and may trigger plan disqualification.
5. Can premiums for insurance that exceeds the "incidental death benefit" be deducted?	Some arrangements permit employers to hold insurance policies within the plan with face amounts that exceed the "incidental death benefit" defined in the plan document.	Contributions attributable to excess death benefits are not deductible in the year made, but are carried over to a subsequent year [subject to IRC §404(a)(1)(E)]. Excess premium payments, which are not only non-deductible, may also be subject to a 10% excise tax.
6. Can a 412(i) plan be intentionally over-funded?	Some arrangements produce cash values that vastly exceed the amount required to pay benefits if premiums were paid to normal retirement age.	These arrangements will not be deemed "fully insured" under §412(i) and will revert to a plan that must annually calculate its funding status and attach an annual actuarial certification to form 5500.

Listed Transactions

The guidance indicates that if an employer has deducted premium payments for a policy with a death benefit that exceeds a participant's death benefit under the plan by more than \$100,000, the transaction will be designated as a "listed transaction." This

See "Abusive Tax Shelters" on page 6

Wanted: Increased Retirement Plan Contributions For Owners! *A Cash Balance Plan Case Study*

Scenario:

Beta Group is a 15-employee consulting firm with two owners, Kelly and Eric. Kelly, the CEO, is 40 years old and earns \$400,000 annually. Eric, the COO, is 42 years old, and earns \$280,000 annually. Both would like their company to contribute a significant amount to their qualified retirement plan on their behalf.

Beta Group's 13 other employees are generally younger than Kelly and Eric and earn between \$35,000 and \$150,000 annually. The company currently sponsors a 401(k) plan with a cross-tested profit sharing feature. Beta typically contributes 5% of compensation to the plan on behalf of staff employees. This contribution allows Kelly and Eric to receive profit sharing contributions of \$28,000 each, which, when added to 401(k) deferrals, takes them to the annual maximum of \$41,000 in a defined contribution plan arrangement.

While the \$41,000 retirement contribution is nice, Kelly and Eric are still looking for enhanced contributions. Eric would like contributions closer to \$100,000 and Kelly around \$85,000. Their accountant introduced them to an ACI consultant, who discussed adding a cash balance pension plan to their retirement plan program.

Why add a cash balance plan?

First, a cash balance plan can permit selected employees to receive benefits in excess of the \$41,000 limit imposed on defined contribution plans. Second, a cash balance plan enables individuals to receive different contribution levels. And third, a cash balance plan appears operationally to be very similar to an individual-account plan, like Beta's existing 401(k) profit sharing plan. It will be much easier for participants to understand the cash balance plan than a traditional defined benefit plan.

The Results

At Beta Group, here's how the numbers played out:

Owner/Staff	Eric	Kelly	Staff
401(k) Deferral	\$13K	\$13K	TBD
Profit Sharing Contribution	\$28K	\$28K	8.5 % of Compensation
Cash Balance Contribution	\$55K	\$45K	\$1K
Total Benefits	\$96K	\$86K	\$50K

By adding a cash balance plan to their retirement plan program, Kelly and Eric were able to meet their individual savings goals, while keeping staff contributions at a manageable level. Staff benefits, which were \$30,000 before adding the cash balance plan, increased by \$20,000 to \$50,000. From an employee benefits perspective, the increased profit sharing contribution was a welcome surprise to Beta Group's employees. In the end, all parties benefited from the addition of the new plan.

Could a cash balance plan help you?

If you would like to increase retirement savings for owners and/or key employees, and you want to retain a degree of individual contribution flexibility, a cash balance plan might be right for you. There are a number of other factors to take into consideration before adopting a cash balance plan, but in certain settings they can be a powerful retirement planning tool.

Look Out for Defaulted Loans

by Tobi Cogswell, Consulting Administrator
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Depending upon the terms of your loan policy, participant loans for which no payment was made during the fourth quarter of 2003 probably defaulted as of March 31, 2004. If your plan allows for participant loans, please do a review and let your ACI plan administrator know if there are any loans that should be defaulted.

If your plan requires that loans are paid back via payroll deduction, this should only be participants with outstanding loans who terminated, and who have not taken a distribution. If your plan does not require loan payments via payroll deduction, this may also include active participants who have neglected to send in their payments.

If you have a 401(k) plan with a daily-valued recordkeeper, there are probably online reports that you, as the plan sponsor, can download to help you with this review. If you are unfamiliar with these reports, or have any questions regarding loans or loan defaults in general, please feel free to contact your ACI plan administrator for clarification.

Pension Plan Interest Rate Matter Resolved

The President signed the Pension Funding Equity Act of 2004 (PFEA) on April 10, 2004. The act is a “stop-gap” measure for 2004 and 2005 which, among other things, replaces the 30-year Treasury bond rate with a new interest rate. The new rate is based on an index of high-quality bonds, which is currently higher than the 30-year Treasury bond rate. Various permutations of this interest rate are used to determine liabilities for many purposes in defined benefit plans.

What is PFEA?

- Replaces the 30-year Treasury Bond Rate
- Establishes an interest rate floor of 5.5% for determining maximum lump-sum benefits
- Changes the determination of current liability
- Allows re-determination of whether quarterly contributions are required for 2004 plan year
- Reduces the variable rate premium paid to PGBC
- Provides two years of reduced deficit reduction contributions for plan sponsors within certain industries

How does PFEA affect my plan?

First off, PFEA only affects defined benefit plans. It's impact will vary depending on the size of your plan and other factors.

If you sponsor a small plan (100 participants or less), PFEA may impact both your ability to pay benefits, as well as the amount of the benefits you can pay. PFEA establishes a 5.5% interest rate floor for 2004 and 2005 for calculating lump-sum benefits for participants whose benefits are at the maximum amount allowed under the Internal Revenue Code. Currently, lump sum interest rates are below 5.5%. This change will reduce the maximum allowable lump-sum distributions from plans. Fortunately there is a transition rule that allows lump sums to be paid in 2004 under the old rules. If you are already terminating your plan or were thinking about taking a distribution, you may want to make sure that happens before December 31, 2004.

If you sponsor a large plan (more than 100 participants), PFEA may reduce the required contribution. If your plan has not been well-funded, you may have been subject to an extra contribution known as the “deficit reduction contribution”. PFEA changes the interest rate for calculating the current liability and allows for recalculation of the current liability in the *prior* years. These changes may reduce or eliminate the deficit reduction contribution. In addition, special rules were enacted for commercial pas-

senger airlines, steel companies and the Transportation and Communication Union to further reduce the deficit reduction contribution.

Whether you are sponsoring a large plan or a small plan, if your plan is paying out benefits to the 25 highest-paid employees, the plan must be funded at 110% of current liability both before and after a distribution to one of the “Top 25” to ensure that the rank-and-file employees aren't left with an under-funded pension plan. PFEA has increase the interest rate used to calculate the current liability, which will reduce the liability and increase the funding ratio for this purpose.

If your plan is covered by the Pension Benefit Guaranty Corporation (PBGC), you pay a premium based on a flat per-person amount, plus a variable rate premium that depends upon the level of unfunded vested current liability. PFEA increases the interest rate used to calculate the variable portion of the premium, which will reduce the level of unfunded vested current liability, and the required premium—another positive change for plan sponsors!

While PFEA is a short-term solution, it still addresses several important issues facing sponsors of defined benefit pension plans. Depending upon the objectives of your plan, PFEA may be viewed positively, negatively, or both. If you have any questions regarding the new legislation, contact your plan administrator or an ACI consultant.

LABC Update

*by Laura Mitchell, Consulting Actuary
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The 2004 Los Angeles Benefits Conference was held January 28th through 30th. At this conference the IRS lets the Los Angeles benefits community know the Services' current thinking on various topics, plans for issuing guidance, and answers myriad questions. Here are just a few of the issues discussed that we thought you would find interesting.

Final 401(k) Regulations

The IRS hopes to issue “new” final 401(k) Regulations before the end of 2004. These regulations become effective in 2006. The intention is to consolidate in one place all of the 401(k) guidance that has come out since the issuance of the initial 401(k) regulations. These regulations must be finalized and effective before the EGTRRA determination letter process can begin.

See “LABC Update” on page 5

Determination Letter Process Issues - EGTRRA

Most plan sponsors just recently restated their plan documents as part of what is commonly known as the GUST restatement process. In the middle of the process, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which allowed for (among other things) increases in contributions to retirement plans. There have been concerns in the pension community about needing new determination letters for the EGTRRA provisions so soon after the GUST determination letter. In addition, the GUST restatement process created a serious fluctuation in the determination letter workload for the IRS. Together these caused the IRS to examine the determination letter process and come up with new approaches that allow for better predictability and planning.

The new approach involves different cycles depending on the type of document used. For individually designed plans, such as cash balance plans, there would be a five year cycle dependent on the employer's EIN where approximately 20% of the documents would need to be submitted each year. Standardized documents such as 401(k) plan, profit sharing plan and

traditional defined benefit plan volume submitter documents would be on a loose six year cycle where the company drafting the standardized documents submits the defined contribution documents to the IRS in Year 1, the IRS process the applications in Years 2 and 3 and the documents must be adopted in Years 4 and 5. The defined benefit documents would be submitted to the IRS in Year 3, processed in Years 4 and 5, and adopted by Year 7, which would also be Year 1 of the new cycle. Both approaches would more evenly distribute the work load over a longer period of time.

The IRS has not determined whether they will require a full restatement of plans for the new determination letter, but they expect the EGTRRA determination letter process to begin in 2006.

Determination Letter Process Issues – The Electronic Age

As a final note, the IRS indicated that electronic administration of the determination letter process will unfold over the next three to four years.

Note – After the drafting of this article, the IRS published two announcements detailing the determination letter process discussed above.

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Another common scenario involves a distribution to the widow of a 65 year-old employee who recently died. The widow is under the impression that her spouse's 401(k) account had \$500,000 in it. However, when she requests a distribution from the account, she's appalled to discover the account value is only \$75,000. Her husband, who may have been adept in many other aspects of his life, was a lousy investor. He chose to invest heavily in aggressive growth funds, and experienced a significant loss. The widow sues the employer, claiming the company should not have permitted a person so close to retirement age to invest so aggressively. She seeks not only the "lost" \$425,000, but interest, as well.

While it may seem counter-intuitive, the widow may have a valid claim, unless the plan complies with section 404(c) of the Employee Retirement Income Securities Act (ERISA). If the plan doesn't comply, the fiduciary (ies) are probably on the hook for some (or all) of the losses.

What can you do to limit your liability?

In a nutshell, comply with ERISA Sections 404(a), which deals primarily with investment due-diligence, and 404(c), which deals with participant investment decisions.

All retirement plans *must* comply with 404(a); it's not optional

(a common misperception). An appropriate compliance program includes a well-constructed investment course of action (probably in the form of a written investment policy), and ensures you're carefully scrutinizing investment options against myriad benchmarks and criteria, while offering a lineup appropriate to your employee demographics.

Compliance with Section 404(c) is optional. But for retirement plan sponsors seeking to limit fiduciary liability, compliance is essential. Compliance with this section of ERISA is the *only* way to avoid liability for participant investment decisions. 404(c) is focused primarily on the distribution of certain required materials to plan participants and beneficiaries, and requires sponsors to establish some internal procedures that are probably not in place now.

A final step to limiting your liability might be to purchase a fiduciary liability insurance policy.

Need help meeting your fiduciary responsibilities?

The first step to managing fiduciary liability is to understand it. ACT's consultants can assist retirement plan fiduciaries in this process. Contact your plan administrator or one of our consultants for more information on these services.

Does Your Plan Require a CPA Audit?

by Tobi Cogswell, Consulting Administrator
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Retirement plans with more than 100 participants as of the beginning of the plan year are subject to an independent audit by a CPA. This audit must be attached to the Form 5500 and related schedules that are required to be filed by the plan each year.

An exception to the large plan audit requirement is available to plans that are within an 80-120 participant corridor. If the plan had between 80 and 120 participants at the beginning of the plan year, the plan sponsor may file the same form as filed the previous year. In other words, if you filed a "short form" 5500 the prior year, you may file the same form for the current year, thereby avoiding the time and expense of a CPA audit.

The only other exception would be for new plans where the first year is a short plan year of less than seven months. In this case, you may defer the audit for the first year but you cannot avoid it.

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The Action Items newsletter is published quarterly.
If you would like to receive future publications of the
newsletter, please contact Lace Greene.

For purposes of determining whether an audit is required, a "participant" is defined as any eligible employee as of the prior plan year-end, *plus* any terminated participants with account balances, *plus* any new participants eligible as of the first day of the plan year. In a 401(k) plan, a participant is any employee meeting the age and service requirements of the plan, and who is eligible to defer *even if they are not deferring*.

If your plan operates on a December 31 year-end, and your plan is going to require an audit for the 2003 plan year, schedule your audit now. If you wait until the last minute you will certainly incur additional aggravation and may incur additional expenses. If you have any questions regarding the audit requirements for your plan, please contact your ACI plan administrator.

Abusive Tax Shelters *continued from page 2*

requires the plan to notify the IRS of such a transaction by submitting a statement with its annual tax return. This disclosure ensures closer scrutiny of the transaction in question, which may result in significant penalties and/or disqualification. The Treasury also requires promoters of listed transactions to maintain a list of their clients who participate in the transactions.

Action Item

If you believe that you or a client sponsors a plan that is subject to the IRS guidance, contact an ACI consultant or competent legal counsel to review the situation. If a plan is subject to this guidance, an immediate, proactive approach is critical to achieving anything approximating a positive outcome.

ACI In the News

SPEECHES

Pat Byrnes spoke at the **Los Angeles Benefits Conference** in Universal City on January 29th, 2004. The session featured key IRS officials answering questions about IRS positions on a wide range of qualified plan issues.

On February 23, 2004, Pat participated in a panel on fiduciary liability at the **ASPA 401(k) Sales Summit** in Orlando. The presentation, which focused on plan design and compliance tracking, was entitled "404(c) Issues: Mapping, Blackouts, Disclosure, Annuities vs. Registered Issues".

Pat is also scheduled to deliver a presentation focusing on cash balance plans at the **CPA Law Forum of Santa Monica** on April 28 and at the **CPA Law Forum of San Gabriel Valley** on April 29.

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 2004 presentation topics, go to our website at www.acibenefits.com.

ACI CLIENT EDUCATION SEMINARS

2004 401(k) Basic Training: An Introduction to 401(k) Plan Operation. This educational presentation covers items such as non discrimination testing, employee deferrals and employer contributions, loans and distributions and payroll issues. This seminar is open to anyone who would like a better understanding of the administration of 401(k) plans. There are only two more seminars left in 2004:

Wednesday, June 16th from 9:00 AM to 12:00 PM
Thursday, August 19th from 9:00 AM to 12:00 PM

Please contact our Marketing Manager at
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