

A Poet's Guide to Employee Benefits Law

2017 Edition

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Chapter I

A POET'S GUIDE TO EMPLOYEE BENEFITS -

INTRODUCTION

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The employee benefits world, with all its legal rules and regulations, is viewed by human resources people, financial people, and for that matter most lawyers, as forbidding territory - the “darkest forest” from the Wizard of Oz. In desperation, people purchase “answer books” which can answer a specific question, with citations, but without explaining why the answer is what it is, and even worse, without verifying that the right question is being asked. This text pursues an alternative approach for those who are willing to expend the effort. It starts with the premise that the basic legal structure of the employee benefits world is not complicated, although admittedly, that basic structure is embellished by (to use an architectural metaphor) lots of flying buttresses and gargoyles known as regulations.

Before examining the structure, it is useful to address the question of why an employee benefits structure exists at all. Why not just have employees use their after tax salary to procure health insurance and save for their own retirement? Congress certainly could have gone this way, but instead they decided to use the Internal Revenue Code to motivate what they considered to be beneficial behavior. In the case of both health care and retirement savings, Congress established an incentive that is employer based, voluntary and tax advantaged.

For health insurance, the system allows, but does not require, an employer to offer health insurance to employees. If it does so, the employer paid cost of the coverage is deductible by the employer, just like salary, but unlike salary, the benefit to the employee is not taxed at all. It is a form of tax exempt income for the employee.

For retirement savings, the system allows, but does not require, an employer to offer a retirement plan to employees. If it does so, the contributions made by the employer are deductible, just like salary, but the value to the employee each year is not taxed currently to the employee. Instead, taxation is deferred, and only occurs when retirement payments are made, sometimes many decades later.

These incentives that are built into our tax system are sometimes referred to as tax expenditures. Even though the federal government is not writing a check, it is forgoing or deferring revenue that it would

otherwise tax currently in order to bring about a result that it deems worthy - in this case health care coverage and saving for retirement.

The incentives are only available through an employer provided program, which an employer may choose not to offer. The fact that the employer is a voluntary player in a game that benefits employees and furthers a government purpose has been recognized by the U.S. Supreme Court in reasoning that the law should not be interpreted in a way that creates disincentives for an employer to voluntarily offer such programs.

OK, that is all of the tax policy I will lob at you for now. Let us move on to the building blocks of the system. We must start by learning some employee benefits jargon. By first demystifying the jargon that is used by “pension experts”, and then methodically analyzing the basic structural components of the law, as the subsequent articles in this series attempt, it is my hope that even the poet, or other non-expert, can come away with a sound and reliable basic understanding of how the pension world works.

I start with a guide to jargon because, in the legal world, jargon is the enemy of clarity. We lawyers are repeatedly guilty of using terms of art, and worse, acronyms, known only to a small group, thereby having the effect (and maybe even the purpose, in some instances) of intimidating everyone outside of that group. Hopefully, this brief tour of some basic terminology will blow away some of the smoke and expose a structure that is not so very complex.

1. ERISA and the Code

Most of the legal concepts, and hence the jargon, regarding employee benefit plans comes from two sources: (1) the Internal Revenue Code, which pension lawyers almost universally refer to as the “Code”, and (2) a second set of federal laws under Title 29 of the United States Code, generally under the jurisdiction of the U.S. Department of Labor. This second set of laws is generally referred to as “ERISA”, sometimes further broken down into “Title I of ERISA” (most of these laws) and “Title IV of ERISA” (the sections having to do with the pension insurance system administered by the Pension Benefit Guaranty Corporation.)

Since we will repeatedly refer to ERISA, it is worth noting the origins of that term. In 1974, Congress passed, and President Gerald Ford signed into law, a comprehensive rethinking of employee benefits law known as the Employee Retirement Income Security Act of 1974. It made major changes to the Internal Revenue Code, and also added a body of non-tax law (Titles I and IV). Most pension lawyers refer to the laws contained in Titles I and IV by their original ERISA numbering system,

but in most cases, judges refer to these same statutes using the U.S. Code numbering system, which is completely different. (I have a theory that this is the federal judiciary's way of achieving a measure of revenge against the employee benefits bar for forcing the judges to deal with a body of law that challenges them greatly.) In any event, most lawyers, when they refer to ERISA, are referring solely to Title I of ERISA, which covers a variety of issues relating to fiduciary responsibility, litigation, and reporting and disclosure, and not to the entirety of the remarkable piece of legislation that went into effect in 1974.

ERISA generally applies to all private sector employees. Public sector – or governmental – plans are not covered by ERISA, although the Code governs the tax treatment of participants in governmental plans. Congress chose not to include governmental plans in its otherwise comprehensive legislation, and as a result, governmental plans remain largely unregulated by the federal government.

2. Pension Plans and Welfare Plans

Generally human resources and financial people in big companies, and the owners of small companies, think of everything that they offer an employee other than salary as part of a “benefits package”. Title I of ERISA conveniently divides the components of this package into two parts which it calls “employee pension benefit plans” and “employee welfare benefit plans”. Most of us refer to them as pension plans and welfare plans. Pension plans involve the deferral of compensation, generally money that will be paid down the road. Pension plans that take advantage of the special tax benefits made available under the Code are called “qualified plans” – this means they meet the rigorous tests set out in Section 401 of the Code. All other pension plans are called “nonqualified”.

Welfare plans include almost everything that is not the deferred payment of money: health insurance, life insurance, dependent care, and the like. Sometimes the line can be blurry. Severance plans, i.e. plans that pay employees for a short time when they lose their jobs, are welfare plans even though they involve the payment of money, and some cash bonus programs may be neither pension nor welfare plans because they are too close to being regular compensation (sometimes called “payroll practices”).

We have focused so far on the words “pension” and “welfare”, but we should also briefly recognize the word “plan”. Employee benefits law focuses on programs that offer employees benefits. These programs can be embodied in a 200 page document and announced with fancy multi-colored brochures and interactive web sites, or they can be the most informal of programs, with nothing more than a page or two of

description. Either way, a “plan” has been established. Employee benefits law deals with plans.

Most of the employee benefits jargon concerns pension plans, so the remainder of this article, and many of the articles that follow, will focus on pension plans. We will return to welfare plans, and examine them in some detail, later in this survey.

3. Basic Structure of a Written Pension Plan

While there are many types of pension plans, all of them will have a plan document that covers certain basic topics. Four topics that are universally addressed are eligibility, vesting, distributions, and the description of the benefits.

The eligibility section of a plan describes who is covered by the plan. It is quite common for a company’s pension plan to cover fewer than all of the employees. There may be waiting periods, and there may be certain categories of employees that never get covered. This information will be set out in the eligibility section of the plan, although quite often it will also be necessary to refer to the “definitions” section of the document where certain terms used in the eligibility section (for example “employee”, “eligible employee”, “hour of service” or “year of service”) may be defined.

The vesting section of a plan sets forth the rules for determining when someone has a right to a benefit under a pension plan even if he or she leaves employment. As we shall see in a later article, pension plans are generally not permitted to require someone to stay until retirement age to get a benefit. Vesting will typically occur after a certain number of years of service, although it may occur immediately. This information will be set forth in the vesting section of the plan document, although again it may be necessary to also refer to the “definitions” section of the plan to determine the meaning of some important defined terms.

The distributions section of the plan explains when and how a vested participant can start to receive benefits. In general, it answers two questions: when the benefit starts; and what form the benefit will be paid in (for example, lump-sum, installment or annuity). Some plans also permit in-service distributions, which are sometimes referred to as “withdrawals” to distinguish them from distributions after termination of employment. Quite often there is a separate section to cover death benefits: whether there is a death benefit, and how and when that death benefit is distributed.

We have left out one major structural component of a plan, the description of the benefit. This is because there is tremendous variation

in the way benefits are calculated. The next subsection of this article describes some of these variations.

4. Defined Benefit and Defined Contribution Plans

Of all the terms used in the pension area, the ones that seem to confuse the non-expert more often than any other are “defined benefit” and “defined contribution” as descriptions of the two categories of pension plans. These terms are critical to understand, because they are used all the time. Furthermore, the concepts are not difficult if they are explained properly.

A defined benefit plan promises a participant a benefit in the future that either is a fixed amount or is an amount that can be calculated using a formula set forth in the plan. A very simple defined benefit plan would state the following: “every employee, at age 65, will receive a monthly benefit of \$50”. The benefit has been totally defined. More typically, the benefit is defined not with a set amount but with a formula which may have variables for a participant’s compensation, years of service, and even anticipated social security benefits. A typical example of this kind of defined benefit plan would be: “each participant will receive an annual benefit, at retirement age, equal to 1% of final salary multiplied by years of service”. Again, the benefit has been defined. Once the variables can be plugged into the formula, the individual will know exactly what benefit to expect. By contrast, the employer will not know for certain what it must contribute. In a defined benefit plan, the contributions that the employer makes to the pension fund are never defined. The employer will have to contribute whatever it takes (as determined by an actuary and as mandated by the Code) so that there is enough money to pay each participant’s defined benefit when it becomes payable.

A defined contribution plan, in contrast, never defines the benefit. Instead, it establishes an account on behalf of a participant, and credits to that account certain contributions, usually on an annual or more frequent basis. The portion of the actual plan earnings that are attributable to the participant’s account are also credited to the participant’s account. At retirement, or at such earlier time when payment is due, the participant will get the account balance, whatever it is. In a defined contribution plan, the benefit due to the participant is never defined, and will only be known on the date the benefit is paid, because the earnings can fluctuate. What is defined is the formula that calculates the contribution that will be credited to a participant’s account. The simplest defined contribution plan is one that would say “each participant’s account will be credited with a \$600 contribution at the end of each year during which the participant is employed.” More typically, the contribution will vary from participant to participant, usually in proportion to compensation: “each

participant's account will be credited with an amount equal to 3% of annual compensation." In this type of plan, it is the contribution that is defined, not the benefit.

That, in a nutshell, is the distinction between a defined benefit and a defined contribution plan. Many important observations flow from that simple distinction. First, one can say that in a defined benefit plan, the investment risk is on the employer. In other words, the employer is completely responsible for assuring that there is enough money in the plan to pay the defined benefits. If the investment experience is excellent, then less additional money will have to be paid in by the employer. If the investment experience is poor, then more money will have to be paid in. To determine how much money needs to be paid in each year, the employer must engage the services of an actuary, who will go through a well structured, and quite complicated, procedure for analyzing the funding requirements of the plan. This leads to the second observation about a defined benefit plan: that it is relatively complex and expensive to administer.

In a defined contribution plan, in contrast, one can observe that the investment risk is on the employee. Once the employer has credited the account with the promised contribution, the employer has satisfied its financial obligation. From that point on, the participant's benefit, which has not been defined, will depend on the investment experience of the plan. Two employees in two different companies who receive precisely the same contribution each year over the course of a career may still have very different benefits depending on the investment experience in each account. Another observation about a defined contribution plan is that it does not require the services of an actuary, and therefore is relatively simpler and cheaper to administer.

There are certain other clichés about defined benefit and defined contribution plans which, while often true, are not absolutes. For example, a defined benefit plan often is biased in favor of older participants, but it need not be. Furthermore, a defined contribution plan may allow each participant to direct the investment of his or her account balance, but it need not do so. Finally, while it is very common these days for a defined contribution plan to permit elective deferrals on a pretax basis (so called "401(k) contributions"), a defined contribution plan need not have such a feature.

In recent years, the terms "defined benefit" and "defined contribution" have expanded to cover benefits other than pension plans. For example, some predicted (before the Affordable Care Act, which is discussed later in this survey) that employer provided health benefits, which historically were provided on a "defined benefit" basis (in other words, the employer promises to pay all or a set portion of the total cost

of the benefit) would be replaced by a defined contribution health program (in other words, the employer will contribute a certain amount of money, and then let the employee shop for health coverage, with the employee making up any shortfall out of his or her own pocket.)

Subcategories of Defined Benefit Plans – The Cash Balance Plan

While there is tremendous variation in the way in which defined benefit formulas are written, there is only one subcategory of plan that will be mentioned in this tour of pension jargon: the cash balance plan.

In a traditional defined benefit plan, the benefit will be expressed as a monthly or annual amount payable beginning at a certain time, such as age 65. Therefore, someone who is 37 years old and working for a company will be told that if her salary continues at the present level until age 65 she will be entitled to an annual payment of \$X. It is difficult for that 37-year-old to comprehend the value of the benefit she has earned so far.

A cash balance plan, while still a defined benefit plan, expresses the benefit as a current lump sum amount. Typically, that lump sum amount will go up every year based on additional services rendered and interest at a pre-announced rate on the lump sum already earned. The lump sum never goes down; investment risk is still on the employer as in any defined benefit plan. A cash balance plan is simply a user-friendly defined benefit plan.

This description is an oversimplification of a very complex phenomenon. In fact, many large companies shifted to cash balance plans during the 1990s and the first few years of this century, and that shift was motivated not only by user-friendliness, but also, in many cases, to effectuate a fundamental change in the underlying formula, giving proportionately greater annual accruals of benefits to younger people and proportionately smaller annual accruals to older people. This fundamental change caused some older employees to question whether cash balance plans discriminate against them. The situation was further aggravated where the transition to a cash balance plan resulted in a period during which no further benefits were accrued (sometimes called “wear away.”)

The regulatory agencies, particularly the Treasury, were slow to issue guidance on cash balance plans, and this encouraged litigation challenging whether cash balance plans violated provisions in ERISA and the Code that prohibit age discrimination. Finally, Congress addressed this serious situation in the Pension Protection Act of 2006 (the “PPA”), signed into law in August 2006. The PPA sets forth a number of new requirements for cash balance plans, but in return gives assurance that

such plans are in compliance with ERISA and the Code. Unfortunately, that assurance is only prospective – PPA is explicitly noncommittal as to the status of such plans prior to August 2006.

Subcategories of Defined Contribution Plans

The defined contribution world has many more subcategories than the defined benefit world. First and foremost is a somewhat archaic but still relevant distinction between plans which must promise an announced contribution each year, and those where the contribution can either be announced in advance or discretionary, to be determined by the employer each year. Plans with required promises are called defined contribution pension plans and plans with more flexibility are called defined contribution profit sharing plans.

Defined Contribution Pension Plans

The most prevalent category of defined contribution pension plan (just about the only category that is used today) is the money purchase pension plan or money purchase plan. A money purchase plan will provide for an absolute promise of a contribution: “each participant’s account will be credited with a contribution equal to 5% of compensation”. Money purchase plans constitute a small minority of defined contribution plans. Their usage was mainly a result of a Code provision that permitted higher contributions than those that could be made to profit sharing plans, but as of 2003, this distinction was eliminated. Money purchase pension plans remain in existence, however, and as we will see, they are subject to some special rules that distinguish them from profit sharing plans (mainly greater restrictions on the form and timing of distributions and greater protection for spouses.)

Profit Sharing Plans

The term “profit sharing plan”, used in the Code, is an unfortunate choice of words. These plans have nothing to do with profits; they are simply plans that allow discretion as to how much money will be contributed in a given year. The simplest of all profit sharing plans is a plan where the employer makes a contribution to each participant’s account each year. It is like a money purchase plan except that the employer can decide to vary the contribution, or not make one at all, and does not need to announce the actual contribution until after the end of the year. If an employer has a plan like this, but uses the same formula every year to determine the contribution, the plan will look identical to a money purchase plan, but as noted above, it will have a number of rules which are different from those applicable to money purchase plans.

401(k) Plans

A 401(k) plan is a subcategory of the profit sharing plan category. Instead of the employer making an across the board contribution on behalf of all participants, each participant can decide on an individual basis how much should be contributed out of (“deferred from”) salary on a pre-tax basis (“pre-tax deferrals”). Very often there is a matching employer contribution to reward those who choose to contribute. The same plan might also have a discretionary employer contribution that can be made at the end of the year.

401(k) plans have become so common that there is sometimes a tendency to treat them as separate type of plan, or even the only type of defined contribution plan. It is useful to keep in mind that a 401(k) plan is simply a profit sharing plan with a 401(k) feature.

ESOPs and Other Stock-Based Plans

In general, it is permissible for profit sharing plans to invest in employer securities. A 401(k) program, for example, might have the matching contribution made in employer stock.

It is also possible to devise a profit sharing plan that invests solely in employer stock. These plans traditionally were called stock bonus plans, but the most common type of stock bonus plan today is an employer stock ownership plan, or ESOP. One type of ESOP, a “leveraged ESOP”, is a very complicated type of defined contribution plan that, over a period of time, can transfer a substantial percentage of the ownership of the company to its employees. Congress has given employers substantial tax incentives to create ESOPs, but there are also many complexities and much potential for pitfalls.

Profit sharing plans that allow or require investment in employer stock have come under scrutiny, and have been the subject of much litigation, in recent years. The controversy is whether employer stock is a suitable investment in a retirement plan, and what burdens should be placed on fiduciaries to make a decision as to suitability on an ongoing basis.

403(b) Programs

For reasons that are historical rather than rational, non-profit corporations, as well as public educational systems, have had access to a type of defined contribution program that is governed by Section 403(b) of the Code rather than Section 401. 403(b) programs come in all shapes and sizes. They can look like full-fledged defined contribution plans with employer contributions, or they can appear in a form that is more like

individual deferral accounts maintained on an employee by employee basis; these individual accounts are sometimes referred to as “403(b) annuities” or “tax-sheltered annuities” or “TSAs”. Very often these days, 403(b) programs do not look like annuities at all, but instead look the same as accounts in a 401(k) program, namely an amount of money which is invested among a variety of mutual funds.

These programs are considered “pension benefit plans” for ERISA purposes if they are sponsored by a private sector entity, and are more than just individual deferral accounts. If there are just individual deferral accounts, they are not considered employer sponsored, and are not governed by ERISA. In either case, they are not “qualified plans” under the Code. Governmental plans, of course, are not governed by ERISA in any event.

In recent years, the IRS has issued comprehensive regulations relating to 403(b) programs that make the rules governing them more consistent with 401(k) plans.

457 Programs

The pension plans of governmental entities are governed by the Internal Revenue Code, although somewhat different rules apply to these plans. Therefore, governments can, and do, have defined benefit and defined contribution pension programs. Unfortunately, Congress did not extend the very popular 401(k) program to governmental entities. In addition, 403(b) programs (which, as noted above, can be 401(k) substitutes) are available only to educational institutions, not to other governmental entities. As a result, if a government wants to allow employees to defer compensation into a tax deferred program, it must avail itself of a completely separate program known as a “457 plan” (because it is governed by Section 457 of the Internal Revenue Code). 457 programs have their own special rules, which have changed over the years, but in recent years, the IRS has issued comprehensive regulations relating to governmental 457(b) programs that makes the rules governing them more consistent with 401(k) plans and 403(b) programs. To make matters more complicated, Section 457 also applies to non-profit organizations, but only with respect to benefits for highly compensated employees.

Individual Retirement Accounts (IRAs)

The individual retirement account, or IRA, was one of the brand new ideas that came out of the 1974 passage of ERISA. It was intended to be a substitute pension program, on a miniature scale, for employees whose employers did not choose to have pension programs. It continues to this day in that form. The annual contribution limit is \$5,500 in 2017.

The IRA was also given another important job by Congress, namely to be a receptacle into which certain distributions from pension programs could be rolled over and allowed to accumulate until distribution. This rollover receptacle job has become increasingly significant as more and more baby boomers retire early with large lump sum distributions.

Finally, Congress has for many years tinkered with allowing after-tax contributions to be accumulated in IRAs. The latest and most sweeping product of that tinkering is the “Roth IRA”, a retirement vehicle which is separate and distinct from the traditional IRA, although it shares some of its rules and features.

Congress has also made several efforts to encourage employers to establish pension programs by offering stripped down and simplified forms of programs. Two examples are “simplified employee pensions” or “SEPs”, and “simple retirement accounts” or “SIMPLEs”. Each of these programs utilizes IRAs rather than having all of the assets of the plan accumulate in a trust established by the employer. None of these programs has really caught on in a material way.

Non-Qualified Deferred Compensation

There is a whole world of special benefit programs reserved for top executives. These programs all fall under the umbrella term “non-qualified deferred compensation” to indicate that the programs do not satisfy all of the complicated Internal Revenue Code rules for “qualified” plans, and therefore do not get the special benefits of qualified plans. We will learn about these rules in a subsequent article. Non-qualified deferred compensation can be in either defined benefit or defined contribution form.

Stock option and stock purchase plans

Many publicly traded companies compensate executives, and even rank and file employees, with employer stock. One technique is to award options to purchase stock in the future at a price that hopefully will be a bargain. Plans that offer these options are called “stock option plans.” Another technique is to allow employees to purchase stock currently at a price that is less than what the market is charging. These plans are called “stock purchase plans.” Stock option plans and stock purchase plans are governed by the Code, but they are not considered ERISA pension benefit plans because they do not defer compensation for an extended period. Since they are not welfare plans either, they are not governed by ERISA at all.

5. Conclusion

We have now completed our tour of the jargon used in the employee benefits area. The tour is by no means complete; all of you who proceed to learn more about this area will undoubtedly be frustrated by the complicated terms that are used. Hopefully, this brief journey will protect you from that awful feeling of being left at the starting gate because you, like many who preceded you, are still trying to figure out the language that is being spoken.

Chapter II

A POET'S GUIDE TO THE QUALIFIED PLAN: A BRIEF GUIDED TOUR OF THE WORLD OF SECTION 401(a) OF THE INTERNAL REVENUE CODE

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1. What Is A Qualified Plan?

In pension jargon, a retirement plan is "qualified" if its assets are held in a trust which constitutes a qualified trust under Section 401(a) of the Internal Revenue Code. To achieve this status, it must meet all of the many requirements listed in Section 401(a).

2. What Are the Advantages of Qualification?

There are three critical aspects to the tax status of a qualified plan which, together, make it highly desirable.

- **The employer derives an immediate tax deduction for contributions made to the trust.** From an employer's perspective, contributions to a qualified plan are treated the same as the payment of cash compensation.
- **Contributions to a qualified trust are NOT immediately taxed to the employee.** In this way, contributions to a plan are treated more favorably than the payment of cash compensation. Even if the employee has a vested (nonforfeitable) right to the money, it will not be taxed until it is paid out. From the government's perspective, it is allowing a deduction to the employer, while forgoing an immediate tax on the employee. The government will eventually get its taxes, but only when payment is made from the trust.
- **The trust itself is tax exempt.** The investment earnings on the money held in the trust are not taxable. From the perspective of both the employee and the government, this is not an elimination of a tax but merely a deferral. When the money is eventually paid out, it is taxed in full.

3. What Are the Requirements for Qualification?

The concept of the qualified plan is a classic use of the carrot and the stick by the government. The carrot, the deferral of all taxes until distribution, is juicy. Correspondingly, the stick, in the form of a host of requirements set forth in Section 401(a), is powerful and potentially painful.

Simply plowing through the list of requirements in the subparagraphs of Section 401(a) in order, from (1) to (37), can leave the reader overwhelmed with the complexity and scope of the requirements for qualification. Moreover, several of these subparagraphs simply cross-reference other equally complex sections of the Code. Nevertheless, the major requirements can be rendered more rational and more understandable by grouping them into a few categories.

The first category consists of various non-discrimination provisions. Essentially, Congress is saying that in order to attain the benefits of a qualified plan, the employer must agree to provide benefits to its employees in a reasonably non-discriminatory manner. The non-discrimination provisions are intended to ensure that highly compensated employees are not unduly benefited by a plan in comparison to non-highly compensated employees.

- A. Non-discrimination in participation. Section 401(a)(3) states simply that the requirements of Section 410 must be met. Section 410 provides minimum age and service requirements for when an employee must be allowed to participate in a plan, and in addition, provides complex mathematical tests for whether the eligible group of employees, if it consists of less than all of the employees in the company, is non-discriminatory.
- B. Non-discrimination in contributions and benefits. Section 401(a)(4) requires that within the group actually participating in the plan, contributions or benefits must not discriminate in favor of highly compensated employees. (Section 401(a)(5) adds details to these rules, but not nearly as much detail as the extraordinarily complex regulations which have been issued under Section 401(a)(4) by the Treasury.)
- C. Minimum vesting rules. Section 401(a)(7) requires that a plan satisfy Section 411 of the Code, which contains minimum vesting rules. Vesting means nonforfeitability, a point after which the participant will have a right to the benefit even if he or she terminates employment. Section 411 also contains minimum accrual of benefit rules and prohibitions on cutbacks of benefits.

- D. Special protection in owner-dominated plans. Section 401(a)(10) contains additional rules for plans dominated by owners ("top-heavy plans" for example). The gist of these rules is to add additional non-discrimination requirements and limitations to plans which Congress deems to be inherently more prone to discrimination.
- E. Cap on compensation. Section 401(a)(17) sets a cap on the maximum compensation level that can be used in determining a contribution or benefit. This section is not an absolute cap, but rather is a rule that effectively discriminates in favor of those employees whose compensation is less than the cap. The cap, which is indexed for inflation, is \$265,000 for 2016 and \$270,000 for 2017.
- F. Minimum size of plan. Section 401(a)(26) imposes a minimum size, by participating employees, for defined benefit plans, the thrust being to prevent a profusion of small defined benefit plans which, although they may meet other requirements, may have the effective result of discriminating in favor of highly compensated employees.

The second group of provisions sets absolute caps on the amount of benefits that can be provided by, or contributions that can be made to, a qualified plan.

- G. Caps on contributions and benefits. Section 401(a)(16) requires every qualified plan to comply with Section 415 of the Code, which contains a comprehensive set of limitations on contributions made to a defined contribution plan and on benefits provided by a defined benefit plan.
- H. Cap on elective deferrals. Section 401(a)(30) requires that every qualified plan which provides for elective deferrals (such as 401(k) plans) incorporate the cap on elective deferrals imposed by Section 402(g)(1) of the Code. This cap, which is indexed for inflation, is \$18,000 for 2016 and 2017). In addition, an extra "catch-up contribution" is allowed for those over 50 years old. This catch-up contribution, which is indexed for inflation, is \$6,000 for 2016 and 2017.

The remaining provisions of Section 401(a) are uncategorizable, comprising a diverse and broad set of rules designed to protect the interests of the government and participants. I will highlight a few below because they have the broadest impact.

- I. Exclusive benefit. The preamble of Section 401(a) requires that the plan be operated for the "exclusive benefit of employees or their beneficiaries". Section 401(a)(2) requires that it be impossible for any part of the trust to be diverted to any other purpose. These two provisions impose "fiduciary" type rules on employers which are very similar to those set forth in Title I of ERISA.
- J. Minimum distribution rules. Section 401(a)(9) sets forth minimum distribution rules designed to require the ultimate payout of compensation which has been deferred pursuant to a qualified plan.
- K. Spousal rights. Section 401(a)(11), which references Section 417 of the Code, sets forth rules giving spouses certain property rights in pension assets.
- L. Anti-alienation. Section 401(a)(13) prohibits the assignment or alienation of pension benefits. This rule keeps pensions from being pledged to banks and other lenders, and protects these benefits from creditors. A notable exception contained in Section 401(a)(13) gives a spouse and other dependents the right to have pension benefits assigned pursuant to a qualified domestic relations order/decreed (a "QDRO").

The above list is not comprehensive, but gives an idea of the scope of Section 401(a). A great deal is asked of the employer who wishes to take advantage of the benefits of a qualified plan.

4. How Does A Plan Become Qualified?

A plan is a qualified plan if it meets all of the requirements of Section 401(a) of the Code. No formal registration is necessary. Nevertheless, until 2017 the Internal Revenue Service offered a program whereby an employer could submit a plan every five years with a request for a determination letter which states that the plan, as set forth in the written document, is qualified. As a practical matter, virtually every employer who maintained a qualified plan (other than a prototype – see below) would want a favorable determination letter to avoid the risk that the plan will inadvertently not be qualified. Such a letter does not offer absolute protection because a plan can still become disqualified because of the way it operates. Nevertheless, the favorable determination letter provided a justifiable degree of comfort to an employer. After the "cycle" of submissions in January 2017, this program is being eliminated except for brand new plans and terminating plans. The impact of this change on sponsor conduct is not yet clear as this guide goes to print.

Many employers utilize prototype (or volume submitter) plans. These are plans which are designed by an entity in the pension business, such as a bank or an insurance or investment company, and submitted to the IRS in advance along with one or more adoption agreements which can be completed by individual employers. The prototype receives a favorable opinion letter. Upon subsequent adoption by an individual employer, by completing the adoption agreement, the employer's plan in many cases will be automatically covered by the favorable opinion letter without any further filing. If the employer chooses an adoption agreement which permits greater variation (a "non standardized" adoption agreement), then it may make a simplified submission for a determination letter to get the full protection of a favorable determination letter. In either case, the procedure is simpler and cheaper than applying for an individual favorable determination letter. It may be that the substantial elimination of periodic favorable determination letters may motivate more sponsors to move to prototype or volume submitter plans.

5. What Is the Effect of a Plan Being Disqualified?

If a plan is not a qualified plan, then a vested employee is taxed immediately on the benefits, the employer gets a deduction only when an employee is vested, and the trust becomes a taxable trust. If a plan that has operated for a number of years is retroactively disqualified, the results can be quite devastating. The Code has provided a special rule softening the impact of an inadvertent disqualification if it is a result of the failure to meet the non-discriminatory coverage rules (Section 410(b) of the Code). In such case, only highly-compensated individuals will be saddled with the impact of the plan's disqualification. See Code § 402(b)(4).

6. Special Relief for Inadvertently Disqualified Plans

It is not an easy task to maintain a plan that meets all of the requirements of Section 401(a) all of the time. There are many complex mathematical tests which can be failed by erroneous compilation of data or erroneous application of that data in a mathematical test. In addition, plans are so complicated that it is not surprising that some administrators will fail to operate the plan exactly in accordance with the rules of the written document, and the IRS takes the position that this alone can result in plan disqualification. In fact, disqualification rarely occurs. The Treasury has established a formal and well-organized set of programs that permit the correction of errors. These programs have evolved over time, and are now consolidated into an Employee Plan Compliance Resolution System ("EPCRS"), most recently promulgated in IRS Revenue Procedure 2016-51.

The simplest component of EPCRS is the Self-Correction Program ("SCP"). This program permits the correction of an operational

error without government intervention as long as the corrections are made by the end of the second calendar year after the year in which the operational error occurred. If the error was minor, the correction can be made even after the two-year period. No submission to the IRS is required; the action to correct the error cleanses the plan.

The next component of EPCRS, known as the Voluntary Correction Program (“VCP”), requires the payment of a relatively small fee and the filing of an application with the IRS explaining the mistake, suggesting a correction, and explaining why the mistake will not happen again. This component can only be used at a time when a plan is not under audit. VCP will typically be used when SCP is not available (such as after the end of the 2-year self-correct period where an error is not minor.)

The final program, known as the Audit Closing Agreement Program (“AUDIT CAP”), is to be used where mistakes are identified in an audit. Generally, corrections can still be made, but the stakes are higher. The IRS can impose a penalty up to the full amount of the tax that would be payable by the employer and employees as a result of disqualification, although the expectation is that a much smaller number can be negotiated.

While some of the terminology seems overly complicated in a bureaucratic way, the fact is that EPCRS has been a great success. It provides practitioners with a way of dealing with problems without putting their clients at a dire, even if unlikely, risk. Rev. Proc. 2016-51 even contains very helpful correction methodologies which, while not mandatory, provide blueprints for solutions to problems. In short, EPCRS has made disqualification an unlikely event which will only occur where there is complete and prolonged neglect.

Chapter III

A POET'S GUIDE TO THE NON-DISCRIMINATION RULES

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The area we are about to explore, the various non-discrimination rules imposed on qualified plans, can numb the mind of any lawyer who is not also an actuary. What I propose to do is explain the basic framework, and set forth the simpler mathematical rules, in a way that (hopefully) even a poet could grasp. For those who specialize in this area, it is essential to dig deeper and explore the challenging regulations that the Treasury has issued regarding the application of these rules.

1. The Basic Rules

The basic non-discrimination rules are contained in two places, Section 410 and Section 401(a)(4). Section 410(a) of the Code sets minimum age and service requirements for participation in a plan for a group of eligible employees. Section 410(b) provides rules for determining whether a group of eligible employees that consists of fewer than all of the employees of an employer is non-discriminatory. Section 401(a)(4) then tests whether contributions or benefits provided to those who are actually participating are non-discriminatory.

There are numerous other sections of the Code which come into play in policing non-discrimination. Some of these involve the definitional terms that will be used in applying Section 410 and Section 401(a)(4): highly compensated employee (Section 414(q)); compensation (Section 414(s) and Section 401(a)(17)); and employer (the controlled group rules set forth in Section 414(b), (c), (m), (n), and (o)). In addition, there are special rules regarding the minimum size of defined benefit plans (Section 401(a)(26)), and special rules which apply to plans in which owners are dominant (Section 416 regarding top-heavy plans). Each of these sections will be mentioned at least briefly in this Chapter. We will begin with a discussion of two concepts which are critical to an understanding of the non-discriminatory coverage test of Section 410(b): the definitions of highly compensated employee and excludable employee.

2. Who Is A Highly Compensated Employee?

The term "highly compensated employee" is used extensively in the Code to determine whether a plan is non-discriminatory. The concept has been around since before ERISA arrived in 1974, but for many years, the term had no statutory definition and was applied by each IRS local

office on a facts-and-circumstances basis. It was not until 1989 that a uniform statutory definition first went into effect, and it quickly became a monument to the over-complexity which Congress created in the 1980s in its effort to produce fairness. Fortunately, in late 1996 Congress finally passed a simplification bill which overhauled the definition of highly compensated employee beginning in 1997.

The current definition is that the following employees will be highly compensated:

- a. 5% owners in the current or prior year; or
- b. Employees who had compensation in the prior year of more than an inflation adjusted dollar amount. For testing in 2014 the dollar amount is \$115,000 applied to 2013. For testing in 2015 the dollar amount is \$115,000 applied to 2014. For testing in 2016 the dollar amount is \$120,000 applied to 2015.

There is an option to limit category (b) to the top 20%, at the employer's discretion. This is relevant for employers who have a lot of highly paid employees.

Note that in category (b), the compensation rule is applied only to the prior plan year; the 5% ownership rule - category (a) - will apply to both the current and prior years. Because of the “look back” nature of category (b), an employer can know for certain at the beginning of the testing year who will be highly compensated for that year. For example, for 2017 someone will be highly compensated only if his or her 2016 compensation exceeded \$120,000.

One irony of this definition is that every employee is non-highly compensated in the first year of employment, because the prior year compensation is zero. Some may even be non-highly for two years. For example, an employee hired late in 2016, at an annual compensation of more than \$120,000, might be non-highly compensated in both 2016 (zero compensation in 2015) and 2017 (less than \$120,000 in 2016 because hired late in year). The rule is completely mechanical in this regard.

3. Who Are Excludable Employees?

The non-discrimination rules imposed by Section 410(b) of the Code are applied to all non-excludable employees of an employer; in other words, certain employees can be excluded from the test. The real message is that a plan can exclude certain people from coverage without any fear of running afoul of the non-discrimination rules.

There are three categories of employees who are excludable. The first, nonresident aliens who receive no earned income from sources within the United States, is of limited applicability. A second category, employees who are included in a unit of employees covered by a collective bargaining agreement, as long as retirement benefits were a subject of good faith bargaining, is a much more significant exception. Union employees can be excluded from a plan if they bargain for alternative benefits, and the employer's plan will be tested for non-discrimination only with respect to non-union employees.

The last category of excludable employees consists of those employees who have not yet met the age and service requirements imposed by the plan. Section 410(a) of the Code sets forth the limits on the age and service requirements that can be imposed. Essentially, a plan can require that an employee attain age 21 and complete one year of service before becoming a participant. In the case of a plan which provides for full vesting after not more than two years of service, two years of service can be used as an eligibility requirement rather than one year (although not for 401(k) plans).

Once the eligibility criteria are satisfied, an employee must become a participant not later than either the first day of the next plan year or six months after satisfying the criteria, whichever comes first. This rule is usually satisfied by having two entry dates, one at the beginning of the plan year and one on the first day of the seventh month of the plan year.

There are complicated rules regarding the computation of a year of service for purposes of these eligibility rules. The most important point is that there can be a requirement that an employee complete a minimum number of hours within the designated 12-month period for it to be a year of service. The minimum number of hours can be any number as long as it does not exceed 1,000 hours. The effect of this rule is to impose a mathematical test for the exclusion of part-time employees. An employee who completes more than 1,000 hours during the designated 12-month period is eligible to participate regardless of whether he or she is categorized as a part-time employee.

It probably goes without saying that there are also complicated rules regarding the computation of an hour of service. In general, however, initial eligibility will be determined by counting actual hours.

Some plans, typically large ones, use the "elapsed time" method for determining a year of eligibility service. This translates into requiring an employee to reach the anniversary date of employment. While this method is simpler since it eliminates keeping track of hours, it also requires the inclusion of part-time employees.

4. The Test for Non-Discriminatory Coverage (410(b))

Every qualified plan must satisfy the non-discriminatory coverage rules at all times. These rules compare who, among the employer's non-excludable employees, is, and who is not, eligible to participate in a given plan. There are two different tests that can be used, a relatively simple one known as the 70-percent ratio test, and a much more complex one known as the average benefit percentage test.

70% Ratio Test

The 70-percent ratio test compares the percentage of highly compensated non-excludable employees participating in the plan with the percentage of non-highly compensated non-excludable employees participating in the plan. The test has three steps:

1. The total number of non-highly compensated non-excludable employees of the employer is determined, and the percentage who participate in the plan is established.
2. The total number of highly compensated non-excludable employees of the employer is determined, and the percentage who participate in the plan is established.
3. The ratio of the number determined in (1) above to the number determined in (2) above must be at least 70 percent.

EXAMPLE

Total Non-Excludable Employees = 120

	<u>Non-Highly</u>	<u>Highly</u>
Total	100	20
Participating	40	10
% Participating	40%	50%
	$\frac{40}{50} = 80\%$	

TEST IS PASSED

The 70-percent ratio test is a strict mathematical test. No inquiry is made into the criteria for determining who is eligible to participate and who is not. For example, a plan could exclude all individuals whose last names began with the letters T through Z, and as long as it passed the 70-percent ratio test, the plan would be deemed to be non-discriminatory on the basis of coverage.

The Average Benefit Percentage Test

The average benefit percentage test is much more complex, and will be resorted to only in situations where the 70-percent ratio test cannot be passed. The average benefit percentage test is actually two different tests, each of which involves a mathematical component.

1. The first component requires that a classification for coverage must not discriminate in favor of highly compensated employees. This sounds like a subjective test, but the Treasury, in issuing regulations, has added an objective component, a separate numerical test which combines elements of the 70-percent ratio test described above with a test that measures what percentage of the company consists of non-highly compensated employees. The mechanics are beyond the scope of this discussion.
2. The second branch of the test focuses on the actual benefits or contributions provided to each employee as a percentage of compensation, and then derives a separate group average for the highly compensated employees and non-highly compensated employees. These averages are then compared in the same general manner as the 70-percent ratio test described above. As long as the comparison of the non-highly compensated group to the highly compensated group is 70 percent or more, this test is passed.

The average benefit percentage test typically is used in situations where a company has more than one plan, at least one of which cannot pass the 70% ratio test. In such a case, the average benefit percentage test is comparing benefits provided to different groups of people under different plans. Even with sophisticated computer models, the running of this test can be extremely complicated, and will almost always be performed by outside consultants. It is a very valuable tool, but it is a test whose results typically cannot be predicted or estimated by human resources employees or lawyers.

Final Thoughts on 410(b) Testing

In a great many cases, the 70-percent ratio test can be passed with flying colors and no further analysis is needed. Where the 70-percent ratio test cannot be passed, a company has two options: either redesign the plan, or call in a sophisticated attorney, and an outside consultant, who together can not only perform an average benefit percentage test, but also consider the use of other tools, such as separating the group into two groups if each is engaged in a “separate line of business”; or testing an

acquired division separately for up to two years after an acquisition. These concepts are beyond the scope of this article.

5. Who is the Employer? - The Controlled Group Issue

If Section 401(a) simply defined the employer to be the legal entity that established the plan for its employees, a large corporation could easily "end run" the requirements of Section 410(b) by establishing multiple corporations. For example, all of the highly compensated employees could be put in one corporation with a very rich pension plan, while all of the non-highly compensated employees could be placed in a second corporation with a much less generous plan. Each one would cover 100% of the non-excludable employees, and, therefore by definition, pass the 70-percent ratio test.

In order to prevent this result, Congress included in ERISA, and subsequently embellished, a series of provisions that requires entities under common control to be consolidated in running most of the numerical tests required for qualification, including notably the 410(b) tests.

The controlled group rules are complex, borrowing concepts used in the Internal Revenue Code rules for filing consolidated tax returns. To oversimplify, two companies with a parent-subsidary relationship will be deemed under common control if one is at least 80 percent owned by the other. Two companies with a brother-sister relationship (that is, owned by a common parent or common set of parents) will be deemed to be under common control if they are 50 percent owned by the same group of people taking into account only identical percentages of those same people in each company.

Since the rules described in the preceding paragraph only apply to corporations, Congress added a rule, in Section 414(c), that applies substantially identical tests for entities other than corporations, like partnerships.

Subsequent to the passage of ERISA, clever minds developed interlocking relationships (especially in the medical services area) where there would never be 80 percent common ownership, but there would still be a control relationship that would allow companies to exclude lower paid individuals who, but for these rules, probably would have been their employees. Congress devised, as a response, the affiliated service group rules of Section 414(m). These are quite complex to apply, even for an experienced practitioner. They bring to mind Supreme Court Justice Potter Stewart's statement about pornography, that he knows it when he sees it. Many experienced practitioners will develop a "sixth sense" to

identify the risk of an affiliated service group situation, and then focus on the complex statutory framework.

A discussion of the controlled group issue would not be complete without mentioning certain rules relating to people who are not considered employees. The first of these is the employee leasing rule set forth in Section 414(n). While this is not, strictly speaking, a controlled group rule, it polices another similar potential abuse that might permit a plan to discriminate. This rule requires that certain individuals who are leased by a leasing company to an employer, and therefore are employed by another company (the leasing company), must nevertheless be included as part of the employer's non-excludable group in performing the 410(b) test. An individual will be considered a leased employee if the person has performed services on a substantially full-time basis for a period of at least one year and the employer in question has control over that person's employment.

The other non-employee rule is not found in statute, but in case law. In the case of Vizcaino v. Microsoft Corp., 120 F.3d 1006 (9th Cir. 1997), cert. denied, 522 U.S. 1098 (1998), the Court held that certain individuals initially classified as independent contractors but ultimately determined to be employees were entitled to retroactive inclusion in the Company's 401(k) plan, because the Plan's provisions did not specifically exclude this group of employees. Companies have now been sensitized to at least considering the consequences of a large group of independent contractors being reclassified as employees.

Finally, note should be made of Section 414(o), which gave the Treasury Department the power to issue such further regulations as were necessary to prevent the avoidance of the rules set forth in Section 414(m) and 414(n). This final word was Congress' way of saying that it really expects to win the controlled group battle.

6. Section 401(a)(4)-Basic Operation.

Whereas Section 410(b) tests for discrimination in coverage (who is eligible to participate versus who is not), Section 401(a)(4) focuses solely on participants, and tests whether there is discrimination in benefits and contributions. To use a simple example, if a profit sharing plan provided for a contribution of 2% of the first \$20,000 of compensation and 15% of amounts over \$20,000, one can see instinctively that this would discriminate in favor of highly compensated employees. Section 401(a)(4) polices this type of discrimination.

Unlike Section 410(b), which sets forth specific tests, Section 401(a)(4), which predates ERISA, merely states the proposition that there cannot be discrimination. Section 401(a)(5) provides some more detailed

rules about how Section 401(a)(4) will operate (it states the perhaps obvious but very important rule that contributions and benefits which bear a uniform relationship to compensation are not discriminatory in favor of highly compensated participants). But it is left to regulations to flesh out the rules. For a long time, there was no regulatory guidance, and each district office of IRS used its own set of guidelines. The current set of regulations, which were first issued in proposed form in the very late 1980's, and were made final effective January 1, 1994, are monumental in size and scope. They cover 75 double column small print pages. With apologies to James Joyce, one might say they are the Finnegan's Wake of pension regulations: even the experienced practitioner can always find something new or discover a different interpretation upon rereading an obscure subparagraph.

The basic structure of the regulations is to set forth first a number of "safe harbors" (simple and automatic ways of passing) and then a general test for both defined contribution plans and defined benefit plans. For defined contribution plans, the simplest and most popular safe harbor is a plan that allocates all contributions in accordance with compensation for the plan year.

EXAMPLE:

Contribution = 10% of W-2 Compensation.

For a defined benefit plan, a number of safe harbors are provided. Perhaps the most common is the so called unit credit plan, where the pension formula, which will be applied uniformly to all participants, provides for a set percentage of compensation for each year of service.

EXAMPLE:

2% x Years of Service x Final Average Compensation.

For both defined contribution plans and defined benefit plans, the general test, to be used when no safe harbor can be satisfied, can be enormously complex. The essence of the test is to divide the covered group into overlapping "rate groups". There is one rate group for each highly compensated participant(s) at a given level of contributions or benefits that is composed of such highly compensated participants and all participants, highly or non-highly, with a level of contributions and benefits equal or higher. Each such rate group is then tested separately under Section 410(b), to see whether it is a non-discriminatory rate group. If you find this hard to follow, do not despair. The general test will rarely be performed by a lawyer. Inevitably, a third party administrator with a sophisticated understanding of the intricacies of these rules, and a powerful computer, will crunch the numbers on an annual basis to demonstrate that the general test will be met.

7. Permitted Disparity

While Section 401(a)(4), on its face, seems to prohibit discrimination in favor of highly compensated participants, in fact there is a long-standing exception which permits a certain degree of legal discrimination in favor of highly compensated in order to make up for the discrimination in favor of non-highly compensated participants inherent in the Social Security system. This form of permissible discrimination is known as "integration with Social Security" or "permitted disparity." In concept, it is supposed to provide an additional benefit for those whose compensation exceeds the Social Security taxable wage base, since the employer is only providing a contribution to the Social Security system calculated on amounts up to the taxable wage base. In practice, the permissible degree of discrimination, now set forth in Section 401(1) of the Code, is only vaguely connected to the actual amount of the Social Security contribution made by an employer. Over the years, the degree of discrimination permitted to integrate with Social Security has been whittled down. Nevertheless, it is still common to find both defined benefit plans and defined contribution plans which provide a slightly higher benefit for those whose incomes are higher than a defined breakpoint. When you see such a formula, you can almost be certain that the designers have taken advantage of the rules set forth in Sections 401(a)(4) and 401(1) with respect to integration with Social Security.

8. Cross Testing

One of the surprising aspects of the Section 401(a)(4) regulations is that they specifically permit (and perhaps even encourage, by giving step by step instructions) a strategy known as cross testing. What this means is that a defined contribution plan may be tested to see if it discriminates by focusing not on contributions but on benefits. Similarly, a defined benefit plan can be tested by focusing not on the benefits it provides, but on the contributions required to fund those benefits.

This complex subject is far beyond the scope of this Chapter, but suffice to say that the effect of permitting cross testing is to validate as non-discriminatory, under Section 401(a)(4), plans that to the naked eye of a mere mortal (at least one without a degree in actuarial science) would appear to be blatantly discriminatory. An age weighted profit sharing plan, for example, permits a far higher contribution, as a percentage of compensation, on behalf of a 55 year old owner than on behalf of a 25 year old clerk. The reason, in theory, is that the clerk has 40 years to participate in the plan until reaching the normal retirement date age of 65 (and therefore 40 years of contributions), while the owner only has 10 years to participate. While this may make mathematical sense, as a practical matter, once the owner retires at 65, the plan will almost

inevitably terminate and the clerk will no longer participate. Nevertheless, the plan will be validated under the cross testing rules.

9. Minimum Participation (Section 401(a)(26))

One of the most curious subsections of Section 401(a) is Section 401(a)(26), referred to as the "minimum participation" rule. This is to be distinguished from the minimum coverage rules of Section 410(b). The minimum participation rule focuses on the minimum size of a plan, in terms of participants. The specific rule, as presently in effect, is that a defined benefit plan must cover at least the lesser of:

40% of all non-excludable employees;

- or -

50 employees.

The history of the rule is interesting. During the 1980's, it became increasingly common for a controlled group involving professionals to establish a large number of small plans to cover their highly compensated individuals, with a single large plan to cover the rank and file. Sometimes the smaller plans would be custom designed to cover single participants. An actuary would be retained to use the cross testing rules described above to show that the plans were "comparable" (the predecessor to the general test of Section 401(a)(4)), and in the aggregate did not discriminate in favor of highly compensated participants.

Many observers thought this was an abuse, a case of actuaries using magic tricks that the IRS could not effectively fight because it did not have the resources to police the tricks. In an effort to cut this "abuse", Congress promulgated Section 401(a)(26). In its original form, it covered defined contribution plans as well as defined benefit plans. Furthermore, the initial position taken by the Treasury Department was that it applied not only to separate plans, but to separate benefit formulas within a single plan.

Practitioners were very critical of Section 401(a)(26). First of all, if it was intended to prevent the abuse described above, why did it require plans to have a minimum of 50 participants, rather than a much smaller number? Furthermore, with respect to the "separate benefit structure" interpretation taken by the Treasury, many older defined benefit plans had a variety of special rules, applicable to specific groups of employees, which were not in any way abusive of the non-discrimination rules. Now these rules, if applicable to fewer than 50 people, could disqualify the entire plan.

Along the way, the Treasury adopted a new interpretation that the rule applied only to separate plans and not separate benefit structures

within a plan. Furthermore, Congress amended Section 401(a)(26) to limit its application to defined benefit plans. As now structured, the rule is more livable, although practitioners may still wonder whether it is really necessary.

10. Non-Discrimination in Availability of Benefits, Rights and Features

An entire Section of the 401(a)(4) regulations is devoted to the non-discriminatory availability of benefits, rights and features. The gist of this Section is that even if a plan provides a non-discriminatory contribution formula, or benefit formula, it must also provide other features on a non-discriminatory basis. For example, optional forms of benefit (lump sum, annuity) must be available on a non-discriminatory basis. Ancillary benefits such as disability coverage and life insurance must be available on a non-discriminatory basis. Plan loan provisions, the right to direct investments, and the availability of particular investment options, must all be available on a non-discriminatory basis. Articulating this rule was an important innovation of the Section 401(a)(4) regulations. Practitioners now know that a plan can become disqualified for illegal discrimination in favor of highly compensated employees even if the plan formula passes with flying colors.

11. Section 401(a)(17) - The Cap on Compensation

One of the most important non-discrimination rules is found not in the Section 401(a)(4) regulations but rather in Section 401(a)(17). This Section limits the amount of compensation that can be taken into account in determining contributions or benefits, and in performing the various non-discrimination tests. When the Section first went into effect in 1989, the cap was set at \$200,000. It increased based on cost of living over the next several years. In 1993 the cap was reduced to \$150,000, again indexed for inflation. For 1999, the cap was \$160,000. For 2000 and 2001, it was \$170,000. Then, as a result of the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the cap was increased to \$200,000, an amount which will be indexed for inflation in subsequent years. This indexing has resulted in several increases in the limit, most recently to \$265,000 for 2015 and 2016 and \$270,000 for 2017.

The dramatic effect of this provision can be seen by taking a simple example of a money purchase pension plan with two participants, one whose income is \$530,000 and the other whose income is \$53,000. If there was no Section 401(a)(17) cap, a 10% contribution formula would result in a contribution of \$53,000 for the highly paid employee and \$5,300 for the non-highly paid employee. If the 2016 cap of \$265,000 is instead applied, then the same 10% formula will provide a contribution of

\$26,500 for the highly paid employee, and the same \$5,300 for the non-highly paid employee. More to the point, since the highly paid employee probably wants a contribution of \$53,000 (the maximum permitted under Section 415 in 2016), a 20% contribution formula would have to be chosen. For the highly compensated employee to get \$53,000, the non-highly compensated employee would have to receive a contribution of \$10,600.

The Section 401(a)(17) cap, when it was imposed in 1989 and especially when the cap was set at \$150,000 in 1993, was a dramatic change in the pension rules. It may well have dissuaded small companies from establishing plans, since it became much more expensive to provide a sizable benefit for owners whose compensation is far in excess of the cap. In large companies, it resulted, to some extent, in the proliferation of non-qualified deferred compensation plans as a means of providing extra benefits to executives. Although non-qualified deferred compensation plans have many drawbacks, the alternative of increasing the qualified plan formula in order to provide additional benefits to a small group of highly based on compensation capped at the 401(a)(17) figure was prohibitively expensive. The change to \$200,000 in 2002, and now to \$265,000 in 2016 and \$270,000 since 2017, eased up on this drawback to some extent, by permitting employers to reach a set goal for highly without expending as much on behalf of non-highly.

12. Non-Discrimination in Defining Compensation

Because most pension formulas include compensation as a factor, a plan that appears to treat everyone in a non-discriminatory manner (for example, a plan that provides "4% of compensation" to each participant) might be discriminatory if the way in which compensation is defined is discriminatory. In order to prevent this abuse, Section 414(s) of the Code requires that a non-discriminatory definition of compensation be used in applying Section 401(a)(4).

It is only a slight oversimplification to say that the automatic safe harbor definition of compensation under Section 414(s) is W-2 compensation. An alternative safe harbor definition is W-2 compensation increased to add back in elective deferrals under a 401(k) plan or a Section 125 plan.

To the extent that a plan does not satisfy a safe harbor, because it excludes certain compensation, it must be tested to see if it is non-discriminatory. A classic example is a plan that excludes overtime or bonuses, or perhaps overtime and bonuses. Such a plan would have to be tested to see what percentage of the compensation of highly compensated employees as a group was being included, and what percentage of the compensation of non-highly compensated employees as a group was

being included. If the included percentage for highly compensated exceeded that of non-highly by more than a de minimis amount, then the definition of compensation, and therefore the plan, would be deemed discriminatory.

It should be noted that despite Section 414(s) and its regulations, many plans use base compensation in determining their benefits, thereby eliminating overtime pay from consideration. As long as bonuses are also excluded, and as long as highly compensated individuals actually have bonuses that are at least equivalent in magnitude to the overtime pay of non-exempt employees, there is generally not a problem meeting the test imposed by Section 414(s).

13. Top-Heavy Plans

Effective in 1984, Congress added a broad new section to the Code, Section 416, to deal with what it perceived to be the special discrimination issues involving small owner dominated plans. Until that time, self-employed entities had come under special scrutiny and were subject to special statutory rules that limited their pension plans, but incorporated entities, even small ones which otherwise looked very much like self-employed entities, remained free of that scrutiny and those special rules. Section 416 changed all of that in 1984. No longer would the form of entity govern which pension rules would apply. Instead, the degree of dominance by owners would be the test.

In its current guise, Section 416 imposes special benefit accrual rules and special vesting rules on top-heavy plans. Top-heavy plans are defined as plans where more than 60% of the benefits go to “key employees”. Code § 416(g). For defined benefit plans, the present value of future benefits is used for purposes of this measurement. For defined contribution plans, account balances are used.

“Key employee” is a term which attempts to identify the employer’s insiders, either by ownership or clout. Code § 416(i)(1). The definition is different from that of “highly compensated” under Section 414(q). Key employees are any of the following:

- a. officers making more than an inflation adjusted dollar amount - the 2015 figure is \$170,000 per year;
- b. 5% owners; and
- c. 1% owners making more than \$150,000.

Some of the other complicated rules for determining top-heavy status have also been simplified.

It is evident that the calculation of whether a plan is top-heavy is complex, and can produce results which vary from year to year. As a practical matter, entities whose plans bear the risk of being top-heavy will comply with the special accrual and vesting rules imposed by Section 416 of the Code.

The special vesting requirement, *see* Code § 416(b), is quite simple: a top-heavy plan must use 3-year cliff vesting, or a schedule that starts at 20% after two years and goes to 100% after six years. It should be noted that only traditional defined benefit plans are impacted by this “special” rule, since all other plans must have vesting schedules that are as liberal as those mandated for top heavy plans.

The minimum benefit accrual requirement, *see* Code § 416(c), is more complex, and will only be outlined briefly here. For defined benefit plans, there must be a minimum accrual of 2% times final average compensation for each year of service, up to a maximum of 20% of final average compensation. Code § 416(c)(1). Final average compensation is the average of the 5 years which produces the highest result.

For a defined contribution plan, the minimum contribution is a contribution each year of 3% of compensation. Code § 416(c)(2). There is an exception if no key employee gets a contribution of 3%, in which case the minimum is the highest percentage contribution that any key employee gets. The application of this rule is particularly complicated in 401(k) plans, and this issue is described briefly in the separate article on 401(k) plans.

These minimums have the effect of raising the benefit or contribution that might otherwise be provided under the formula to non-key employees. By narrowing the gap between the contribution or benefit paid to key employees and the contribution or benefit paid to non-key employees, an additional blow is struck against discrimination in favor of highly compensated individuals.

The entire top heavy system, all set forth in Section 416 of the Code, has been among the most criticized of all of the complex regulatory regimes applicable to qualified plans. The argument that critics make (and it is a persuasive one) is that there are enough provisions protecting rank and file employees without Section 416, and that the added layer of complexity has administrative costs which outweigh the benefits.

14. Conclusion

As we end our brief tour of the non-discrimination rules, it is useful to step back and assess their wisdom. There is no question that the concept of non-discrimination is a critical “stick” to counterbalance the

"carrot" of the qualified plan. It is indisputable that without these rules, many plans would be designed to favor the highly compensated, and perhaps a special group of non-highly compensated that were loyal or indispensable. If there are valid criticisms of the rules discussed above, they probably address not the goal, but the means of achieving the goal. One must question whether so many different rules were needed, and whether they had to appear in so many different places in the Code. Section 401(a)(26) is a prime candidate for scrutiny. The top-heavy minimum allocations/minimum benefit rule is another. I close this Chapter by using a track meet metaphor, and showing, as a set of hurdles, the various rules that have been discussed in this Chapter. The picture they present is a nice reminder of the complexity of the statutory and regulatory system involved in policing qualified plans. It also serves as a handy checklist for a practitioner, or a student taking an exam or analyzing a plan, to see if there are any non-discrimination problems.

THE NON-DISCRIMINATION HURDLES

THE STARTING LINE. A decision to offer deferred compensation.

410(a)-Restrictions on exclusion
410(b)-Minimum coverage requirements
411-Minimum vesting standards
401(a)(4)-Non-discriminatory contributions and benefits and rights and features
401(a)(26)-Minimum size of plans
401(a)(17)-Cap on compensation
414(s)-Non-discriminatory definition of compensation
414(b)(c)(m)(n) and (o)-Controlled group rules
416-Top-heavy plans - special vesting and minimum contribution/benefit rules
401(k) and (m) -Special non-discriminatory rules for elective deferral and matching plans

THE FINISH LINE. A qualified plan

WARNING! DO NOT FORGET ABOUT THE DOLLAR LIMIT HURDLES:

402(g)-Cap on elective deferrals
415-Limits on contributions/benefits
404-Limits on employer deduction

Chapter IV

A POET'S GUIDE TO PLAN CONTRIBUTION AND BENEFIT LIMITS

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This brief chapter will explore a very important set of rules that set maximum limits on the benefits and contributions that qualified pension plans can provide to the individuals they cover. Having established an important tax incentive, Congress had to determine what limits to put on its use. Congress could have relied exclusively on the non-discrimination rules, on the theory that there would be a practical disincentive for companies to excessively reward executives under a qualified plan, namely that they would have to give a proportionate reward to non-highly compensated. The problem with this approach is that there are many small companies whose only employees are highly-compensated employees and their families; in these companies, the non-discrimination rules would not provide a disincentive for providing unlimited contributions or benefits.

Whatever the reasons, Congress imposed, in addition to the non-discrimination rules, absolute caps on the amount that could be contributed to a defined contribution plan in any given year, and on the benefit that could be accrued over a career in a defined benefit plan. In addition, Congress separately imposed limits on the aggregate deduction that a company could take in any given year for contributions to a qualified plan. We will now examine these two sets of limitations.

1. The Absolute Caps - Section 415 Limitations

Section 415 of the Code was added by ERISA to be effective in 1976. The section imposes limitations on both defined contribution plans and defined benefit plans.

Defined Contribution Plans

With respect to defined contribution plans, Section 415(c) limits the “annual additions” to any participant’s account balance to the lesser of (a) a specified percentage of compensation or (b) a specified dollar amount. “Annual additions” includes (i) all employer contributions, including elective 401(k) contributions, (ii) employee after tax contributions, and (iii) forfeitures that are allocated to accounts. Major changes were made to this rule effective for “limitation years” (usually plan years) beginning in 2002, and therefore we will first discuss the 2001 rules, and then show what has changed.

In 2001, annual additions were limited to the lesser of (a) 25% of compensation or (b) \$35,000. For purposes of this rule, “compensation” was defined as W-2 compensation increased by 401(k) deferrals, cafeteria plan (Section 125) elective contributions, and qualified transportation (Section 132(f)) elective contributions.

Effective in 2002, annual additions were increased to the lesser of (a) 100% of compensation or (b) \$40,000. For years after 2002, the \$40,000 was adjusted for cost of living. For example, in 2016 and 2017, the limit is \$53,000. The same definition of compensation continues to be used.

If an employer has more than one defined contribution plan, the aggregate annual additions to a participant under all such plans cannot exceed the Section 415(c) cap.

Defined Benefit Plans

Section 415(b) applies a cap on the benefits available to any participant under a defined benefit plan. In this case, the limit is expressed as a cap on the annual benefit that can be paid as a straight life annuity at age 65. In 2001, the limit was the lesser of (i) 100% of final average compensation for the participant’s high 3 years, or (ii) \$140,000. For 2002, the dollar amount was raised to \$160,000, with adjustments for cost of living thereafter. For example, for 2016 and 2017 the limit is \$210,000.

In general, if a benefit payment commences at an earlier or later time than age 65, or if the benefit is paid in a form other than a straight life annuity, there is an actuarial adjustment to the dollar cap, but there are a number of exceptions to this general rule. First of all, if a qualified joint and survivor annuity is payable to a spouse, the joint portion of the annuity can be for the full dollar cap rather than a reduced amount. (For example, if the cap is an annuity of \$210,000 per year, a participant could choose a joint and survivor annuity paying \$210,000 per year to the participant for life, with a survivor benefit of \$210,000 per year for the spouse’s life, without violating the 415(b) cap.) This exception does not apply if the survivor is someone other than the spouse. Furthermore, beginning in 2002, a benefit payable at or after age 62 can be for the full dollar cap with no reduction. The cap for benefits payable prior to 62 is actuarially reduced from the capped amount that could have been payable at age 62.

If an employer has more than one defined benefit plan, they must be aggregated for purposes of the Section 415(b) cap.

The Combined Cap – Section 415(e)

For years prior to 2000, if a participant was covered by both a defined contribution plan and a defined benefit plan, a more complex “combined” cap was imposed in addition to the 415(b) and 415(c) caps described in the preceding paragraphs. The thrust of the combined cap was to not allow a participant to take full advantage of both the defined benefit and the defined contribution maximums. This combined test, set forth in Section 415(e), was repealed effective for years commencing in 2000. Thus, it is now possible for a participant to max out on both a defined contribution plan and a defined benefit plan.

Consequences of Violating Section 415

The consequence of failing to satisfy the Section 415 rules for any participant is plan disqualification. Fortunately, the correction procedures promulgated by the IRS, EPCRS discussed in Chapter 2, allow for the correction of Section 415 violations.

Although plan disqualification for failure to comply with Section 415 is rare, the case of Buzzetta Construction Corp. v. Comm., 92 T.C. No. 35 (1989), in which a plan was disqualified for Section 415 violations, illustrates that this potential problem should not be overlooked. The moral is that Section 415 testing must be performed as faithfully as the 410(b) non-discrimination tests and the ADP/ACP tests applicable to 401(k) programs.

2. Section 404 Limitations

Section 404 of the Code governs deductibility by the employer of contributions to a qualified plan. With respect to defined benefit plans, there is no specific dollar limitation. Section 412 of the Code, governing funding, provides a methodology for actuaries to determine the minimum and maximum funding amounts permitted for a given limitation year. Section 404 provides that any contribution up to this maximum amount is automatically deductible by the employer.

With respect to defined contribution plans, this situation was much more complicated through 2001, but was considerably simplified effective in 2002.

For years through 2001, a defined contribution plan subject to the funding rules of Section 412 (primarily money purchase pension plans) had no separate deductibility limit. Any amount that was allowed as an annual addition under Section 415 was deductible by the employer. With respect to profit sharing plans, however, including employee pre-tax deferrals under 401(k) programs, a plan had to meet the requirements of

Section 404(a)(3) of the Code, namely that in order to be deductible on the employer's tax return, the total employer contributions could not be in excess of "15% of the compensation otherwise paid or accrued during the taxable year to the beneficiaries." This test was performed by aggregating contributions made to all participants, including elective pre-tax contributions under a 401(k) program, and measuring them against the compensation of all of those who were eligible to participate in the plan to make sure they did not exceed 15%. Prior to 2002, compensation, for purposes of this test, was all taxable compensation paid or accrued by the employer. Treas. Reg. § 1.404-9(b). In other words, elective 401(k) contributions, which were not included in the taxable income of the participant, were not included as compensation.

The pre-2002 rule had a number of significant consequences. First of all, a straight profit sharing plan, one which made an employer contribution to every participant, could not provide for contributions in excess of 15% of compensation. Thus, if an employer wanted to take full advantage of the 25% limit of Section 415(c), it had to use a money purchase plan, or a combination of a profit sharing plan for up to 15% and a money purchase plan for the balance.

If an employer had a profit sharing plan with a 401(k) program, the situation was more complex. A plan could be designed to provide for the possibility of an individual participant making an elective contribution which, when combined with matching contributions and discretionary employer contributions, would make full use of the 25% cap under 415(c) as long as in the aggregate such contributions were not more than 15%. The variation in elective contribution levels from participant to participant (including many who contributed 0%) usually would keep Section 404 from being a problem, but to make sure that Section 404 deductibility would not be a problem, most employers would cap the elective contributions of non-highly compensated employees, usually at a number not exceeding 10 or 12%. It should be noted that prior to 2002, an elective contribution had two impacts: it raised the amount of contributions and at the same time lowered the electing participant's compensation that was used for the 404 test.

The failure to meet the requirements of Section 404 had, and continues to have, serious consequences, since nondeductible employer contributions are subject to the 10% excise tax imposed by Section 4972 of the Code. There is no carryover of unused deductions from one year to the next, so this test needs to be passed every year.

In 2002, the entire approach to limiting deductions for contributions to defined contribution plans was changed. First of all, there is now a single rule that applies to all defined contribution plans, including profit sharing plans, 401(k) programs and money purchase

pension plans. The rule is that an employer cannot deduct more than 25% of the aggregate compensation of eligible participants. In determining the 25% figure, there are a number of new rules. First of all, compensation was changed to be W-2 compensation plus elective deferrals under Sections 401(k), 125 and 132(f). In addition, the contributions that are measured against this grossed up compensation do not include elective deferrals under a 401(k) program. Therefore, it is only non-elective employer contributions and matching contributions that are tested for this 25% limit.

The upshot of the 2002 rules is that almost no currently designed defined contribution plan will have problems with the 404 deductibility limit. Another consequence of the changes in Section 404 is that it will never be necessary to adopt a money purchase pension plan solely for the purpose of maximizing contributions. A profit sharing plan can fully accommodate all contributions that are permitted to be made pursuant to Section 415. Therefore, many commentators predicted that the 2002 change to Section 404 would result in the death of the money purchase plan over the next several years.

3. Section 402(g) Cap

A third absolute cap, set forth in Section 402(g) of the Code, applies only to elective deferrals, which we will learn about in the chapter on cash or deferred arrangements under Section 401(k). It is important to distinguish between the Section 415(c) caps for annual additions to defined contribution plans, \$53,000 as of 2015, and the cap on that portion of annual additions which consist of elective deferrals, \$18,000 as of 2017. Taken together, these caps require that if a participant is to receive an annual addition of \$53,000 in 2017, only \$18,000 can be elective deferrals, and the remaining \$35,000 must be something else: e.g. employer contributions, matching contributions, or reallocated forfeitures.

4. Section 414(v) Catch-up Contributions

Commencing in 2002, a new Section 414(v) was added to the Code to permit “catch-up contributions.” Catch-up contributions are elective deferrals that individuals who will be over 50 by the end of the taxable year may make to a 401(k), 403(b) or 457 program in addition to the maximum deferrals that would otherwise be permitted by law or by plan design. This extraordinary provision allows extra contributions; no proof is needed that the participant is “catching up.” It permits contributions that will not be subject to the plan limits of Sections 415 or 404, not be subject to individual limits of Section 402(s), and not be subject to any non-discrimination tests. Catch-up contributions will be allowed in an amount up to \$1,000 in 2002, \$2,000 in 2003, \$3,000 in

2004, \$4,000 in 2005 and \$5,000 in 2006. Thereafter the amount gets adjusted for cost of living (it is \$6,000 as of 2017).

Chapter V

A POET'S GUIDE TO THE VESTING RULES FOR QUALIFIED RETIREMENT PLANS

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Any qualified retirement plan can be described fairly comprehensively by answering four questions:

- 1. Which employees get to be participants?*
- 2. What kind of benefits or contributions does a participant get?*
- 3. Under what circumstances can a benefit be taken away from the participant?*
- 4. When and how will the benefit be distributed?*

In previous articles we have explored the first two questions. In this article we will examine the circumstances in which a benefit can be taken away from a participant.

1. Applicable Pension Jargon

As always, there is special jargon to describe the rules in this area. When a benefit can be taken away from a participant if employment ceases, it is described as forfeitable. When the period of forfeitability comes to an end, the benefit is described as non-forfeitable. Another way of saying the same thing is to use the term “vested”. When a participant is vested, the benefit is non-forfeitable. Before vesting occurs, the participant’s benefit is not vested, and therefore can be forfeited.

2. Some History

Prior to the passage of ERISA in 1974, there was no uniform rule with respect to when a benefit in a qualified plan had to become vested. Local IRS offices often required some kind of a vesting schedule in order to conclude that the plan was not discriminatory, but the rules they invoked were not uniform. It was quite common for a qualified plan to require an employee to work for 15 or more years before having a vested right to a pension benefit. Both the non-uniformity, and the possibility that an employee could work for many years and then be terminated just before vesting might occur, were perceived by Congress to be major shortcomings that needed to be addressed by ERISA.

ERISA’s solution was to impose minimum vesting requirements on all qualified plans. The original 1974 rules required that vesting occur either all at once after 10 years of service (10-year cliff vesting) or in gradations starting at 25% after 5 years and rising gradually to 100% after

15 years. These rules seem quite stingy by today's standards, and in fact as early as the late 1970's the IRS was dissatisfied with these rules and was using its regulatory authority to impose a stricter schedule (starting at 40% after 4 years and going to 100% after 11 years) on all new plans.

In 1984 Congress revised the minimum vesting requirements, promulgating the rules that are now in effect, namely 5-year cliff vesting or a graduated schedule that starts at 20% after 3 years and increases, at 20% per year, to 100% after 7 years. These rules will be described in more detail below.

3. The Concept of Vesting

The vesting of a participant means that if that participant terminates employment, he or she will still have the right to the benefits he or she has earned or accrued. In addition, if the participant does not terminate, there can be no condition subsequent, not even poor performance or disloyalty, that can result in the forfeiture of the accrued benefit.

Because the promise of a pension is made by an employer to an employee performing services for it, it is logical to view the promise as contractual in nature, and therefore enforceable, as opposed to being a gift which is not made for consideration and therefore can be revoked. In fact, a pension should be viewed in the same way as current compensation; the mere fact that it is deferred should not detract from the fact that it is bargained for remuneration for services rendered.

Any compensation can be promised on a conditional basis: for example, "employees who are still employed on December 31 will receive a year-end bonus". Thus the idea that pension compensation can be subject to a set vesting schedule is not inconsistent with such compensation being bargained for remuneration. This should be contrasted with an employer's retention of the right, in its sole discretion, to take away or reduce the benefit after the required years of service are completed. Such a condition, subject to no standard or rule, would be inconsistent with the compensation being bargained for consideration, and the law correctly prohibits that kind of condition.

4. The Basic Rules

The current vesting requirements for qualified plans are set forth in Section 411 of the Code. Compliance with Section 411 is one of the requirements for qualified plans set forth in Section 401(a). See Code § 401(a)(7). Until 2007, Section 411(a) generally required a plan to have a vesting schedule which met one of the following two minimums set out in Section 411(a)(2):

Full vesting must occur upon the completion of 5 years of service (5-year cliff vesting)

- or -

20% vesting must occur after 3 years of service with an additional 20% upon the completion of each additional year of service until full vesting is achieved after 7 years of service.

While a plan did not have to adopt either one of these schedules, it had to adopt a schedule which was at least as generous to employees in all circumstances as one of the schedules.

Commencing in 2007, the above rule only applies to defined benefit plans. All employer contributions to defined contribution plans will have to satisfy one of two stricter schedules, either 3 year cliff vesting, or graded vesting which provides for 20% vesting after 2 years of service and an additional 20% for each year until full vesting is achieved after 6 years. This rule already applied to matching contributions, but now applies to all employer contributions to defined contribution plans. In addition, commencing in 2008, a unique stricter vesting schedule, 3 year cliff vesting with no graded vesting alternative, applies to cash balance plans, leaving only traditional defined benefit plans subject to the “general rule.”

The schedule adopted by the plan constitutes the only requirement for vesting. The plan cannot impose other requirements or conditions to vesting. Notably, a “bad boy clause” – that is, a provision that forfeiture can occur if the employee engaged in bad conduct, such as anti-competitive behavior or theft – is not permitted if it would result in a forfeiture not permitted by one of the above schedules.

5. What is a Year of Service? – The Service Counting Rules

One of the least glamorous but still very important sets of rules in ERISA and the Code concerns how years of service get counted. There are 2 basic methods. One involves counting hours of service, which are generally hours for which someone gets paid, usually for the performance of services. Under this method, if someone works 1,000 hours during an annual measurement period, he or she is credited with a year of service for vesting. The annual measurement period can either be a uniform period for all participants, such as a calendar year or fiscal year, or it can be each individual employee’s anniversary year.

Some employers may have trouble counting hours, and in such cases they can use approved equivalencies such as 10 hours for a day, 45 hours for a week, and 190 hours for a month.

The other method of counting service for vesting is called elapsed time. Under the elapsed time alternative, the plan simply focuses on the hire date and the termination date, and gives credit for all of the service in between. The number of hours worked is irrelevant under the elapsed time scheme. Breaks of less than a year are disregarded. The elapsed time alternative is simpler in many ways, and is utilized by many big companies. Its drawback, which will be of concern to some employers, is that it can dole out service credit more liberally – to part timers and seasonal employees who might never work 1,000 hours during a year.

There are many more rules regarding the counting of years of service. One group of rules focuses on breaks in service, that is, periods of time when an employee is not working. This could be an unpaid leave of absence, or it could be a termination of employment followed by reemployment. The general rule is that old service cannot be wiped out. In other words, a returning employee must get vesting credit for the service completed before the break. There are, however, a number of exceptions which permit pre-break service to be wiped out for at least some purposes. These rules are technical and complex, and beyond the scope of this article.

Again, the service counting rules are not glamorous, yet they are very important. Stepping back from the technicalities of these rules, we can see an obvious underlying theme. When Congress passed ERISA, it was concerned about the ways in which employers could prevent certain employees from ever accruing a vested benefit. The more liberal vesting schedules promulgated by ERISA certainly helped eliminate this perceived injustice, but that alone would not have been enough if employers could count service in a way that kept part timers from ever vesting and forced rehires to always start from scratch in amassing the needed years of service. By choosing 1,000 hours as the measurement of a year, for example, Congress made a determination that certain people who work less than full time should vest in a pension benefit. By prohibiting the elimination of prior service in many cases, Congress made a determination to protect transient workers. Congress' desire to protect the part time and transient workforce is apparent in these complicated service-counting rules.

6. Other Issues Which Impact Vesting

Not surprisingly, there are a number of additional rules that must be explored in order to have a clear picture of the vesting system imposed

by the Code. This section is a tour of some important miscellaneous rules.

Employee Contributions – Immediate Vesting

Not surprisingly, the Code requires that a participant be immediately vested in any contributions made by the participant. Code § 411(a)(1). This includes after-tax employee contributions, and pre-tax elective deferrals pursuant to Section 401(k). A terminating participant will never be denied the return of these contributions and the earnings associated with them.

Matching Contributions – Special Vesting Rules

Matching contributions made by an employer with respect to 401(k) or other elective contributions became subject to a faster vesting schedule than other employer contributions in 2002. Effective that year, matching contributions, unlike other employer contributions to defined contribution plans, had to either satisfy 3 year cliff vesting, or graded vesting which provides for 20% vesting after 2 years of service and an additional 20% for each year until full vesting is achieved after 6 years. It was not clear why Congress chose to make this distinction between matching contributions, and other employer contributions. In any event, as noted above, effective in 2007 all employer contributions to a defined contribution plan have become subject to the faster vesting schedule requirements.

Normal Retirement

It is important to remember that many of the rules we deal with in qualified plans were crafted at a time when defined benefit plans were the norm. The concept of a “normal retirement date”, the date on which an employee was predicted to terminate employment with a full pension, is a concept which makes sense for defined benefit plans, but has virtually no relevance for defined contribution plans. Nevertheless, every plan is required to designate a normal retirement date, and the vesting rules require that an employee be fully vested on that date. See Code § 411(a), introductory sentence. Age 65, the maximum age permitted under the Code, is a typical normal retirement date. Many defined benefit plans take advantage of an option provided in the statute and define normal retirement date as the later of age 65 or the date on which an employee completes 5 years of service. Code § 411(a)(8). This alternative essentially adds a 5-year cliff-vesting requirement to normal retirement age. An earlier normal retirement age may be chosen, and is most commonly seen in defined benefit plans for small entities, where the focus is on providing the full defined benefit pension to the owners at an earlier age.

Plan Termination

Section 411(d)(3) of the Code requires that a plan immediately vest all participants upon a plan termination or, in the case of a profit sharing plan, a complete discontinuance of contributions. The idea here seems to be that if the program terminates, it is fairer for the funds in the trust representing unvested benefits to be allocated to the participants rather than to revert to the employer. If the plan terminates but the employer continues in business, this may be something of a bonanza for the employees, especially if a different type of plan is substituted. Nevertheless, this is the rule.

Partial Plan Terminations

Some of the most interesting litigation in the vesting area has taken place regarding a parallel rule that exists alongside the plan termination rule discussed above. This rule provides that upon the partial termination of a plan, all affected participants will become fully vested. Code § 411(d)(3). A common example would be a company with 2 facilities, each with 100 employees, and a single profit sharing plan covering the entire company. If one of the facilities is closed, eliminating 50% of the employees, the law would require that with respect to the eliminated group, the plan be treated as terminated, resulting in immediate vesting. For those employees in the facility that does not close, there is no plan termination and no immediate vesting. This is known as a “vertical” partial termination, because a vertical line is drawn through the plan, with account balances on one side automatically vesting and those on the other side not vesting.

So far, the rule sounds simple. The problem is that until 2007 there was no clear guidance with respect to how large a reduction in the workforce is required to constitute a partial plan termination. Obviously, a reduction of 10% or less should not be a partial termination, since fluctuations of this magnitude occur all the time. Just as obviously, a 50% or more reduction should always be a partial termination. It was the cases in between that have caused all the uncertainty, and as a result, litigation. To make matters more complicated, if there were a number of small reductions over a period of several years, it was not clear to what extent they must be aggregated. Finally, there was disagreement as to whether, in computing the percentage reduction, one had to include those in the group being reduced who were vested in any event, and therefore did not need the partial termination rule to vest.

Fortunately, in 2007, the Treasury issued Revenue Ruling 2007-43, which adopted a rebuttable presumption that a partial termination occurs where there is a reduction of at least 20%, included both vested and non vested employees in the count, and used a measurement period

that was generally one year but could be longer if there were a series of related reductions..

As if the partial termination rules were not complicated enough, there is another concept called a “horizontal” partial plan termination. This is where individual participants are not lopped off, but instead plan benefits are lopped off. Theoretically, in such a situation there would be automatic vesting of that portion of the benefit that was being discontinued prospectively. This is a hard rule to conceptualize, and an even harder one to put into application. Therefore, horizontal terminations have been written about in the literature but rarely applied or enforced.

7. Events That Do Not Result in Vesting

Involuntary Termination

In crafting the vesting rules, Congress decided not to make a distinction between voluntary and involuntary termination. Therefore, if 2 individuals terminate employment with 4 years of service and are covered by a qualified plan which requires 5 year cliff vesting, neither of them will have a vested pension benefit. The fact that one voluntarily chose to terminate employment because of another job opportunity, while another was laid off because business was not good, makes no difference. This neutrality can certainly be defended, but it is worth noting that when executive compensation agreements are negotiated, it is very common to have a vesting rule that distinguishes between voluntary and involuntary terminations, providing immediate vesting for involuntary terminations, but not for voluntary terminations. Perhaps this distinction, while workable with a small group of executives, would be difficult to administer among the rank and file. Perhaps also executives have greater bargaining power.

It should be noted that Title I of ERISA has a provision, Section 510, that prevents an employer from discharging an employee “for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan....” This provision, which has no Code counterpart, could be of use to the individual who was laid off just before attaining vested status, although the case law that has developed requires a demonstration that the intent to deny the pension was primary, and generally allows broad employer discretion.

Death

When Congress carved out the special tax advantaged rules for qualified plans, its goal was to provide for retirement benefits, not death benefits. Therefore, perhaps it should not be surprising that death is not

an event that requires automatic vesting, and that with one important exception described below, it is even permissible for death to be an event that results in divesting. Code § 411(a)(3)(A). My own experience is that most people are surprised to learn that a plan is not legally required to provide a death benefit.

In practice, divestiture on death is not all that common. While a defined contribution plan could provide that employer derived plan benefits are forfeitable upon death, I have never seen a defined contribution plan that did not provide for a death benefit equal to the entire vested account balance upon death. In fact, most defined contribution plans provide that death results in automatic 100% vesting even for previously unvested participants.

With defined benefit plans it is more common to see a plan that does not provide an across the board death benefit to either vested or non-vested participants. The theory is that the intent of the plan is to provide a retirement benefit for living retirees and that in service death, a fairly rare event, is generally covered by some form of group life insurance.

A major exception to the rules described above applies to married participants. Both defined contribution and defined benefit plans must in some way provide a spousal death benefit. The rules vary depending upon the type of plan. These rules, set forth in Sections 401(a)(11) and 417 of the Code, will be discussed in more detail in another article.

8. Minimum Accrual

The vesting rules provide for the nonforfeitability of an accrued benefit after a maximum of five years of service. That rule could easily be frustrated if a plan was designed to provide that a participant does not begin to accrue more than a miniscule benefit until after five years of service. Congress, therefore, thought it necessary to impose a specific rule against “backloading” the accrued benefit, that is providing a much larger accrued benefit in the later years of participation than in the early years of participation.

These anti-backloading rules, which apply only to defined benefit plans, are set forth in Section 411(b) of the Code. They are very complex, but in essence, require a fairly smooth and uniform rate of accrual of benefit for an employee whose salary remains constant over his or her career.

These rules should be contrasted with the anti-discrimination rules with respect to accrual of benefits that are set forth in Section 401(a)(4) and the regulations issued thereunder. Those rules require that the pension formula not discriminate in favor of highly compensated participants. The anti-backloading rules of Section 411(b) prohibit

backloading whether or not it would discriminate in favor of highly compensated participants.

It is interesting to note that the anti-backloading rules do not apply to defined contribution plans. Therefore, one could devise a profit sharing plan that provided a 5% of compensation contribution during the first five years of participation, and a 10% contribution thereafter. Such a formula would not violate Section 411(b), which only requires that a defined contribution plan not reduce or cease the rate of allocations because of the attainment of any age. Code § 411(b)(2). In fact, it is not unheard of for a 401(k) plan to provide a higher level of match for participants who have completed more years of service. It may well be, however, that such a backloaded formula would violate the nondiscrimination rules of Section 401(a)(4), because participants with more years of service are more likely to be in the highly compensated category.

9. Top Heavy Rules

The top-heavy rules have been described in a previous chapter. Keep in mind in our exploration of the vesting rules that one consequence of top-heaviness is that a traditional defined benefit plan must provide a more liberal vesting schedule: either 3-year cliff vesting, graded vested that starts at 20% after two years and goes to 100% after six years, or something even more favorable than these two alternatives.

10. Section 411(d)(6): Vesting in Rights and Features

We have now spent a considerable amount of time learning that vesting means deriving a nonforfeitable right in an accrued benefit. But what exactly is an accrued benefit? Many students would guess that an accrued benefit is an amount of money which will be payable at one or more points in time. For a defined benefit plan, it is usually expressed as an annual or monthly amount. For a defined contribution plan, it is usually expressed as an account balance, which in effect is a lump sum dollar amount.

The Code, however, takes the position that the accrued benefit is something more than just the amount of benefit. Section 411(d)(6), in providing that a plan may not be amended to reduce an accrued benefit, specifically provides that the elimination or reduction of an early retirement benefit or retirement subsidy, or the elimination of an optional form of benefit, will constitute an impermissible cutback of an accrued benefit. In other words, the trappings that go along with the amount – for example, the right to get it early, or the right to get it in a lump sum – are part of the accrued benefit that cannot be taken away. Regulations issued under Section 411(d)(6) have gone even further, creating the term

“411(d)(6) protected benefit,” and indicating in excruciating detail what comes within that term and what does not. Treas. Reg. § 1.411(d)-3 and § 1.411(d)-4.

Using those regulations, and the case law that has developed, as our guide, we learn that 411(d)(6) protected benefits, which generally cannot be taken away, include any early retirement subsidy, any cost of living feature, any form of benefit, and any timing rule with respect to receipt of a benefit. Things that are not Section 411(d)(6) protected benefits, and therefore can be taken away, include the availability of plan loans, the right to make after-tax employee contributions or elective deferrals, the right to direct investments, and the right to a particular form of investment.

The inability to reduce or amend Section 411(d)(6) protected benefits has proved to be incredibly frustrating for pension practitioners. While this rule undoubtedly protects some rights which are very important to participants, it has traditionally also protected features that are of little or no importance. For example, if a plan was drafted in 1985 to permit distribution in a lump sum, installment or annuity, and in practice no participant ever chooses any form other than a lump sum, the 411(d)(6) rules made it impermissible to eliminate the installment or annuity as a form of benefit. In the case of an annuity, this was a particular concern because, as we will learn in a future article, the presence of an annuity as an optional form of benefit activates a whole layer of complexity known as the qualified joint and survivor annuity rules.

Fortunately, in 2000, the Treasury, after considerable study of the issue, gave some much-needed relief to defined contribution plans by amending the regulations under Section 411(d)(6). These amendments provide that as long as an immediate lump sum distribution is offered, a plan can be amended to eliminate all other forms of benefit without violating Section 411(d)(6). This relief will primarily aid defined contribution plans other than money purchase plans, since money purchase plans, like defined benefit plans, must provide an annuity to satisfy the qualified joint and survivor annuity rules. Most defined contribution plans, however, will be able to eliminate all forms of benefit other than a lump sum, and probably will eventually do so. The rationale, which I certainly agree with, is that the universal existence of a rollover right ensures that any participant can take a lump sum and roll it into an IRA that will permit any form of benefit the participant desires, whether annuity or installment. This new rule will permit defined contribution plans to get out of the distribution business, permitting only an all or nothing decision by the participant to take the entire account balance or leave it for another day.

11. Conclusion

Early vesting was one of the key goals of ERISA. The vesting rules of ERISA ensured that individuals could be certain of keeping their accrued benefits even if they did not work for one company for an entire career. No longer would a participant have to live in mortal fear of being involuntarily terminated short of retirement after a long period of service. The rules have not only offered protection for the amount of benefit, but have been expanded to broadly define the accrued benefit that is to be protected. These rules are universally complied with and produce very little litigation or controversy. They constitute one of the triumphs of ERISA.

Chapter VI

A POET'S GUIDE TO CASH OR DEFERRED ARRANGEMENTS - THE 401(k)ING OF THE QUALIFIED PLAN

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1. Introduction

In 1977, the term “401(k)” did not exist. Now, the term is so well known that TV commentators and editorial writers can use it without any need for further explanation. The phenomenal popularity of this type of defined contribution program justifies devoting an entire chapter to it.

The essence of a 401(k) is an election by each participant to defer a percentage of compensation, up to a statutory cap (\$18,000 in 2016 and 2017). It is often accompanied, but does not have to be, by an employer matching contribution, which can be made as the deferrals are made or at the end of a plan year. It also can be appended to a defined contribution plan that makes other employer contributions, though often the elective deferral and match stand alone.

There are a number of restrictions that apply to 401(k) programs. Vesting must be immediate on deferrals, though not on the match. In service distributions are quite restricted, with complicated hardship rules, but loans can be made available.

By far the biggest hurdle for 401(k)s is the need to pass a special non-discrimination test, known as the “ADP/ACP test”, which measures actual participation levels of highly compensated vs. non-highly compensated. Equal opportunity is not sufficient. There are several ways of dealing with this hurdle. First, the employer can wait until the end of the year, apply the test, and then, if the plan fails, either make refunds to highly or make further contributions to non-highly. Second, the employer can impose ongoing restrictions on highly to make sure the test will not fail. Finally, and most important, the plan can be designed to meet a safe harbor, in which case the test does not need to be run at all. All of these choices are covered in detail in this article.

Finally, 401(k)s are often associated with participant self-directed investments. The fact of the matter is that any defined contribution plan can be self-directed, and there is nothing unique about 401(k)s in this regard. Self-directed investments will be covered in a separate chapter.

The remainder of this chapter examines in much greater detail the broad concepts described above.

2. What is a Cash or Deferred Arrangement?

Section 401(k) of the Code permits defined contribution plans to offer cash or deferred arrangements. A cash or deferred arrangement is a feature in a qualified plan that allows each participant to make an individual decision whether to take the employer's contribution in cash or to defer receipt and have it paid into the plan. Regulations have made it clear that a participant's salary can be the basis for a deferral election; virtually all 401(k)s give participants the election to defer salary or take it in cash.

Under a qualified cash or deferred arrangement, if the contribution is paid into the qualified plan, income taxation is deferred. The contribution is considered an employer contribution. While "qualified cash or deferred arrangement" is the proper term, almost everyone refers to this type of an arrangement as a "401(k)", and I will generally use the term "401(k)" for the remainder of the chapter.

For many years, practitioners wondered whether a 401(k) is the only program under which an employee may be given discretion whether or not to participate in a plan. For example, under the law prior to 1974, self-employed were specifically authorized to elect whether to be covered by a profit sharing plan or just take all compensation in cash. IRS regulations now confirm that the 401(k) is the exclusive method for elective deferrals, with one limited exception. The exception is a one-time irrevocable election, upon first becoming eligible to participate, not to participate, or to participate only at a certain level.

3. A Brief History of 401(k)s

The concept of the 401(k) predates the enactment of Section 401(k) as part of the Revenue Act of 1978. Prior to the passage of ERISA, profit sharing plans which allowed a choice of cash or deferral were approved by the IRS. See Rev. Rul. 56-497, 63-180, & 68-89. In 1972, the IRS issued proposed regulations that applied a "constructive receipt" analysis to cash or deferred arrangements that operated on a salary reduction basis (i.e. the deferrals would be taxed immediately because they could have been received immediately), and cast doubt on the viability of such arrangements.

Congress reacted negatively to the IRS' new position, including as part of ERISA a Section 2006, which set a moratorium until 1977 on the issuance of regulations that would affect existing plans. The moratorium was further extended to 1980. Before the moratorium expired, Congress acted again, in the Revenue Act of 1978, adding Section 401(k) to the Internal Revenue Code, thereby setting forth the

requirements for a cash or deferred arrangement that would not result in constructive receipt problems.

At first, 401(k)s were not very popular. On November 10, 1981, the Treasury issued proposed regulations explaining how 401(k)s could operate. The regulations confirmed that salary reduction was a permissible way of making contributions, and set forth a number of methods for passing the complicated numerical test for non-discrimination imposed by the statute. By giving employees a detailed yet workable rulebook, the Treasury opened the floodgates, and the 401(k) torrent commenced.

Congress must have been surprised, and a bit alarmed, by the enormous popularity of 401(k) programs. In the Tax Reform Act of 1986, they toughened the numerical test for non-discrimination in 401(k) contributions, and added an absolute dollar cap on elective deferrals (Section 402(g)). Nothing could be done to slow the torrent, however, and by the turn of the century almost every company that chose to offer a qualified plan to employees included a 401(k) program.

4. Statutory Requirements for 401(k)s

A 401(k) must be part of a qualified profit sharing plan. Accordingly, it must comply with the many rules generally applicable to qualified profit sharing plans.

In addition, 401(k)s have some extra statutory requirements. There is a special eligibility rule, a special vesting rule, and most significantly, a special cap and a special non-discrimination rule. All of these special rules will be discussed in this article, with most of the focus on the special non-discrimination rule. Another special statutory rule, namely some very strict restrictions on in-service distributions, is considered in a separate article on distributions.

5. Special Eligibility Requirement

The maximum waiting period for eligibility in a 401(k) is one (1) year. This is in contrast to the general maximum of 2 years for other qualified plans that provide for immediate vesting. The special eligibility rule applies only to the 401(k) feature, and not to other features of the profit sharing plan, such as qualified matching contributions (see below) and qualified non-elective contributions (see below).

It should be noted that employees with less than 1 year can be included in a 401(k) without having to include their data in the special non-discrimination test (the ADP/ACP test) as long as that group of

employees constitutes a non-discriminatory group under Code Section 410(b) (which it almost always will). This eliminates what might otherwise be the primary reason for having a 1-year waiting period for eligibility in a 401(k): keeping out brand new non-highly compensated people who are less likely to defer, and who therefore will hurt the non-discrimination test.

A 401(k) must satisfy the coverage requirement of Section 410(b). The 401(k) feature is treated independently of the rest of the profit sharing plan for this purpose. (This is called “mandatory disaggregation.”) For purposes of the 410(b) test, however, all employees eligible to make elective deferrals in a plan will be treated as participating in that plan, even if they elect a zero percent (0%) deferral.

6. Special Vesting Requirement

The participant's right to an accrued benefit derived from 401(k) elective deferrals must be nonforfeitable. This same requirement applies also to “qualified matching contributions” (see below) and “qualified non-elective contributions” (see below), but not generally to matching contributions and non-elective contributions.

7. Special Nondiscrimination Rule – the Actual Deferral Percentage (ADP) Test

Certainly the greatest amount of attention in the administration of plans with 401(k)s must be devoted to the actual deferral percentage (ADP) test. This special non-discrimination test is substituted for the more general non-discrimination test of Code Section 401(a)(4). The test is an objective, mechanical one which measures the level of participation of each participant, and then compares the level of participation of highly compensated employees as a group with the level of participation of non-highly compensated employees as a group.

Performing the ADP test

The ADP test involves a comparison of the average deferral percentages (ADP) of the highly compensated and non-highly compensated groups. For each group, the average is obtained by adding the individual deferral percentages of each member of the group and then dividing the sum by a number equal to the total members in the group (including those whose deferral percentage is zero (0)). One of two comparative tests must be satisfied:

Test 1: 125% of ADP for Non-Highly Group greater than or equal to ADP for Highly Group.

Test 2: Must satisfy both Part (i) and Part (ii).

Part (i): 200% of ADP for Non-Highly Group greater than or equal to ADP for Highly Group;

Part (ii): ADP for Non-Highly Group plus 2% greater than or equal to ADP for Highly Group

Although there are 2 distinct tests, once the actual deferral percentage for the non-highly compensated group is known, the more favorable test can be determined by consulting the following chart:

More favorable test	If Non-highly ADP is	Then Highly ADP cannot exceed
Test 2: 200% part governs	1%	2%
	2%	4%
Test 2: +2% part governs	3%	5%
	4%	6%
	5%	7%
	6%	8%
	7%	9%
	8%	10%
Test 1: 125% test	9%	11.25%
	10%	12.50%

The test must be performed for each plan year. The consequences of failing the test are sufficiently unpleasant (see below) that it makes sense to perform a sample test quarterly to see if problems are developing. (A plan may be designed in a way which eliminates or reduces this need. See below.) If problems are developing, then the employer can limit the level of contributions for highly compensated employees as long as the plan permits.

Let us look at Example 1, which focuses on 2017, the first year of a 401(k) established by an existing company.

Example 1**2017 Average Deferral Percentage Test**

Eligible Employee	2016 Actual Gross Compensation	5% Owner	Deferral Group	2017 Compensation for ADP Test	Amount	Deferral Ratio
1	300,000	100%	Highly	270,000*	16,200	6
2	125,000	---	Highly	125,000	12,500	10
3	120,001	---	Highly	120,000	6,000	5
4	54,000	---	Non-highly	56,000	5,600	10
5	53,000	---	Non-highly	55,000	5,500	10
6	48,000	---	Non-highly	50,000	3,000	6
7	19,000	---	Non-highly	20,000	2,000	10
8	17,000	---	Non-highly	18,000	1,080	6
9	15,000	---	Non-highly	16,000	640	4
10	14,000	---	Non-highly	15,000	0	0
11	9,500	---	Non-highly	10,000	500	5
12	9,500	---	Non-highly	10,000	600	6
13	9,500	---	Non-highly	10,000	500	5
14	7,500	---	Non-highly	8,000	0	0
15	7,500	---	Non-highly	8,000	400	5

***Section 401(a)(17) cap**

There are 5 other employees who are not yet eligible to participate in the 401(k) plan, because they have less than 1 year of service.

Determine Average Deferral Percentage

Highly: $6.00 + 10 + 5 = 21.00 \div 3 = 7.00$

Non-highly: $10 + 10 + 6 + 10 + 6 + 4 + 0 + 5 + 6 + 5 + 0 + 5 = 67 \div 12 = 5.58$

Test 1: $5.58 \times 125\% = 6.975$. 7.00 is greater than 6.975.
Test 1 is failed.

Test 2: a) $5.58 + 2 = 7.58$. 7.00 is less than 7.58.
b) $5.58 \times 200\% = 11.16$. 7.00 is less than 11.16.

Test 2 is passed.

More details on the ADP Test

Congress amended Section 401(k), effective in 1997, to give employers greater certainty that they can pass the ADP test. (The same rules apply to the 401(m) test for matching and after-tax employee contributions (the "ACP test") discussed later, and this discussion applies to both tests.) This method (which is the standard one, but can be elected out of) is to use the prior plan year's ADP for the non-highly group, and the current year's ADP for the highly group. The benefit to the employer is that it can know with certainty what the non-highly group number will be for the current year (for example 4.2%), and therefore know in advance what the maximum percentage will be for highly compensated individuals (working off of 4.2% for non-highly, this would be 6.2%).

The employer can then use this information in a variety of ways. For example, a conservative employer might announce to all highly compensated participants that the maximum percentage that can be elected for the year will be capped (at 6.2%, in this example).

A less conservative employer might allow highly compensated participants to make a higher initial election, but then will test the aggregate of such elections immediately to see whether the predetermined maximum percentage (6.2% in our example) will be achieved. If not, presumably a cap can be announced, and with some modest monitoring, the employer will be virtually assured of passing the ADP test.

In most cases the "prior year" method is implemented by mechanically using the prior year ADP number of the non-highly group. It is irrelevant that some of the people whose deferrals were the source of that number may have become highly compensated, or terminated, in the current year. The only exceptions are where there is a significant change in the covered group from one year to another (like a merger of one plan into another), or where the plan switches from a "current year" to "prior year" method (see discussion below). In both of these cases, special rules will apply.

For a 401(k) plan's initial year, the "prior year" rule discussed above is modified: such a plan can use 3% as a deemed percentage for the non-highly, or can elect to use the current year's data. In many cases, the current year's data will be more favorable than 3%, but 3% serves as a base.

Using the prior year's ADP for the non-highly group is not mandatory. Employers can elect instead to continue testing the old-fashioned way, that is by using current plan year data for both non-highly's and highly's. This is an important option, since not every

employer will be satisfied with the participation level of the non-highly group for the prior year. If, for example, an employer is embarking on an educational program which it hopes will boost elective participation by the non-highly group, it may find it unappealing to rely on the prior year's data, and instead will take its chances with the current year's data. Each employer will have to make a decision based on its own facts and circumstances.

The statute contemplates that a plan pick either the "prior year" or "current year" method. An employer must designate either the prior year or current year method. The chosen method ultimately must be reflected in the plan document. In general, a plan can change from "prior" to "current" in any year, but once "current" is chosen, it must be used for a minimum of 5 years.

8. Special Cap on Elective Deferrals – the 402(g) Cap

Once 401(k)s became popular in the early 1980's, it became clear that an employee could easily redesign its defined contribution plan so that the entire contribution, up to the Section 415 limit, could be made by salary reduction. This apparently was perceived to be bad public policy, and accordingly, as part of the Tax Reform Act of 1986, Congress added a new Section 402(g) to the Internal Revenue Code. Section 402(g) focuses on individuals, not plans, imposing on each individual a dollar cap on the aggregate annual amount of elective deferrals under Sections 401(k), 403(b) and 408(k) (salary reduction SEPs). The limit, originally \$7,000, gradually rose with the cost of living, and was \$10,500 for 2000 and 2001. In 2002, Congress acted again, raising the limit to \$11,000 in 2002, with additional increases of \$1,000 each year thereafter until 2006, when it reached \$15,000. Thereafter, it is further increased for cost of living (\$18,000 in 2017.)

This cap is based on the employee's tax year (usually the calendar year). The employee is limited to the cap even if he or she is covered by 401(k)s with more than one employer. Each spouse gets his or her own cap, however, even if they file a joint return. The plan must have a provision limiting elective contributions in the plan to the cap amount for the year, and that limit must be policed by the plan administrator. See Code § 401(a)(30). In all other respects, however, the burden to police the cap is on the employee. As we shall see, the penalties for violation of this cap are imposed on the employee, and not the employer or the plan.

The 402(g) cap is more likely to frustrate a highly compensated employee than a non-highly compensated employee. Interestingly, this cap makes it easier for plans to pass the ADP test, by preventing many highly compensated from choosing a high percentage of deferral.

(Remember, the ADP measures percentages, and not amounts, of deferral.) To understand this interrelationship, one must also keep in mind the Section 401(a)(17) limit of compensation that can be considered in a plan or a test. Take, for example, a participant whose actual compensation is \$300,000. In 2017, the highest permitted deferral percentage will be 6.67% (\$18,000 divided by the Section 401(a)(17) limit of compensation, \$270,000).

9. Catch-up Elective Deferrals

Commencing in 2002, a new Section 414(v) was added to the Code to permit “catch-up contributions”. Catch-up contributions are elective deferrals that individuals who will be over 50 by the end of the taxable year may make to a 401(k), 403(b) or 457 program in addition to the maximum deferrals that would otherwise be permitted by law (402(g) and 415) or plan design (some plans have their own caps.) Catch-up contributions were allowed in an amount up to \$1,000 in 2002, \$2,000 in 2003, \$3,000 in 2004, \$4,000 in 2005 and \$5,000 in 2006. Thereafter the amount is adjusted for cost of living (\$6,000 in 2017).

Catch-up contributions can only be made by an over 50 individual who would otherwise be cut off by either a statutory limit (the 402(g) limit) or a plan imposed limit, such as a maximum deferral percentage. In addition, if there is a failure of the ADP test, and elective deferrals must be returned to highly compensated, the catch-up contribution provisions may permit such contributions not to be returned to those highly compensated who will be over 50 by the end of the plan year.

Catch-up contributions are not subject to any of the normal dollar limitations (Section 402(g) or Section 415(c)), and are not included in any non-discrimination tests, such as the ADP/ACP test.

The term “catch-up contribution” is something of a misnomer. Participants over age 50 can make catch-up contributions regardless of whether or not they have previously failed to take advantage of the maximum contribution amount each year. Therefore, they are not based on need or other special circumstances, and probably will primarily benefit wealthy individuals who are already hitting the caps that would otherwise apply.

10. Using Matching Contributions or Non-Elective Contributions to Pass the ADP Test

Many employers feel, or have learned from experience, that a stand-alone 401(k) will not attract sufficient interest from rank and file employees to pass the ADP test. To increase the chances of passing the

test, several methods have been authorized by the Code, regulations and other official guidance.

Qualified non-elective contributions

Non-elective contributions, made to all participants or only to non-highly compensated participants, may be used to make passing the ADP test more likely. Qualified non-elective contributions (QNCs) will be added to the numerator of each participant's individual deferral ratio, as if they were elective deferrals. In order for non-elective contributions to be "qualified non-elective contributions", they must be immediately vested and meet the special distribution restrictions applicable to elective contributions (discussed in the chapter on qualified plan distributions).

Matching contributions

One way to encourage participants to make elective contributions is to offer an employer match, for example 50 cents of employer contribution for each dollar electively deferred, up to a deferral of 4% of compensation. Matching contributions can be accounted for in a separate subaccount, can have a deferred vesting schedule applied to them (either cliff of up to 3 years or graduated over 6 years), and can be subject to the liberal distribution rules applicable to other profit sharing contributions. (Warning: If they are to be "qualified matching contributions", see below, there is less flexibility.) There is no specific limit to the amount or percentage of the match, except that a higher match may result in problems meeting the 401(m) ACP test - see below.

It should be noted here that matching contributions are the only incentive that can be used to encourage elective contributions. For example, limiting participation in a medical/dental program, or in a defined benefit program, or even limiting the opportunity to make voluntary after-tax contributions, to those who make a certain minimum elective deferral (for example 4%) would disqualify the 401(k).

If an employer wants to treat the matching contributions as additional elective deferrals, and use them in the numerator of each participant's ratio for the ADP test, they must be qualified matching contributions (QMACs). To be qualified matching contributions, the matching contributions will have to be immediately vested and meet the special distribution restrictions applicable to elective contributions (discussed in the chapter on qualified plan distributions). Qualified matching contributions give an employer more flexibility in performing the ADP test to achieve a successful result.

11. Using Automatic Contributions to Pass the ADP Test

Another “tool” to help pass the ADP test is to automatically enroll employees at a set percentage, subject to an employee’s absolute right to override that enrollment by taking specific action. This tool began as a footnote, and now appears to be at the center of government policy, so it is worthy of some extended consideration.

In 2000, in response to a growing use of the technique, the IRS specifically ruled that automatic enrollment will not result in a deferral being deemed other than elective. Rev. Rul. 2000-8. The theory behind this technique is that many rank and file employees will ignore an elective right, whether it is an election in or an election out. Left on their own, they will not elect to defer. If there is automatic enrollment at 3% on the other hand, they will not override the enrollment, and the result will be a materially higher aggregate non-highly compensated deferral percentage.

While the initial motivation for this technique may have been selfish, i.e. to pass the ADP test, it was viewed enthusiastically by policy makers as a way to “encourage” broader participation in a voluntary retirement program at a time when other traditional retirement programs were withering. This enthusiasm has now resulted in the technique, now christened an “eligible automatic contribution arrangement”, becoming statutorily recognized by the Pension Protection Act of 2006 (it is defined in new Code §414(w)). The PPA endorses automatic contribution arrangements by giving them a special preemption from any state law constraints, setting out notice procedures that will automatically comply with law, and giving a “safety valve” by permitting plans, to allow automatically enrolled participants to pull out their deferrals within 90 days of enrollment without any penalty. In addition, for an eligible automatic contribution arrangement, the employer has 6 months to correct an ADP test failure if an eligible automatic contribution arrangement is used - see Code §4979(f).

The PPA permits a “safe harbor” for automatic contribution arrangements, known as a qualified automatic contribution arrangements, or QACA – more on that below.

It is clear from the endorsement of automatic contribution arrangements by Congress in the PPA that it believes that the technique of automatically enrolling participants and leaving it to them to elect out is viewed as a benign form of forced savings.

12. Safe harbors for those who wish to avoid ADP testing.

Many employers have been frustrated by the complexity of the ADP test, and their inability to control, or even predict, the results. In 1997, Congress added two safe harbors to Section 401(k), granting employers an automatic “pass” if they added a particular non-elective contribution provision or matching provision to the plan. A third safe harbor was added in 2008. The safe harbors are briefly described below:

- a. The first safe harbor is an across the board non-elective contribution equal to 3% of compensation. This contribution would have to be made to everyone who participates in the plan, including those who do not complete 1,000 hours, those who are not employed on the last day of the year and those who make no elective deferral. In addition, the non-elective contribution would have to be immediately vested in all cases.
- b. The second safe harbor is a matching contribution of 100% of the first 3% of elective deferrals, and 50% of the next 2% of the elective deferrals. Here again, the contribution must be made on behalf of all participants, including those who did not complete 1,000 hours, and those who are not employed on the last day of the year. The matching contribution must be 100% vested. This safe harbor design gives employers some flexibility to come up with an alternate matching program, as long as the matching percentage does not go up as the deferral percentage gets higher, and as long as the net effect, at any percentage level, is at least as favorable as the standard version described above.
- c. A third safe harbor was added in 2008, dubbed a “qualified automatic contribution arrangement” or QACA. This arrangement requires the plan to automatically enroll participants at a minimum of a 3% deferral rate for the period ending at the end of the first full plan year, and then increasing the deferral rate by 1% each plan year until a minimum of 6% (and a maximum of 10%) is reached. Coupled with this is a requirement to either make (i) matching contributions of 100% of the first 1 percent and 50% of the next 5% of compensation, or (ii) non elective contributions of 3% on behalf of each non highly compensated participant. This is a kind of variation on the two earlier safe harbors. Notably, it does not require immediate vesting, instead allowing 2 year cliff vesting.

The original two existing safe harbor 401(k) plans elicited some interest, and are especially useful for top-heavy plans which have to make minimum contributions in any event (see below.) Most large employers did not go in this direction, however, because the size and immediate vesting of the required match is seen as undesirable, and because they had gotten used to the ADP test and presumably found it manageable. But the “qualified automatic contribution arrangement” safe harbor has become quite popular, and shows signs of even becoming a standard for large plans. Perhaps Congress has found the right incentive to create some uniformity among large employer qualified plans.

12. Section 401(m) and the ACP Test

Prior to the Tax Reform Act of 1986 there was some confusion as to how a matching feature was tested for Section 401(a)(4) non-discrimination purposes. At one time, IRS had used a rule that as long as the match only applied to elective contributions of 6% or less, it would be deemed non-discriminatory, regardless of who took advantage of it. IRS subsequently announced that that rule could not be relied on and employers were left with no guidance at all.

As part of the Tax Reform Act of 1986, Congress added new Code Section 401(m), and its entirely new "actual contribution percentage" (ACP) test. Under this test, the combination of voluntary after-tax contributions and matching contributions are tested in exactly the same way as elective contributions are tested in the ADP test.

This test is independent of Section 401(k), and applies even if an employer has no 401(k) program. The ACP test focuses on voluntary employee after-tax contributions, and on matching contributions, whether the match is based on elective deferrals under a 401(k) or on voluntary employee after-tax contributions. (Plans that matched after-tax contributions were known as "thrift plans".) The passage of Section 401(m) effectively eliminated stand-alone voluntary after-tax contribution features for many employers, since highly compensated employees were much more likely to avail themselves of this benefit, and therefore the ACP test could not be passed.

Note: If the only matching contributions are QMACs, and they are used to perform the ADP test, then no ACP test need be performed. (See Section 14 below, which contains a discussion of flexibility when performing ADP and ACP tests.)

13. Using a Safe Harbor to avoid ACP Test

The safe harbors that have been promulgated to avoid the ADP test, see Section 11 above, will also avoid the ACP test if 3 conditions are met: (i) the matching formula is designed so that the matching percentage does not increase as the deferral percentage increases; (ii) the match in the plan is not made with respect to elective deferrals in excess of 6%; and (iii) the matching contribution for a highly is not greater than the matching contribution for a non-highly at any rate of deferral or contribution.

14. Issues When Both ADP Test and ACP Test Apply

Where both an ADP and an ACP test must be performed, the regulations allow a great deal of theoretical flexibility as to which dollars are to be included in which test. For example:

- i. Qualified non-elective contributions (QNCs) can be used either in the ADP or the ACP test.
- ii. Qualified matching contributions (QMACs) can be used either in the ADP test or the ACP test.
- iii. Elective deferrals can be used in the ACP test rather than the ADP test.

In all three cases, the contributions theoretically can be split between the two tests, as long as it is done in a non-discriminatory manner. Unfortunately, the rules for taking advantage of this complexity can boggle the mind of even the most eager pension expert.

Most pension servicers do not make full use of this flexibility, but may use it in certain ways. For example, if a plan has only elective contributions and QMACs, the servicer can compare running only an ADP test with running two tests to see which produces a more favorable result. Similarly, if there are also QNCs, they can be held in abeyance for application to the ADP test or ACP test, whichever one needs help to pass.

15. The "Top-Heavy" Trap

As we discussed in a previous chapter, a "top-heavy" defined contribution plan must provide a minimum contribution to all non-key employees. This minimum contribution is the lesser of (1) three percent (3%) of compensation or (2) the highest percentage of compensation that any key employee receives as a contribution during the plan year. The

way in which 401(k) plans are treated with respect to these requirements is not what the reader might guess.

- a. First of all, elective contributions by key employees are treated as contributions in determining the top-heavy minimum contribution for non-key employees. However, elective contributions for non-key employees are disregarded in determining whether the minimum contribution is met.
- b. Matching contributions for non-key employees are counted in determining whether a non-key employee's minimum contributions have been met.
- c. Finally, non-elective, non-match contributions to non-key employees are counted in determining whether a non-key employee's minimum contribution has been met.

The effect of these rules, taken together, is to virtually eliminate the possibility of a top-heavy plan having an "elective deferral only" 401(k) plan, or probably even an "elective deferral and match only" 401(k) plan, other than a safe harbor plan. As a practical matter, if the key employees were deferring anything close to the \$17,500 cap, a non-elective contribution of three percent (3%) to all non-key employees will have to be made. But Congress chose to give an automatic pass on top heavy testing if one of the match safe harbor arrangements is adopted. In other words, a safe harbor match arrangement (traditional or QACA) will pass muster with the top heavy rules even though non key employees who choose not to defer will get no employer contribution.

16. Excess Contributions, Excess Deferrals, and Excess Aggregate Contributions

In the course of administering a plan with a 401(k) feature, it is possible that the contribution limitations resulting from the application of Section 401(k), 402(g) and/or 401(m) will be violated. An elective contribution by a highly compensated employee in excess of the ADP test limit is called an "excess contribution." An elective contribution that exceeds the 402(g) cap is called an "excess deferral." An employer matching contribution or a voluntary after-tax employee contribution by or in favor of a highly compensated employee in excess of the ACP test limit is called an "excess aggregate contribution."

Excess contributions under §401(k)

If the ADP test is not satisfied, the employer has the option (if the plan permits) of contributing additional QMACs or QNCs after the end of

the plan year. The standard QMAC and QNC language found in most plans allocates them to all participants and, in the case of QNCs, in proportion to compensation. Over the years, however, practitioners have learned that there is more “bang for the buck” in targeting QMACs or QNCs to the lowest paid non-highly compensated. For example, a “correcting” QNC of \$1,000 to a non-highly earning \$20,000 will increase the deferral percentages by 5%, while a “correcting” QNC of \$1,000 to a non-highly earning \$60,000 will only increase the deferral percentage by 1.67%. Since each non-highly’s percentage is given the same weight in the formula, more is added to the NHC average by targeting the lowest paid. This technique is sometimes referred to as a “bottoms up” QMAC or QNC. The IRS ultimately determined that the unchecked use of bottoms up QMACs and QNCs could result in abuse, and in regulations issued in 2005 cut back on, but did not eliminate, a plan’s ability to award post year end QMACs and QNCs to only the lowest paid portion of non-highly.

If the employer is not willing to make additional contributions in the form of QNCs, the excess contributions must be distributed. The amount of excess contributions that needs to be returned is determined by reducing, point by point, the deferral percentages of the highly compensated employees with the highest percentages, until the test is passed. The amounts deferred in excess of the corrected percentages are excess contributions. Since the compensation and election figures will generally be known shortly after the end of the plan year, the determination of excess contributions should be made as soon as possible thereafter. Distribution of the excess contributions must be made before the close of the following plan year to avoid disqualification of the 401(k) program (or at least resort to one of the permitted correction procedures under EPCRS (See Chapter 2.)). Code § 401(k)(8). As a practical matter, however, the employer will want to correct the excess contributions not later than 2 1/2 months after the end of the plan year in order to avoid imposition of an excise tax on the employer in an amount equal to 10% of the excess contributions. Code § 4979(f). It should be noted that if an eligible automatic contribution arrangement is used, then the correction must be made not later than 6 months after the end of the plan year. Code § 4979(f).

The distribution must be accompanied by the earnings thereon. The current regulations require that earnings be calculated not only for the plan year in which the contribution was made, but also for the “gap period” in the year it is returned. Effective in 2008, earnings for the gap period will no longer have to be calculated.

The actual distribution of funds formerly was made from accounts of those whose deferral percentages were reduced, in an amount equal to

the reduced percentage of their compensation. Beginning in 1997 (in other words for corrections beginning in early 1998), the method was changed so that the dollar amounts are now taken first from the account of the highly compensated employees who made the largest deferral by amount, not percentage. The following example will illustrate this complicated rule.

<i>Highly Compensated</i>	<i>Compensation</i>	<i>Percent Deferral</i>	<i>Deferred Amount</i>
A	100,000	8%	8,000
B	150,000	6%	9,000

Assume excess contribution was \$1000, all attributable to lowering A's deferral percentage to 7%.

- Prior Law Correction Method

\$1,000 (plus earnings) gets returned to A, the employee with the highest percentage, reducing A's account accordingly.

- Current Law Correction Method

\$1,000 (plus earnings) gets returned to B, the employee with the largest dollar deferral, reducing B's account accordingly.

The amounts distributed within the 2½ month period will be includable in the employee's gross income in the prior year (unless it is under \$100, in which case it is taxable in the year of distribution). This can cause lots of practical administrative problems, since some participants may have already received their W-2s and filed their tax returns. For this reason, some employees choose to distribute the excess contributions after the 2½ month deadline and pay the 10% excise tax. Under the rules, correcting distributions which are made after the deadline are taxed in the year of distribution. Fortunately, this rule was changed effective in 2008; distributions of excess contributions made for that year and thereafter will be taxed in the year received even if they are made in the first 2 ½ months of the next plan year.

A third method of correcting excess contributions set forth in the regulations is to have excess contributions recharacterized as after-tax employee contributions, rather than distributed. This will not be a satisfactory method in most cases, however, because it will simply cause the employer to fail the ACP test under Section 401(m).

Excess deferrals under §402(g)

If the employee exceeds the §402(g) cap for the calendar year, it is his or her responsibility to correct the situation by asking the employer to make a correcting distribution. The reason for placing the burden on the employee is that very often, this error is caused by participation in more than one employer's program, so that neither employer will be aware of the problem. The correcting distribution, with income attributable thereto, must be made by April 15 of the following calendar year. If it is, the amount received is taxable in the prior calendar year (in other words, there is no salary reduction for the contribution), but no penalties are imposed. The failure to make the correcting distribution by April 15 has no adverse effect on the plan or the employer, unless an amount in excess of the limit is deferred into that employer's plan. (See Code § 401(a)(30), discussed above, which makes exceeding the 402(g) cap in an employer's program or programs a qualification defect.) For the employee, however, the consequences are disastrous. The excess over the cap will not be reduced from the employee's W-2 compensation for the prior calendar year, and will be taxed currently. When it is eventually distributed, however, it will again be subject to income taxation. Finally, it may be subject to early distribution penalties. In other words, the employee may have to pay a double income tax, plus penalties, on such amount.

Excess aggregate contributions under §401(m)

If the ACP test is not passed, the determination of excess aggregate contributions is determined in a manner similar to the method used to determine excess contributions under the ADP test, discussed above. The timing of the correction is also similar to that relating to the correction of excess contributions. It must be made by the end of the next plan year to avoid disqualification (or resort to an EPCRS correction), but within 2 1/2 months of the end of the plan year to avoid imposition of a 10% excise tax on the employer under §4979.

The method of distributing excess aggregate contributions is analogous to that used for excess contributions, but there are important differences. If there are only employee after-tax contributions, these will be returned with income attributable to them. (The after-tax contributions, of course, will not be subject to income taxation; only the income will be taxable.) If there are only matching contributions, the excess aggregate contributions, along with earnings, typically will be forfeited rather than distributed if not vested, and can be either forfeited or distributed if vested. (This is one of the rare situations where vested amounts can still be forfeited.) If there are both matching contributions and after-tax employee contributions, the employer has some flexibility,

but the matching contributions left in the plan must not be discriminatory under §401(a)(4).

Interrelationship

The regulations provide guidance as to the coordination of the correction of excess contributions, excess deferrals, and excess aggregate contributions. The rules are very complicated.

17. Special Distribution Rules

Elective deferrals, QMACs, QNCs and the earnings attributable to them are subject to special restrictions on distributions. These restrictions are discussed in a separate article on qualified plan distributions.

18. Roth 401(k) Feature

Effective for 2006 and years thereafter, plan sponsors may add a Roth 401(k) feature to their 401(k) programs. A discussion of Roth 401(k) features is contained in Chapter VIII, on IRAs and Roth IRAs.

19. Conclusion

The 401(k) has revolutionized the qualified plan industry. For many younger companies, a 401(k) plan is the only plan that will be adopted. To a large extent, the responsibility for building a retirement benefit has been shifted back to the employee, although a lot of incentives may be offered to help motivate the employee's conduct. These plans are extremely popular. Sometimes employees will value a 401(k) plan more than a defined benefit plan, even though the defined benefit plan is far more expensive from the employer's perspective. A cynic might observe that the 401(k) has been a public relations coup for employers: "less" has been made to seem like "more". But it may be that the freedom and empowerment which these plans offer employees are appropriately valued, and that this shift is good for society. The long-range impact of the change may not be fully understood until several decades from now.

Chapter VII

A POET'S GUIDE TO QUALIFIED PLAN DISTRIBUTIONS: TAXATION, PROHIBITIONS, AND MANDATES

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1. Introduction

A critical feature of a qualified plan is that it defers the taxation of compensation for a substantial period of time. To understand the deferral feature, we must examine two highly regulated aspects of it: when distributions can or must occur; and how distributions will be taxed when they do occur. Unfortunately, the answers to these questions, while very important, have been far from simple. Fortunately, there is a discernible trend toward simplification. This article will attempt to answer the critical questions regarding distributions, as well as give a brief history of how we got to where we are, and identify the policy goals that are reflected in the decisions that have been made.

2. Taxation of Distributions

General Rule

As a general rule, distributions from a qualified plan are taxed as ordinary income in the year in which they are received. Code §§ 402(a) & 72. This rule is so disarmingly simple that it seems to be out of place in the byzantine world of qualified plans. As might be expected, there are a number of exceptions, but fortunately many of these exceptions have been eliminated in recent years, and remain only as grandfathered provisions which are applicable to a shrinking number of people.

Exception 1: Where Employee After-tax Contributions Have Been Made

When a plan contains not only employer contributions (which includes elective deferrals) but also employee after-tax contributions, a special rule is needed to avoid taxing the employee again when distribution is made. This protection is accomplished by a series of rules contained in Section 72 of the Code. Where payment is to be made in the form of an annuity, the effect of the rule is to apportion each payment into a taxable and a non-taxable component. This apportionment, once calculated, will apply until all of the employee's contributions have been paid back.

With respect to payment other than in the form of an annuity, the rule is a little bit more complicated.

- a. First of all, if, as most individual account plans do, the plan accounts separately for the after-tax contribution portion and the pre-tax portion (employer contributions and 401(k) contributions), the after-tax portion of the account may be, and typically will be, accounted for separately from the pre-tax portion of the account.
- b. With respect to the pre-tax portion, every dollar of distribution will be taxable as ordinary income.
- c. With respect to the after-tax portion, a part of each distribution will be deemed to be the return of after-tax contributions and not be taxable, while the balance will be ordinary taxable income. The proportion of non-taxable to taxable dollars will be determined each year, and will be a fraction, the numerator of which is the remaining after-tax contributions in the account, and the denominator of which is the total account balance.
- d. The upshot is that it is not possible to simply withdraw after-tax contributions and have no taxable income. Instead, any withdrawal will be deemed to have a portion which is after-tax contributions and a portion which is taxable income (typically earnings on the after-tax contributions).

Exception 2: Capital Gains Treatment

Before 1981, a portion of a lump sum distribution could be treated as capital gains, and be subject to lower tax rates. This rule remains only on a grandfathered basis, namely to certain participants whose participation in a plan goes back to years before 1974.

Exception 3: Five-Year Averaging and Ten-Year Averaging

Another special tax rule regarding distributions, which only remains as a grandfathered rule, allows certain lump sum distributions to be taxed using a method that could be very favorable to many middle to higher income taxpayers. The original form of this method was called "ten-year averaging." The name was somewhat misleading, since the entire amount of the tax was paid in the year of distribution. The calculation of the tax, however, used a method that first divided the taxable amount by 10, then applied the tax rate that a single taxpayer would use if the distribution was his or her only income, and then multiplied the resulting tax by 10. Without going into all the gory details, the net effect would be to tax a distribution exclusively at the lower band of rates in a progressive tax schedule. Since tax schedules changed over the years (notably, becoming much less progressive after 1986, and then gradually more progressive, but only bit by bit, since then), the magnitude of the savings varied considerably over the years that ten year averaging was in effect.

In 1986, ten-year averaging was eliminated except for those who had reached age 50 by January 1, 1986, and five-year averaging was substituted for everyone else. Five year averaging worked the same way as ten year averaging, except that by dividing by 5 and multiplying by 5, it produced a less dramatic tax saving. Five-year averaging has been eliminated for taxable years after 1999.

Currently, the simple bottom line is that unless we are dealing with someone who is age 69 or over, the likelihood is that 10 year averaging and 5 year averaging will not be available, and that every taxable distribution will be taxed at the marginal tax rate for ordinary income.

Exception 4: Rollovers

The most important exception to the general rule that all plan distributions are taxed as ordinary income in the year of distribution is the rule that permits tax-free rollover of many distributions to an IRA or another qualified plan. Code § 402(c). This very major exception is best examined once we have reviewed the entire plan distribution matrix of rules.

Exception 5: Employer Securities

There is a special tax rule for plans which permit the distribution of employer securities (for example, a 401(k) plan that permits a participant to direct that certain assets be used to purchase employer common stock). Code § 402(e)(4). The rule is that the immediate taxation of ordinary income will be in an amount equal to the original cost of the shares (the "basis") rather than the current fair market value. Then, upon the subsequent sale of the securities, the difference between the basis and the sale price will be taxed as capital gain. This method can only be used if the shares, or proceeds thereof, are not rolled over to an IRA or another qualified plan.

3. Timing of Distributions

Overview

There is a complex, unwieldy, and rather uncoordinated set of rules relating to the timing of distributions from a qualified plan. Some are absolute prohibitions or mandates. Others are penalty taxes that are imposed if certain rules have been violated. It is a challenge to describe them in a coherent way, because they did not develop in one coherent process.

Nevertheless, a good way to start to understand these rules is to see them as a tug of war between the understandable goals of three

different parties: the government; the employer/plan sponsor; and the plan participant.

The government exhibits two seemingly contradictory views on the timing of plan distributions. Wearing its tax collector hat, the government wants to make sure that money is not deferred for an unduly long period. After all, the purpose of allowing qualified plans to exist is to enable people to plan for their retirement years, not to hoard money and pass it along to future generations. Wearing its policy hat, on the other hand, the government does not want an individual to be able to use up the deferred funds long before her or his retirement years. If the money is not used for retirement, then the government is simply offering a tax shelter without a policy purpose.

The government's conflicting goals are embodied in two broad sets of rules. The first consists of an absolute mandate that distributions must begin at age 70½ or retirement if later. The second is a 10% penalty tax imposed on distributions that are made "prematurely," as well as an absolute prohibition on all in-service distributions from a pension plan, and on all pre 59½ in-service distributions, except for hardship, from 401(k) plans.

The employer plan sponsor would ideally like to have complete control over when distributions are made. It could use this power to reward (for example, by allowing an immediate distribution in return for a voluntary termination on good terms), and punish (for example, forcing a valued employee who goes to work for a competitor to wait until age 65 to get a distribution). The government has not accommodated plan sponsors very much. Limitations on distributions are not permitted at all after termination of service at age 65, and although limitations after termination of service and prior to age 65 are permitted, they must be based on a uniform set of rules applicable to every employee, rather than employer discretion. Finally, the law prohibits mandatory distributions without participant consent (for example, to alleviate paperwork once somebody leaves) unless the amount of the distribution does not exceed \$5,000 (an involuntary *de minimus* cash out).

The plan participant would like the qualified plan to be like a bank account, permitting withdrawals at any time, but also allowing the participant to leave funds in the plan for an unlimited period. The government protects the participant from all except *de minimus* involuntary distributions prior to normal retirement (age 65), and from the withholding of distributions at the plan sponsor's discretion (see above), but otherwise significantly frustrates the participant's desires, by restricting early withdrawals, and by requiring minimum withdrawals at age 70½ or retirement if later.

Having viewed the broad perspective of how the competing interests of interested parties are balanced and resolved, we will go through a more detailed analysis of the rules regarding qualified plan withdrawals and distributions.

The Role of the Plan Document

Many of the rules regarding timing of distributions will be included in the plan documents. Some provisions will be restatements of mandatory legal provisions (for example, that distributions must begin at the later of age 70½ or termination of employment). But some provisions are permitted but not required (for example, whether to permit in-service withdrawals from a profit-sharing plan, or immediate distribution upon termination of employment prior to age 65). Although the employer can exercise discretion in deciding whether or not to include such provisions, Section 411(d)(6) of the Code and regulations issued thereunder require that distribution rules be applied to participants on an objective and non-discretionary basis. (For example, it is not permissible to state that immediate distribution will be made “in the employer’s discretion”.) Section 401(a)(4) of the Code and the regulations issued thereunder require that either the same rule must apply to all participants, or the distinctions must not discriminate in favor of highly compensated participants. (For example, it probably would not be discriminatory to provide for an optional immediate lump sum distribution if an account balance is between \$5,000 and \$25,000; such a rule would create an objective distinction that would not discriminate in favor of highly compensated. But it probably would not be discriminatory to provide a lump sum option only if the account balance was over \$100,000.)

Prohibition on Certain In-Service Withdrawals

The rules regarding in-service withdrawals are based on the historic and somewhat irrational distinction between pension plans and profit sharing plans. Pension plans (including defined benefit plans, cash balance plans and money purchase pension plans) cannot have in-service distributions at all prior to normal retirement age (usually 65). If they allow these distributions, they will be disqualified. Rev. Rul. 74-254.

An important exception to the rule prohibiting in service distributions from pension plans was added by the Pension Protection Act of 2006. Effective in 2007, in service distributions from pension plans after age 62 are permitted if the plan so provides. See Code § 401(a)(36).

Profit sharing plans other than 401(k) plans, on the other hand, may include provisions allowing in-service withdrawals as long as such withdrawals are made after a minimum period of deferral or are otherwise restricted by a hardship standard. This general principle has evolved into

a set of quite specific rules for in-service withdrawals from profit-sharing plans:

- a. Funds cannot be withdrawn until they have been in the plan for two full years, unless rule (b) below applies. Rev. Rul. 54-231.
- b. If an individual has been a participant for five years, any funds can be withdrawn while in service. Rev. Rul. 68-24.
- c. Funds can be withdrawn without meeting (a) or (b) two above if the withdrawal is on account of a hardship. Rev. Rul. 71-224.

There is an exception to the above rules for that portion of an account balance which is attributable to CODAs (401(k) arrangements). This exception is explained in detail below.

Special Distribution Rules for 401(k)s

Special restrictions are placed on the "amount attributable to employer contributions made pursuant to the employee's election." Internal Revenue Code § 401(k)(2)(B). These amounts may not be distributed until one of the following events:

- a. separation from employment, death or disability;
- b. termination of the plan without establishment of a successor plan;
- c. attainment of age 59 1/2; and
- d. in the case of elective deferrals under a 401(k), hardship of the employee.

The restriction, and the exceptions set forth in (a) through (c), apply to elective contributions, to qualified matching contributions (QMACs) and qualified non-elective contributions (QNCs), and to the earnings attributable to all three. The hardship exception, (d) above, applies only to elective contributions. QMACs and earnings, QNCs and earnings, and the earnings on elective contributions cannot be distributed due to hardship. (A special transition rule allows income on elective contributions earned through December 31, 1988, and QNCs and QMACs through December 31, 1988, to be distributable in the event of a hardship.)

A great deal of energy has been expended over the years with respect to two issues: what is a separation from service, and what is a hardship. Regulations and letter rulings have addressed both issues.

With respect to separations, the statutory phrase, until 2002, was “separation from service”, rather than “separation from employment.” The IRS caused a great deal of unhappiness by promulgating what has come to be known as the “same desk rule” to interpret “separation from service.” The same desk rule was an interpretation of this phrase to mean that a person cannot receive a distribution of 401(k) assets if she or he keeps working at the same job, although for a different employer. As an example, if a company “outsourced” its photocopying department, but all of the personnel were hired by the new company that is going to perform the service, and the affected personnel continued to work at the same tasks, then they were viewed as not having incurred a separation from service. Although they were not working for the same employer, and no longer participating in their original employer’s 401(k) plan, they could not get a distribution of their 401(k) assets. There was an exception where there was a sale of a division or a subsidiary, but no exception for the outsourcing situation described in this paragraph. Fortunately, the same desk rule was eliminated by Congress in its passage of EGTRRA, effective January 1, 2002.

In answer to the question “what is a hardship”, the government has promulgated a complex regulatory framework, with two safe harbors. There are two components to a hardship. There must be an "immediate and heavy financial need of the employee", and the funds must be "necessary to satisfy such financial need." According to the regulations, the determination of these elements must be made in accordance with "non-discriminatory and objective standards set forth in the plan," and reference is made to Section 411(d)(6). It is not totally clear how much subjective judgment can be exercised.

The existence of an "immediate and heavy financial need" is to be determined on the basis of all relevant facts and circumstances. Treas. Reg. § 1.401(k)-1(d)(2)(iii). Certain events are deemed to be immediate and heavy financial needs:

1. Medical expenses described in section 213(d) incurred by the employee, the employee's spouse, or any dependents of the employee (as defined in Section 152 of the Code);
2. Purchase (excluding mortgage payments) of a principal residence for the employee;
3. Payment of tuition for the next semester or quarter of post-secondary education for the employee, his or her spouse, children, or dependents; or

4. The need to prevent the eviction of the employee from his principal residence or foreclosure on the mortgage of the employee's principal residence.

The 401(k) regulations promulgated in 2005 added two additional safe harbor hardship events:

5. The need to repair a primary residence as a result of a casualty loss.
6. The costs of a funeral for a member of the participant's family.

The IRS has indicated that the permissible amount of a hardship distribution may be grossed up to include the taxes that must be withheld from the distribution.

Whether a distribution is necessary to satisfy this need is also a facts and circumstances test. As a general rule, a distribution will be treated as necessary if the employee represents that the need cannot be relieved:

1. Through reimbursement or compensation by insurance or otherwise.
2. By reasonable liquidation of the employee's estate, to the extent that this does not cause an immediate and heavy financial need. The spouse's assets, and the assets of children if reachable, will be included.
3. By cessation of elective contributions or employee contributions under the plan.
4. By other distributions or non-taxable loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms.

This obviously is a tough standard, and the employer must question whether reliance on an employee's affidavit that all conditions have been met will be reasonable, even though the regulations give protection to such reliance unless the employer has actual knowledge to the contrary.

Many employers will therefore feel more comfortable with the safe harbor definition of "necessary." The Code provides that a distribution was be deemed necessary if:

1. The distribution was not in excess of the amount of the immediate and heavy financial need of the employee.
2. The employee had obtained all distributions, other than hardship distributions, and all nontaxable loans currently available under all plans maintained by the employer.
3. The plan, and all other plans maintained by the employer, provided that the employee's elective contributions and employee contributions would be suspended for at least 6 months after receipt of the hardship distribution.

In effect, the difference between the general rule and the safe harbor is contained in items 2 and 3. In 3, a 6 month suspension is imposed before the participant resumes participation. For this price, the benefit is that, in 2, no focus will be made on assets outside the plan or the ability to obtain a commercial loan.

It should be noted that a hardship distribution, even if the requirements are met, is not a great bargain. The amount distributed will be fully taxable. In addition, the 10% excise tax on early distributions, discussed in the next section, generally will apply. Thus, in many cases, almost half of the distribution will be paid as tax and will not be available for a hardship.

For this reason, there is likely to be pressure on the employer to institute a loan program. Loan programs are discussed in Section 7 below.

10% Additional Tax on Certain Early Distributions

Section 72(t) of the Internal Revenue Code imposes a 10% tax on any taxable distribution that is made to a participant from a qualified plan before the participant reaches age 59½, unless one of a limited number of exceptions applies. The exceptional situations in which the 10% tax does not apply are as follows:

- a. A distribution to a beneficiary after the death of the participant;
- b. A distribution attributable to the participant becoming disabled;
- c. A distribution for deductible medical expenses;
- d. A distribution to an alternate payee under a Qualified Domestic Relations Order (“QDRO”);

- e. Distribution in a series of substantially equal periodic payments over the life or life expectancy of the participant or the participant and a designated beneficiary; or
- f. A distribution made after a separation from service which occurs after age 55.

Only the last two of these exceptions permit a healthy participant to begin receiving funds before age 59½ without paying a 10% penalty tax. The first of these exceptions (exception (e)) requires the participant to lock in an annuity type payment over a very substantial period of time, something that will not appeal to most participants who have any choice in the matter. (In other words, it is typically useful for defined benefit plans that require annuities, but not for most defined contribution plans.) The second exception ((f) above) really changes the age 59½ rule to an age 55 rule for those participants who terminate employment at or after age 55. This exception was included in the statute to accommodate many qualified plans which already provided, prior to the imposition of the 10% tax, for early retirement as early as age 55.

Apart from the above exceptions, "early" taxable distributions will be subject to an extra 10% tax. While a 10% tax might not seem prohibitive, when combined with the ordinary tax, which in some cases will be at a level from 28% to 39%, it produces a substantial diminution in the actual amount of after-tax money available to the participant. It has been a very effective tool in motivating participants to roll distributions over into an IRA or a qualified plan of a subsequent employer. A rolled over distribution, because it is not taxable, is not subject to the 10% tax.

IRAs are governed by the same 10% tax on early distributions that applies to qualified plans, except that the exception regarding participants who terminate employment after age 55 does not apply. In addition, effective in 1999, the law permits withdrawals from an IRA for higher education expenses for the IRA owner, the spouse or child, and for the acquisition costs of a "first-time" homebuyer, without the 10% additional tax.

The Period between Age 59½ and Age 70½

For terminated participants, the period between age 59½ and age 70½ is the time period which is virtually free of government regulations. There are no penalty taxes for early distribution, and no required distributions. From the government's perspective, in this period the plan can be seen as a bank account, from which the participant may choose to make no withdrawals or as many withdrawals as he or she deems appropriate. It should be kept in mind, however, that most plans will be

drafted to limit this kind of flexibility. Some plans may not even permit distribution to terminated participants until normal retirement age. More commonly, a plan will permit an election of an earlier distribution to a terminated participant over age 59½, but will require that it be an all or nothing election. (For example, an election of a lump sum, a locked in series of installments, or an annuity.) For this reason, many participants will find that the wisest strategy is to take a lump sum distribution from the qualified plan, if it is permitted, and roll it into an IRA, since an IRA, between age 59½ and 70½, will have the same lack of government regulations and typically will permit unlimited withdrawals upon demand during this period.

Required Minimum Distributions (RMDs) at Age 70½ or Upon Death

As an expression of the policy decision that qualified plan funds be used for retirement rather than to pass wealth to the next generation, the Internal Revenue Code requires that distributions generally must commence shortly after a participant reaches age 70½, and within a limited time after death. This rule is embodied in both a mandate imposed upon qualified plans, in Section 401(a)(9), so that they will be disqualified if they do not make these distributions, and in a 50% excise tax, in Section 4974, on any funds that are required to be distributed but are not so distributed.

The regulatory scheme that was developed by the Treasury was contained in proposed regulations under Sections 401(a)(9) and 408, promulgated in 1987 and never finalized. They constituted one of the most complex regulatory schemes in the entire pension system.

In 2002 the Treasury finalized sweeping modifications to the proposed regulations. Actually, these rules were issued in proposed form in 2001, and went into effect immediately. The final 2002 version made further changes, and substituted an updated life expectancy table. We will discuss only the final 2002 version of the regulations.

The new regulations, which apply to qualified plans and IRAs, have been issued under the banner of simplification. Certainly, they do away with some of the difficult choices that were laid at the feet of participants: under the prior rules, a participant had to choose a beneficiary at 70½, and had to decide whether to “recalculate” life expectancy for purposes of determining the required distributions. While the new regulations simplify matters, the even better news for owner/participants is that they do so by giving owner/participants a much, much better deal. Required minimum distributions are reduced considerably, allowing more dollars to continue to be sheltered in tax exempt vehicles. In addition, upon death, there will be the flexibility, in

many cases, to dramatically reduce the required distributions, allowing the sheltering of qualified plan and IRA assets for close to a century after an individual turns 70½.

Lifetime Distributions

Required distributions must begin by an individual's required beginning date – the April 1st following the year in which such individual turns 70½, or, if later, the year of retirement. For each year for which a distribution is required, the prior December 31st account balance is divided by a divisor which is the applicable remaining life expectancy. Because the earnings often exceed the RMDs in the early years, the plan account or IRA often continues to grow for a number of years. Eventually, the RMDs get large enough to deplete the balance.

Under the new regulations, lifetime RMDs for nearly every participant or IRA owner are based on a uniform life expectancy table. The table assumes that there is joint life expectancy, that the beneficiary is exactly 10 years younger than the participant, and that life expectancy is recalculated. The only exception to the use of the new uniform table is where the beneficiary is the participant's spouse and the spouse is more than ten years younger than the participant. In such a case, RMDs will be based on the actual joint life expectancy, recalculated, of the participant and spouse, allowing an even slower payout than the uniform table.

Example A illustrates sample lifetime minimum required distributions under the new rules.

Distributions After Death

The 2002 regulations made a number of simplifying changes in the rules for post-death distribution. Under the new regulations, upon the death of a participant, distributions will switch to a new payout schedule, depending upon the beneficiary.

- a. *Spouse beneficiary.* If the beneficiary is the spouse, the spouse's life expectancy is used thereafter, and that life expectancy is recalculated each year. Then, upon the spouse's death, the remainder beneficiary continues to take over the spouse's then remaining life expectancy, but no longer recalculated annually (in other words, reduced by one each year). **Example B** illustrates this payout method.

A spouse beneficiary can choose to delay distributions until a participant would have reached 70½, and then take distributions over life expectancy, recalculated. The spouse rule is even a little bit more complicated, since in many cases

the spouse can roll over the qualified plan distribution, or convert the IRA, to the spouse's own IRA, or the spouse's own qualified plan.

- b. *Non-spouse Beneficiary.* The new regulations use the beneficiary's remaining life expectancy determined in the year after the owner/participant's death, and reduced by one each year thereafter. RMDs must begin by December 31 of the year following the participant's death.
- c. *No Designated Beneficiary.* The above death distribution rules require that a designated beneficiary must be an individual. (There is an exception involving trusts, which is beyond the scope of this text.) Under the new rules, if death occurs before the RBD and there is no designated beneficiary as of December 31 of the year following death, the fallback rule, which is also available to designated beneficiaries, applies: the entire account must be distributed by December 31 of the year in which the 5th anniversary of death occurs. If death occurs after the RBD, RMDs continue based on the participant's remaining life expectancy reduced by one each year, regardless of whether or not the beneficiary is an individual.

The regulations provide that the beneficiary need not be chosen for the purposes of these rules until December 31st of the year following the owner/participant's death. This is a big change from the prior rules, which required that a beneficiary had to be locked in as of the participant/owner's date of death or required beginning date, whichever came first. Under the new rules, the participant/owner can retain flexibility by lining up a primary benefit and one or more contingent beneficiaries. For example, the spouse can be named by the participant/owner as primary beneficiary with, for example, the child as first contingent beneficiary and the grandchild as second contingent beneficiary. After the participant/owner's death, the relative merits of who gets the assets versus how long the shelter is continued can be assessed. If the spouse needs the assets, he or she will take as beneficiary. If not, the spouse can disclaim, as can the next generation, so that the individuals with the longest life expectancies can be beneficiaries.

Thus, if the participant/owner in **Example B** died at age 80, a decision could be made during the ensuing year whether the spouse, who was named as beneficiary, should take, in which case **Example B** would govern, or whether the spouse and possibly the child should disclaim in favor of the grandchild, in which case **Example C** would govern. This kind of decision can be made with greater confidence at the time of the owner/participant's death at age 80 than it could have been at age 71,

when the required beginning date occurred. IRAs can, of course, be broken into many pieces, so a large number of grandchildren and great grandchildren can be accommodated in this process.

This new flexibility will allow more participant/owners to permit the ultimate choice of younger beneficiaries, assuming that estate tax considerations will permit this kind of planning. The average owner/participant who reaches 70½ will survive to age 86 or beyond. At this age, in many cases the spouse will disclaim, and the shelter can continue for many years.

Additional Observations Regarding the Minimum Distribution Scheme

The regulations regarding minimum distributions from qualified plans, even after simplification, remain complex and defy adequate treatment in a short description. I close the discussion with a few additional observations that may avoid some possible confusion:

- i. These rules are easiest to describe in the context of defined contribution plans, where there is an account balance to be distributed.
- ii. The rules do not work nearly as well for defined benefit plans. Suffice it to say that traditional defined benefit plans (which generally provide for both life and death benefits in the form of an annuity that does not exceed a single or joint life expectancy, and provide an annuity benefit upon death) will automatically satisfy these rules.
- iii. IRAs are governed by a regulatory scheme of required distributions that closely tracks the scheme for defined contribution plans. Code § 408(a)(6). The difference is that while defined contribution plans will often limit the choices that a participant or a beneficiary will have, IRAs typically give participants and beneficiaries the full panoply of choices which the regulations permit.

4. Excess Distributions Tax From 1987 through 1996

Section 4980 was added to the Internal Revenue Code, effective 1987, to impose a tax on what was called "excess distributions" from qualified plans. Since the minimum distribution rules described above were already in place, this tax was addressed to another perceived problem, namely that certain individuals were simply receiving too much from a qualified plan when the minimum distribution was made. In other words, they had simply gotten too much of a good deal over the years in

which they took advantage of the tax deferrals offered by a qualified plan. The solution was to impose an additional 15% tax on distributions over a certain stated maximum, which generally was \$150,000 per year. (For a lump sum distribution, the maximum was \$750,000.00.)

Many people, including this author, thought that this additional tax made no sense. Since there were already caps on plan contributions and benefits (Section 415), and there were already restrictions on when plan distributions must be made (the minimum distribution rules), then what need could there be for a penalty relating to the size of distributions coming out of a plan? It would appear that the only thing being "punished" by this tax was the skill or luck that resulted in permissible contributions building up as a result of earnings so that, even with the minimum distribution rules, "impermissibly" large distributions would result. Fortunately, Congress may have ultimately agreed that the tax had no valid policy rationale since Section 4980 was first put on hiatus starting in 1997, with the expectation that it would return in the year 2000, and then was permanently repealed. It is now only a historical curiosity, but it serves as one more demonstration of Congress' willingness to add complexity upon complexity to the regulation of qualified plans.

5. Rollovers

A discussion of the treatment of qualified plan distributions would be incomplete without a discussion of rollovers. Portability of pensions from job to job has long been a goal of Congress. While that goal has never been completely reached, especially in the case of defined benefit plans, the tax-free rollover has been the greatest breakthrough in that direction. Rollovers are governed by Internal Revenue Code Sections 402(c) and 408(d)(3).

A rollover is a tax-free transfer from an eligible retirement plan to another eligible retirement plan. For tax reporting purposes, it is considered a distribution followed by a contribution, but typically the transfer is accomplished in one step (a "direct rollover") in order to avoid the imposition of a 20% withholding tax that would otherwise apply. Effective in 2002, the rollover rules were dramatically expanded to allow rollovers between any of the following eligible retirement plans: qualified plans; 403(b) annuities, governmental 457 plans; and individual IRAs.

Any "eligible rollover distribution" from a qualified plan may be rolled over. An eligible rollover distribution is any distribution to a participant (or spouse) that does not fall into one of three exceptions. The first exception is a series of payments over someone's life or life expectancy, or a series of payments made in installments lasting ten years

or more. The second exception is any distribution that is required under the minimum distribution rules of Section 401(a)(9) described above. A third exception is a hardship distribution. Other than these three exceptions, any qualified plan distribution may be rolled over.

The simple rule set out above gives no hint of the complicated history of this provision. As originally drafted, and until very recently, only certain plan distributions which met a complex series of rules could be rolled over, and if a mistake was made the consequences could be disastrous. By vastly simplifying these rules, great strides toward true portability have been made.

Since most of the distribution rules described in this article apply equally to IRAs and qualified plans, a rollover generally will not have any effect on the scheme set out by Congress for controlling the deferral and distribution of qualified plan assets. The 10% penalty will still apply until 59½, and at age 70½ distribution still must commence to a terminated employee.

As indicated above, a rollover may be accomplished in a two step procedure, the first step of which is a distribution to the participant, and the second of which is the recontribution to a qualified plan or IRA. If a rollover is accomplished in this manner, there is a 60 day limit from the time the distribution is received until the time it is rolled over. If the recontribution is delayed beyond 60 days, the amount will be taxable to the taxpayer and the recontribution generally will be impermissible. While the need for a 2-step rollover has been virtually eliminated with the advent of the "direct rollover" discussed above, there is still evidence that "60 day" mistakes are made from time to time with serious adverse tax consequences to the participant.

True portability would be best accomplished by a rollover from the participant's former employer's plan to the next employer's plan. While legally permissible, sometimes this is impracticable, either because the next employer's plan will not allow an immediate rollover or because there is a period of unemployment, or employment with an employer with no plan, in the interim. In such a case, a rollover to an IRA will have to be made. This can be followed by a subsequent rollover to a qualified plan. Prior to 2002, there were many restrictions and potential traps in the is two-step procedure, but with the advent of virtually unrestricted rollovers, this kind of consolidation of tax-deferred vehicles over time is likely to become more popular.

Effective after March 31, 2005, an involuntary *de minimis* cash out (one of \$5,000 or less) must be automatically rolled over directly into an IRA if it is in excess of \$1,000 unless the participant elects to receive it in cash. Until March 31, 2005, rollovers were elective only, and a *de*

minus cash out was paid in cash unless a rollover was elected. The pre-March 31, 2005 rule continues to apply to rollovers of \$1,000 or less.

6. Withholding

The federal income tax withholding rules imposed on qualified plan distributions are unnecessarily complicated. There is a different set of rules for qualified plan distributions and for IRA distributions, and then a different set of rules for qualified plan distributions that are eligible for rollover, and for those that are not eligible for rollover. The withholding rules are set forth in Internal Revenue Code Section 3405 and regulations thereunder.

Distributions from qualified plans which are eligible for rollover are subject to a flat 20% withholding tax. This is the treatment for most lump-sum distributions, and for partial distributions that are not installments or annuities. The 20% withholding tax is mandatory unless the distribution is rolled over directly to another qualified plan or an IRA, in which case the withholding tax is waived. This rule presents some logistical problems for a rollover that is accomplished in two steps. In step one, the distribution will be subject to a 20% withholding tax. In step two the entire distribution may still be rolled over, except that the taxpayer will now only have 80% of that distribution. If the taxpayer wishes to roll over 100% of the distribution, she or he will have to come up with the additional 20% out of her or his own funds. Most taxpayers avoid this inconvenience by accomplishing a direct rollover.

A different withholding scheme applies with respect to distributions that are not eligible for rollover, namely installment and annuity distributions, hardship distributions, and minimum required distributions. (See above sections.) With respect to these distributions, withholding may be waived by the taxpayer altogether, and often is waived. If it is not waived, it is generally applied at either 10% or the rates which would apply if the distributions were wages, depending on the type of distribution.

Distributions from IRAs, whether they are in lump sums, installments, or otherwise, are subject to withholding only if withholding is not waived. There is no mandatory withholding. This is a peculiar rule, since it permits a taxpayer to avoid mandatory 20% withholding by first rolling a distribution into an IRA and then immediately withdrawing it from the IRA and waiving withholding.

7. Loans

While loans are not distributions at all, they are correctly perceived by plan participants as an alternative way of getting at pension

assets prior to their retirement years. It is therefore appropriate to consider them as part of the topic of plan distributions.

A loan is best thought of as an alternative investment of pension funds. To illustrate: Plan assets may be invested in bonds, which are nothing more than loans either to a government entity or to a corporation. A plan loan is like a bond in that it is a loan, the only difference being that the loan is to the plan participant. In other words, instead of lending the money to the U.S. Government or to General Motors, the participant's plan account is lending the money to the participant.

Both the Department of Labor and the Internal Revenue Service have jurisdiction over plan loans. In the case of the Department of Labor, this is because a loan is a transaction between the plan and the plan participant that would normally be a "prohibited transaction", subject to penalty tax and prohibitions. A statutory exception has been carved out of ERISA to permit participant loans, ERISA Section 408(b)(1) and regulations thereunder, but this exception has a number of conditions that are policed by the Department of Labor. The conditions are as follows:

1. Loans must be available to all participants on a reasonably equivalent basis, a basis that does not favor highly compensated employees. This means there can be no discrimination on the basis of race, color, religion, sex, age or national origin. Credit worthiness and financial need can be considered. In addition, there can be a minimum of up to \$1,000.00 (but no higher). Loans can be, and typically are, limited to active participants. Finally, limiting everyone to a certain percentage of the account balance (like 50%) is allowable and typical.
2. There must be a specific plan provision permitting loans.
3. The loan must be at a reasonable rate of interest. The regulations instruct that the loan must provide the plan "with a return commensurate with the interest rates charged by persons in the business of lending money for loans which would be made under similar circumstances." Since plan loans are somewhat unique, practitioners have struggled to determine what kinds of loans should be used as models. "Prime" or prime "plus one" or "plus two" is a typical rate, but the Department of Labor has not blessed any particular rate.
4. The loan must be adequately secured. After indicating that adequacy of security will be determined by reference to "arm's length terms" of similar transactions, the regulations endorse the use of the account balance (but not more than

50%) as adequate security. The account is almost universally used as the only security, and therefore loans must be limited to 50% of the account balance to be adequately secured.

Congress has also imposed restrictions on plan loans in the Internal Revenue Code. These restrictions, set out in Internal Revenue Code Section 72(p), are of course policed by the Internal Revenue Service. These restrictions are as follows:

- a. The aggregate of all currently outstanding loans must be limited to \$50,000, reduced by principal repayments made over the prior year. Thus, if there is currently a \$5,000 loan outstanding, but it was \$10,000 a year ago, the maximum additional loan is \$40,000.
- b. The loan cannot exceed the greater of (i) 50% of the vested account balance; or (ii) \$10,000. (Note - Since the Department of Labor regulations require adequate security, the loan typically cannot exceed 50% of the account balance.)
- c. The loan must be repayable within five years, except for a loan to purchase a dwelling, which has no time limit.
- d. The loan must have level amortization. A balloon payment at the end of five years, for example, is not permissible.

If the restrictions are not met, the loan is treated as a distribution for tax purposes.

8. Conclusion

The distribution rules – when and how they can and must be made – are complex, as this article demonstrates. For most participants, however, the relevant rules are quite simple. For defined contribution plans, loans are the way to access funds; upon termination of employment, there will be a direct rollover to an IRA; and the complicated decisions regarding distributions from the IRA will be put off until age 70½ or death. For defined benefit plans, things are even simpler: unless there is a lump sum option, the only decision will be the choice among annuity options commencing at early, normal or late retirement. The burden of wading through the morass of statutes, regulations and rulings that comprise this area is reserved for the pension professionals.

Example A

Illustration of Lifetime Distributions under New MRD Rules

FACTS:

Owner reached age 70 and age 70½ in 2016. Spouse is beneficiary; spouse reached age 68 in 2016. The IRA is valued at \$200,000.00 on December 31, 2015. Distributions based on Uniform Table.

	Prior Year Dec. 31 Value	Divisor	Interest at 4%	12/31 Required Distribution
2016	\$200,000.00	27.4	\$8,000.00	\$7,299.27
2017	\$200,700.73	26.5	\$8,028.03	\$7,573.61
2018	\$201,155.15	25.6	\$8,046.21	\$7,857.62
2019	\$201,343.73	24.7	\$8,053.75	\$8,151.57
2020	\$201,245.91	23.8	\$8,049.84	\$8,455.71
2021	\$200,840.04	22.9	\$8,033.60	\$8,770.31
2022	\$200,103.33	22.0	\$8,004.13	\$9,095.61
2023	\$199,011.86	21.2	\$7,960.47	\$9,387.35
2024	\$197,584.98	20.3	\$7,903.40	\$9,733.25
2025	\$195,755.13	19.5	\$7,830.21	\$10,038.72
2026	\$193,546.61	18.7	\$7,741.86	\$10,350.09
2027	\$190,938.39	17.9	\$7,637.54	\$10,666.95
2028	\$187,908.98	17.1	\$7,516.36	\$10,988.83
2029	\$184,436.51	16.3	\$7,377.46	\$11,315.12
2030	\$180,498.84	15.5	\$7,219.95	\$11,645.09
2031	\$176,073.71	14.8	\$7,042.95	\$11,896.87
2032	\$171,219.79	14.1	\$6,848.79	\$12,143.25
2033	\$165,925.33	13.4	\$6,637.01	\$12,382.49
2034	\$160,179.86	12.7	\$6,407.19	\$12,612.59
2035	\$153,974.46	12.0	\$6,158.98	\$12,831.21
			Total Payments	\$203,195.50

(283466 v. 2, Sheet 2)

Example B

Illustration of Death Distributions

FACTS:

Owner reached age 70 and age 70 1/2 in 2016. Spouse is beneficiary; spouse reached age 68 in 2016. The IRA is valued at \$200,000.00 on December 31, 2015. Owner dies in 2024. Spouse beneficiary dies in 2030, and distributions continue to the spouse's designated remainder beneficiary.

Distribution Year	Prior Year Dec. 31 Value	Divisor	Interest at 4%	12/31 Required Distribution
2016	\$200,000.00	27.4	\$8,000.00	\$7,299.27
2017	\$200,700.73	26.5	\$8,028.03	\$7,573.61
2018	\$201,155.15	25.6	\$8,046.21	\$7,857.62
2019	\$201,343.73	24.7	\$8,053.75	\$8,151.57
2020	\$201,245.91	23.8	\$8,049.84	\$8,455.71
2021	\$200,840.04	22.9	\$8,033.60	\$8,770.31
2022	\$200,103.33	22.0	\$8,004.13	\$9,095.61
2023	\$199,011.86	21.2	\$7,960.47	\$9,387.35
2024	\$197,584.98	20.3	\$7,903.40	\$9,733.25
2025	\$195,755.13	12.1	\$7,830.21	\$16,178.11
2026	\$187,407.22	11.4	\$7,496.29	\$16,439.23
2027	\$178,464.28	10.8	\$7,138.57	\$16,524.47
2028	\$169,078.38	10.2	\$6,763.14	\$16,576.31
2029	\$159,265.21	9.7	\$6,370.61	\$16,419.09
2030	\$149,216.72	9.1	\$5,968.67	\$16,397.44
2031	\$138,787.95	8.1	\$5,551.52	\$17,134.31
2032	\$127,205.15	7.1	\$5,088.21	\$17,916.22
2033	\$114,377.14	6.1	\$4,575.09	\$18,750.35
2034	\$100,201.87	5.1	\$4,008.07	\$19,647.43
2035	\$84,562.52	4.1	\$3,382.50	\$20,625.01
2036	\$67,320.02	3.1	\$2,692.80	\$21,716.13
2037	\$48,296.68	2.1	\$1,931.87	\$22,998.42
2038	\$27,230.13	1.1	\$1,089.21	\$24,754.66
2039	\$3,564.67	0.1	\$142.59	\$3,707.26
			Total payments	\$342,108.75

(283466 v. 2, Sheet 3)

Example C

**Illustration of Death Distributions -
Spouse Disclaims and Very Young Beneficiary Steps In**

FACTS:

Owner reached age 70 and age 70 1/2 in 2016. Spouse is primary beneficiary; spouse reached age 68 in 2016. Owner's son is first contingent beneficiary, and owner's granddaughter, who is age 6 in 2016, is second contingent beneficiary. The IRA is valued at \$200,000.00 on December 31, 2015. Owner dies in 2024. Spouse and son both disclaim.

Distribution Year	Prior Year Dec. 31 Value	Divisor	Interest at4%	12/31 Required Distribution
2016	\$200,000.00	27.4	\$8,000.00	\$7,299.27
2017	\$200,700.73	26.5	\$8,028.03	\$7,573.61
2018	\$201,155.15	25.6	\$8,046.21	\$7,857.62
2019	\$201,343.73	24.7	\$8,053.75	\$8,151.57
2020	\$201,245.91	23.8	\$8,049.84	\$8,455.71
2021	\$200,840.04	22.9	\$8,033.60	\$8,770.31
2022	\$200,103.33	22.0	\$8,004.13	\$9,095.61
2023	\$199,011.86	21.2	\$7,960.47	\$9,387.35
2024	\$197,584.98	20.3	\$7,903.40	\$9,733.25
2025	\$195,755.13	67.9	\$7,830.21	\$2,882.99
2026	\$200,702.34	66.9	\$8,028.09	\$3,000.04
2027	\$205,730.40	65.9	\$8,229.22	\$3,121.86
2028	\$210,837.76	64.9	\$8,433.51	\$3,248.66
2029	\$216,022.62	63.9	\$8,640.90	\$3,380.64
2030	\$221,282.88	62.9	\$8,851.32	\$3,518.01
2031	\$226,616.19	61.9	\$9,064.65	\$3,661.00
2032	\$232,019.83	60.9	\$9,280.79	\$3,809.85
2033	\$237,490.78	59.9	\$9,499.63	\$3,964.79
2034	\$243,025.62	58.9	\$9,721.02	\$4,126.07
2035	\$248,620.57	57.9	\$9,944.82	\$4,293.96
2036	\$254,271.43	56.9	\$10,170.86	\$4,468.74
2037	\$259,973.54	55.9	\$10,398.94	\$4,650.69
2038	\$265,721.80	54.9	\$10,628.87	\$4,840.11
2039	\$271,510.56	53.9	\$10,860.42	\$5,037.30
2040	\$277,333.68	52.9	\$11,093.35	\$5,242.60
2041	\$283,184.43	51.9	\$11,327.38	\$5,456.35
2042	\$289,055.46	50.9	\$11,562.22	\$5,678.89
2043	\$294,938.79	49.9	\$11,797.55	\$5,910.60
2044	\$300,825.74	48.9	\$12,033.03	\$6,151.86
2045	\$306,706.92	47.9	\$12,268.28	\$6,403.07
2046	\$312,572.13	46.9	\$12,502.89	\$6,664.65
2047	\$318,410.36	45.9	\$12,736.41	\$6,937.04
2048	\$324,209.73	44.9	\$12,968.39	\$7,220.71

2049	\$329,957.41	43.9	\$13,198.30	\$7,516.11
2050	\$335,639.59	42.9	\$13,425.58	\$7,823.77
2051	\$341,241.41	41.9	\$13,649.66	\$8,144.19
2052	\$346,746.88	40.9	\$13,869.88	\$8,477.92
2053	\$352,138.84	39.9	\$14,085.55	\$8,825.53
2054	\$357,398.86	38.9	\$14,295.95	\$9,187.63
2055	\$362,507.18	37.9	\$14,500.29	\$9,564.83
2056	\$367,442.63	36.9	\$14,697.71	\$9,957.79
2057	\$372,182.54	35.9	\$14,887.30	\$10,367.20
2058	\$376,702.64	34.9	\$15,068.11	\$10,793.77
2059	\$380,976.98	33.9	\$15,239.08	\$11,238.26
2060	\$384,977.80	32.9	\$15,399.11	\$11,701.45
2061	\$388,675.46	31.9	\$15,547.02	\$12,184.18
2062	\$392,038.29	30.9	\$15,681.53	\$12,687.32
2063	\$395,032.50	29.9	\$15,801.30	\$13,211.79
2064	\$397,622.01	28.9	\$15,904.88	\$13,758.55
2065	\$399,768.34	27.9	\$15,990.73	\$14,328.61
2066	\$401,430.46	26.9	\$16,057.22	\$14,923.07
2067	\$402,564.62	25.9	\$16,102.58	\$15,543.04
2068	\$403,124.17	24.9	\$16,124.97	\$16,189.73
2069	\$403,059.41	23.9	\$16,122.38	\$16,864.41
2070	\$402,317.37	22.9	\$16,092.69	\$17,568.44
2071	\$400,841.62	21.9	\$16,033.66	\$18,303.27
2072	\$398,572.02	20.9	\$15,942.88	\$19,070.43
2073	\$395,444.47	19.9	\$15,817.78	\$19,871.58
2074	\$391,390.66	18.9	\$15,655.63	\$20,708.50
2075	\$386,337.79	17.9	\$15,453.51	\$21,583.12
2076	\$380,208.19	16.9	\$15,208.33	\$22,497.53
2077	\$372,918.99	15.9	\$14,916.76	\$23,454.02
2078	\$364,381.72	14.9	\$14,575.27	\$24,455.15
2079	\$354,501.84	13.9	\$14,180.07	\$25,503.73
2080	\$343,178.19	12.9	\$13,727.13	\$26,602.96
2081	\$330,302.35	11.9	\$13,212.09	\$27,756.50
2082	\$315,757.95	10.9	\$12,630.32	\$28,968.62
2083	\$299,419.65	9.9	\$11,976.79	\$30,244.41
2084	\$281,152.02	8.9	\$11,246.08	\$31,590.11
2085	\$260,807.99	7.9	\$10,432.32	\$33,013.67
2086	\$238,226.64	6.9	\$9,529.07	\$34,525.60
2087	\$213,230.10	5.9	\$8,529.20	\$36,140.70
2088	\$185,618.61	4.9	\$7,424.74	\$37,881.35
2089	\$155,162.01	3.9	\$6,206.48	\$39,785.13
2090	\$121,583.36	2.9	\$4,863.33	\$41,925.30
2091	\$84,521.40	1.9	\$3,380.86	\$44,484.95
2092	\$43,417.31	0.9	\$1,736.69	\$45,154.00
			Total payments	\$1,104,372.99

(283466 v. 1, Sheet 7)

Chapter VIII

A Poet's Guide to Selected Topics Involving Defined Benefit Plans

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There is a tendency in the employee benefits world to speak of defined benefit plans in the past tense, as if they have been permanently supplanted by 401(k) programs, and are to be studied only for historical purposes. This is a long way from the truth. While not many new defined benefit plans are being created in the private sector, many large and mature companies still have them, and even those companies that have made a switch to 401(k) plans often maintain defined benefit plans in a grandfathered or frozen state. In the public sector, it is probably fair to say that defined benefit programs remain the norm. It is certainly justified, therefore, to spend some time examining several pension issues that are unique to defined benefit plans.

1. Funding

Generally, each qualified defined benefit plan has a trust fund into which the employer sponsoring the plan contributes sufficient funds to pay benefits as they become due. Determining the employer's contribution requires a complex set of calculations that includes projecting the level of future benefits and the timing of their payment, and the rate at which funds invested in the trust will grow as a result of investment experience. To perform these calculations, one must project how compensation will rise, how long employees will stay with the company, how long they will live beyond retirement and therefore get an annuity, and what the rate of return will be on investments. The people trained to make these calculations are actuaries, and every defined benefit plan requires the services of an actuary. Actuaries, like lawyers, are governed by professional standards, and when actuaries approve a set of actuarial assumptions to be used regarding a defined benefit plan, they are restricted in their flexibility by those professional standards.

Beyond this, ERISA and the Code contain complex rules regarding the minimum and maximum funding for a defined benefit plan on an annual basis. Section 412 of the Code (and a counterpart provision in ERISA) contains a set of rules that requires a pension plan to fund its liabilities over a period of time. These rules are at the heart of the original intent of ERISA, namely to prevent situations where promised benefits will not be paid because a plan was not funded properly.

These rules do not require that a plan be fully funded at all times. They simply require that sufficient contributions be made periodically so

that a plan is on track to pay benefits as they accrue. Even the concept of “fully funded” is not a simple matter, since one would have to clarify whether that means having sufficient funds to buy all of the benefits if the plan was terminated, or just being at a stage where all the contributions required by Code Section 412 have been made.

The determination of how much must be contributed is made on an annual basis, in an annual actuarial report. The determination is very much influenced by the assumptions an actuary uses – a change of 1% in the projected future interest rate can have a huge impact on a funding analysis. Actuaries have some flexibility, therefore, but as noted they are governed by professional standards that limit this flexibility.

The Form 5500 Annual Report, filed by a defined benefit plan sponsor, will set forth some of this actuarial information in Schedule B. Given the complexity of the issues and the language used, that information will be of little use to a participant trying to determine how well funded her plan is.

As if all of this was not complicated enough, Congress changed the funding rules of Code Section 412 in the Pension Protection Act of 2006. The purpose of this statute was to tighten up funding rules to lessen the likelihood of plans becoming grossly underfunded, but one immediate impact of the law is to add costs and complexity to an already costly and complex process. The new rules promulgated by the PPA became fully effective in 2011.

2. Actuarial equivalencies

Defined contribution plans usually pay out benefits in a lump sum. Typically, these distributions are rolled over into IRAs. If a participant wants an annuity (a guaranteed stream of payments over his life or the joint lives of himself and a spouse), he can shop for an IRA annuity, and the market place will determine what kind of an annual payment he can get in return for his lump sum payment.

In a defined benefit plan, the standard form of benefit is a straight life annuity for a single participant, and a joint and survivor annuity for a married participant. Almost always, the participant, with spousal consent if appropriate, can choose a different form of benefit instead. A plan may offer other forms of annuity (such as a 10-year certain annuity, which will pay a minimum of 10 years even if the annuitant dies during that period), or, as is increasingly typical, it may allow participants to receive a lump sum distribution rather than an annuity stream. In addition, while the annuity form is typically expressed as a number commencing at age 65, many participants will desire to commence their benefits earlier or later.

A defined benefit plan that offers different forms or timing of benefit payments must provide a methodology for converting a standard form of benefit into an optional form or timing that has the same value. This is another important task in the defined benefit world that is assigned to an actuary. Using assumptions that are part of the plan, sometimes the same ones that are used in determining funding requirements, an actuary converts the standard form of benefit into the alternative form chosen by the participant. This conversion is sometimes described as providing the “actuarial equivalent” of the standard form.

However, a conversion is not always intended to be an actuarial equivalent. The most notable example of this is the subsidized early retirement benefit. Without any subsidy, the payment of an annuity a year early (age 64 vs. age 65, for example) would result in a reduction of from 5 to 6 % of the annuity amount, depending on the assumptions used. Some plans offer early benefits at a much smaller reduction (2 or 3% per year, or sometimes even no reduction for payments beginning after a certain early retirement age). This means that the person retiring early is getting a benefit with a higher value. Another example is a subsidized joint and survivor annuity. If a husband and wife are both age 65, a joint and survivor annuity (one payable until the later of the 2 dies) should be in a lower amount than a straight life annuity, since there is a risk that it will have to pay for more years than the straight life annuity. Some plans pay an unreduced amount (or an amount that is reduced less than the actuarial equivalent) to a married participant.

As in the case of funding, the government does not leave all of the policing of this system to actuaries. While subsidized benefits can be paid, current IRS regulations require that optional forms be presented in a way that indicates the assumptions used, and whether based on those assumptions any particular form is more valuable than another. There is also required disclosure of the financial effect of deferring receipt of a benefit.

With respect to lump sum distributions, the law (statute and regulations) goes beyond this, and actually mandates the actuarial assumptions to be used in converting an annuity into a lump sum. This requirement, dating from the 1980s, apparently was intended to address a potential abuse of converting annuities into lump sums using factors that resulted in the lump sum having a lower value. Since participants often are drawn to lump sums if they are available, an employer might be tempted to design a plan to save money by paying out lump sums at a discount. The laws now prohibits such a tactic.

Code Section 417(e), and the regulations thereunder, set forth the interest rates and mortality tables that must be used to convert the normal form of benefit into a lump sum. These rates are considered to be

relatively generous to, and protective of, participants who choose to avail themselves of a lump sum benefit if the plan offers one. Interestingly, the law does not require that the lump sum value reflect a subsidized early retirement benefit. Therefore, if a plan offers an unreduced annuity at age 62, even though normal retirement date is age 65, the lump sum can still be calculated as an actuarial equivalent of the age 65 benefit. In such a case, the actuarial equivalent lump sum of the subsidized age 62 annuity will be greater than the lump sum payable under the plan, despite the imposition of Section 417(e).

3. The Pension Benefit Guaranty Corporation

The Pension Benefit Guaranty Corporation (“PBGC”) was established in 1976 pursuant to Title IV of ERISA. Title IV, which has been amended several times but continues essentially in its original structure, provides a guaranty to defined benefit participants that they will receive their benefits even if their plan is insolvent. The PBGC, which provides this insurance, is quasi-governmental – while it is run by the government, it is supposed to be self-sustaining financially.

The PBGC insurance system covers only private sector defined benefit plans. Defined contribution plans are not covered. Each defined benefit plan sponsor must pay an annual premium based on the number of covered participants. The amount of the premium has increased dramatically over the three decades of the PBGC’s existence, illustrating the difficulty Congress has had in developing underwriting criteria for this type of “insurance.”

Title IV requires that when any defined benefit plan is to be terminated, an application to the PBGC must be made demonstrating that the plan is sufficiently funded to pay all benefits. This is known as a standard termination. If the plan cannot pay all of its benefits, it must apply for permission to have a distress termination. There are strict criteria that must be met before the PBGC will consent to a distress termination, because this means that the PBGC will assume the liabilities that the plan cannot satisfy. Generally, the PBGC will take over administration of a plan that incurs a distress termination. To complete the picture, the PBGC has the power to act on its own to take over a plan that is in distress but has not applied for a distress termination (an “involuntary termination”).

The PBGC insurance does not necessarily guaranty payment of a participant’s entire benefit. There is a limit, adjusted annually (\$64,432 in 2017 for a straight life annuity at age 65). This limit generally hurts long-term higher compensated participants, who may have accrued an annual benefit substantially higher than the limit. In addition, newly

added benefits are not entirely covered until the expiration of a phase in period.

One might ask why the PBGC system is needed if there are tough and enforceable funding rules. The simple answer is that Congress cannot legislate solvency. If a company is not generating enough revenue to cover its ongoing payroll and costs, it will not have the money to fund its plan. It is fair to say that almost all distress or involuntary terminations involve insolvent companies. Many large distress terminations occur in bankruptcy situations.

One common scenario that leads to a distress termination is an industry with a shrinking workforce, like the steel or automotive industry. If a company has many retirees but fewer active employees, it becomes more likely that current revenues will not be able to meet ongoing pension liabilities. This was the case with the steel industry in the 1980s and 1990s, and appears to be a risk with the auto industry now. In other cases, like the airline industry, companies simply are not sufficiently profitable to cover promises that were made at a more profitable stage of their existence.

The stresses placed on the PBGC by large waves of bankruptcies such as in the steel and airline industries cannot be overstated. Often in the ensuing bankruptcy cases the PBGC becomes one of the largest creditors, but that is not of much comfort, because, even if the companies can be reorganized (as in the case of United Airlines and US Air), the PBGC gets, in return for its claim, common stock worth only a small fraction of the liability it has inherited. The long term solvency of the PBGC is an issue that is often worried about in Washington.

4. The public sector and social security

Many public sector entities sponsor defined benefit plans. States, towns, and school districts often promise their employees relatively generous defined benefit plans. These plans have never been subject to the minimum funding rules applicable to private sector plans – they are excluded from coverage under ERISA. They also are not eligible for PBGC insurance. Unlike private sector entities, governmental units are not dependent on operating profits. Instead they look to taxes to cover expenditures. While some of these entities have long used actuaries to make sure that they adequately fund their defined benefit plans on an ongoing basis, many others have not. For the last ten years, governmental units have been required to account currently for future pension benefits, and, beginning in 2007, they must do the same for future welfare benefits. There is justifiable concern about the impact this requirement will have on those entities' ability to raise money by accessing the bond markets.

The other related topic that should be noted is Social Security. The Social Security system is not a defined benefit plan, but it has many attributes of a defined benefit plan – current liability for future benefits, funded by a fund (the Social Security Trust Fund, which consists exclusively of IOU's from the federal government). The annual funding for Social Security is from FICA taxes imposed on employers and employees, and because the ratio of active FICA paying employees to retirees receiving benefits is getting lower, there is concern that in the long run, the fund will be insufficient to cover benefits – like the distress terminations experienced in the steel industry. Obviously, there is no PBGC to bail out the Social Security system, so if predictions are accurate, some changes will have to be made (lower benefits, benefits that start later, or higher FICA taxes, to give 3 examples) in order to protect the solvency of the system.

Chapter IX

A POET'S GUIDE TO THE IRA, THE ROTH IRA AND THE ROTH 401(k)

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The IRA and the Roth IRA stand in stark contrast to the qualified plan, the 403(b) annuity, the 457 plan and the various quasi-plans that Congress has enacted from time to time (e.g. the SEP, the SIMPLE). All of these other programs are employer based: they require an employer/employee relationship and a voluntary decision by the employer to institute a program. In contrast, the IRA and the Roth IRA allow individuals to make contributions to a tax advantaged retirement program without any employer participation or cooperation. The Roth 401(k), in contrast, is part of a qualified plan with a 401(k) feature, but since it is best understood after learning about Roth IRAs, it is included in this chapter.

1. The IRA

The individual retirement account, governed by Sections 408 and 219 of the Internal Revenue Code, is a creature of ERISA and dates back to 1974. It is so clever in its design that one may question why Congress did not decide to let it take the place of the entire pension system. In fact, it is the low dollar limits that Congress imposed on it, described briefly below, that have kept it from becoming more of a force in the retirement plan world.

The basic structure is that an individual establishes her or his own trust account, known as an Individual Retirement Account (an "IRA"), and contributes up to a set maximum dollar amount each year on a deductible basis. The set amount has changed from time to time, but was \$2,000 per individual for a long time. In 2002, this limit increased to \$3,000, in 2005, to \$4,000, in 2008 to \$5,000, and in 2016 and 2017, as a result of cost of living increases, is \$5,500. In addition, for individuals over 50, a "catch-up" contribution may be made: \$500 from 2002 through 2005, and \$1,000 commencing in 2006 and continuing in 2016 and 2017. Once the funds are in the IRA, most of the rules are the same as for qualified plans, e.g. tax deferred earnings, penalties on distributions before age 59 ½, and mandatory distributions after age 70 ½.

Eligibility for a deductible contribution requires the existence of compensation in an amount at least equal to the contribution. There is, however, one additional limit that effectively eliminates most of the group that would be willing and able to make deductible contributions. In a nutshell, if an individual is also covered by a qualified plan, 403(b)

annuity or 457 plan, then she or he is not eligible to make a deductible contribution unless she or he does not exceed a relatively low income threshold. For 2017 and thereafter, the full \$5,500 deductible contribution can only be made by a single individual whose adjusted gross income is not greater than \$62,000 or married individuals filing jointly whose adjusted gross income does not exceed \$99,000. Above this limit, there is a narrow corridor of adjusted gross income where partially deductible contributions are permitted (on a reducing basis as income rises), and then the deductible contribution phases out completely at \$72,000 and \$119,000 respectively.

This brief description does not begin to go into the complexities of IRAs. For example, there is a special rule that permits an individual to make a contribution to a spouse's IRA, with different deductibility rules. Furthermore, nondeductible contributions can be made by any individual with compensation either to the individual's own IRA or a spouse's IRA.

The bottom line, however, is that the possibility of making deductible contributions to an IRA is limited to those who are not covered by a qualified plan and those who are covered by a qualified plan and have a low income. Neither of these groups is likely to include many people who have the wherewithal to contribute, and therefore individual contributions to IRAs have been relatively inconsequential.

In theory, the existence of the IRA might have encouraged some employers to eliminate pensions and let each employee decide whether to save for retirement. In fact, the very low dollar limit on deductible contributions to IRAs, compared to the limits for deductible contributions to 401(k) plans, makes this idea unpalatable. One might speculate as to why Congress does not raise the IRA limits to the same level as qualified plans. One answer lies in the possibility that, if this were to be done, many employers might consider getting rid of their 401(k) programs and allowing each employee to go it alone. This would make the whole non-discrimination structure that exists for 401(k) programs moot. Congress may have decided that if it is going to offer a very substantial tax advantage, it should get its *quid pro quo*, namely a program that assures at least some retirement income for a broad base of rank and file employees. An "IRA only" system would give no such assurance.

2. Rollover IRAs

From its inception, the IRA was a multi-purpose vehicle. Not only did it permit deductible contributions, but it could also be used to roll over distributions from qualified plans and 403(b) annuities. This rollover feature was a stroke of brilliance. The IRA has become a critical component in the defined contribution retirement system. In fact, it may

even have led to the addition of lump sum features in defined benefit programs, since the IRA provides a tax deferred destination for those lump sums.

Today, the vast bulk of IRA money is a result of rollovers. As the “baby boomer” generation begins to retire, one can safely predict that IRA money will continue to grow. As we have seen in a previous article, the mandated distributions that begin at age 70½ actually allow IRA assets to continue to grow after age 70½ in many cases. The amount of tax deferred money in the IRA system will likely continue to increase for a number of decades.

Until quite recently, rollovers were elective; they would only occur when a participant elected in writing to effectuate it. As noted in the previous chapter, effective after March 31, 2005, an involuntary *de minimis* cash out (one of \$5,000 or less) must be automatically rolled over directly into an IRA if it is in excess of \$1,000 unless the participant elects to receive it in cash. Until March 31, 2005, rollovers were elective only, and a *de minimis* cash out was paid in cash unless a rollover was elected. The pre-March 31, 2005 rule continues to apply to rollovers of \$1,000 or less. This change is likely to result in an increase in small rollovers, simply as a result of inaction on the part of terminating participants. While these are very small amounts, in the aggregate the effect may be a material increase of funds that remain in the deferred compensation system.

3. The Roth IRA

While the IRA can be characterized as kind of a mini-qualified plan, the Roth IRA, which arrived on the scene in 1998, is an entirely new concept, offering different tax advantages, and competing with the traditional IRA for the same dollar.

Contributions to a Roth IRA are limited to the same amount as the traditional IRA, i.e. \$3,000 per year in 2002, increased in 2005 to \$4,000, in in 2008 to \$5000, and in in 2016 and 2017, as a result of cost of living increases, is \$5,500. In addition, for individuals over 50, a “catch-up” contribution may be made: \$1,000 commencing in 2006 and continuing in 2016 and 2017. Contributions to a Roth IRA, however, are never tax deductible. The individual is always contributing after-tax money. The benefit of the Roth IRA is that, as long as certain rules are complied with, the earnings will never be taxed. In other words, while the traditional IRA, like a qualified plan and virtually every other retirement vehicle under the Code, *defers* the income taxation of earnings, the Roth IRA *exempts* earnings from income taxation.

Eligibility for a Roth IRA, like a traditional IRA, requires the existence of earned income. Unlike the traditional IRA, the Roth IRA is available to single individuals whose adjusted gross income for 2017 and thereafter is not more than \$118,000 (with reduced amounts phasing out at \$133,000), and married individuals whose joint adjusted gross income is not more than \$186,000 (with reduced amounts phasing out at \$196,000). These limits apply whether or not an individual is covered by a qualified plan.

It is worth reflecting on the nature of the difference between the traditional IRA and the Roth IRA. The traditional IRA, like the qualified plan, is attractive because of the up front tax deduction and the subsequent deferral of earnings. The Roth IRA, in contrast, does not provide an up front deduction, but when the money is ultimately withdrawn, there is no taxation at all on distributions, whether they consist of the original contributions or the earnings.

Which is better? Obviously the answer will depend on the particular circumstances of an individual, but it is fair to say that for most individuals who will have a long deferral period, the Roth IRA will ultimately provide a better financial deal. The payoff will come a long time into the future, namely when distributions are made, or if earlier, when they would have had to be made from a traditional IRA. (See discussion of mandatory distribution rules below.) At that time, however, the contrast between keeping all of the money (Roth IRA), versus having to pay an income tax on it (traditional IRA), is very significant.

It should be noted that for many Americans, there is not a decision as to whether to contribute to a traditional IRA on a tax deductible basis or to a Roth IRA with after tax dollars. In 2017, single individuals covered by a qualified plan who are making between \$62,000 and \$118,000 can make a full contribution to a Roth IRA but cannot make a full deductible contributions to a traditional IRA. The same goes for married individuals who are covered by a qualified plan and have a joint adjusted gross income of between \$99,000 and \$186,000. This is a large group of individuals with the wherewithal to make a \$5,000 contribution to a Roth IRA.

This article does not begin to go into all of the complexities of the Roth IRA. To attain the tax exempt status described, the funds have to be left in the Roth IRA for at least 5 taxable years after the Roth IRA is established, and then must be distributed only after the owner reaches age 59½, dies, becomes disabled, or is purchasing a “first home”. Withdrawals of the actual contributions on a tax free basis are permitted more liberally, without destroying the future tax exemption of the earnings. Another special rule is that individuals over age 70½ can

continue to contribute to a Roth IRA to the extent they have earned income. This contrasts with traditional IRAs, which cannot receive contributions after age 70½. Finally, as discussed below, the mandatory distribution rules of Section 401(a)(9) do not apply to a Roth IRA during the owner's lifetime.

What is the policy reason behind Roth IRAs? It remains something of a mystery why a Congress that during elections extols the virtues of simplifying the Internal Revenue Code added a provision that makes the retirement system far more complex. It is almost as if Congress viewed the retirement system as a Las Vegas casino, and added another game of chance, the Roth IRA, leaving it to individual taxpayers to decide which game of chance will provide a better result. One simple but disturbing answer to the motivation question is that Roth IRAs produce more income up front, in a potentially disastrous tradeoff of future income tax. Possibly, the 1997 Congress simply wanted to add short term revenue, and let someone else worry about 2025 and beyond.

4. The Roth IRA as a Rollover Vehicle

Congress crafted the Roth IRA so that it could be used as a rollover vehicle. Generally, the rollover can come only from a traditional IRA, but an individual can roll a qualified plan into a traditional IRA and then immediately into a Roth IRA, so indirect rollovers can be made from qualified plans.

A rollover from a traditional IRA into a Roth IRA results in immediate taxation of the amount rolled over. This tax, however, need not be paid out of the rolled over amount. Assume for example that an individual has \$100,000 in an IRA and is taxed at the 33% bracket. The rollover from a traditional IRA to a Roth IRA will result in \$33,000 of income tax, but assuming the individual has \$33,000 in unsheltered wealth in addition to the IRA, the individual can roll over the full \$100,000 and pay the tax out of other funds.

Eligibility to make a Roth IRA rollover, until 2010, was based on an adjusted gross income cap, but it was different from the adjusted gross income cap for regular Roth IRA contributions. The adjusted gross income cap for rollovers was \$100,000, and it was the same whether an individual was single or married and filing jointly. There was no obvious policy reason for this unique, status-neutral limit. Commencing in 2010, the gross income cap has been eliminated, and anyone can roll a distribution from a qualified plan or a traditional IRA into a Roth IRA.

Once again, the policy reasons behind the Roth IRA rollover option are difficult to identify. One can argue that still another game of

chance has been added at the Las Vegas casino. An individual can enter the Roth IRA game via rollover if she is willing to pay an up-front income tax as an entry fee. Whether it will turn out to be a good tradeoff depends on how long the rolled over assets will be sheltered, but most models demonstrate that if there is a long deferral period after the rollover, the Roth IRA will be more favorable.

In this regard, a somewhat surprising difference in rules exists with respect to mandatory distributions. In brief, while traditional IRAs are required to make mandatory distributions beginning at age 70½, utilizing the Section 401(a)(9) rules, Roth IRAs do not require mandatory distributions during the life of the owner. Once the owner dies, Roth IRAs must make mandatory distributions in the same manner as IRAs or qualified plans. This seemingly innocuous difference has potentially staggering consequences, but only in decades to come.

The ability of a Roth IRA owner to defer distribution from age 70½ for his or her remaining life expectancy (perhaps another 15-20 years) means that during that time period, the compounding earnings get the benefit of the tax exemption. This is in sharp contrast to the traditional IRA, which is gradually spewing funds out of its tax shelter.

5. Concluding Thoughts on IRAs

Congress has established a non-employer based, voluntary, tax subsidized retirement system consisting of traditional IRAs and Roth IRAs. It has engineered the traditional IRA and Roth IRA so that they can also be used as receptacles for rollovers for the employer based retirement system. The coexistence of the traditional IRA and Roth IRA demonstrates that the philosophy behind the individually based retirement system is fuzzy at best and perhaps even incoherent. The conflict between the goal of encouraging savings for retirement and the goal of maximizing current revenue is perhaps nowhere better demonstrated than in the creation of the Roth IRA. It remains to be seen whether the Roth IRA will turn out to be a curiosity of limited value, or a gigantic tax avoidance vehicle for wealthy Americans.

6. Roth 401(k)s

In 2002, as part of EGTRRA, Congress added a new concept, that of a “Roth” type account in a 401(k) program, but put off its effective date until 2006. It is set forth in Section 402A of the Code.

Essentially, if a plan chooses to add a Roth 401(k) feature to a 401(k) program, it will give each participant an election as to whether to defer on a pre tax or after tax (“Roth”) basis. If a participant defers on an

after tax basis, the deferrals are accounted for in a Roth account. Amounts in this account are treated in almost every way, including for purposes of distribution, in the same manner as distributions from a Roth IRA. The participant's W-2 form for the year will exclude traditional deferrals from taxable income, but will include Roth deferrals.

If the plan permits, a participant could choose to treat some deferrals as traditional and some as Roth deferrals. Over time, it might be that many participants would have both a traditional deferral account and a Roth deferral account.

From the plan's perspective, it will be neutral whether a participant chooses to defer on a traditional basis or a Roth basis. Both types of deferrals will be included in the ADP test. If the plan has a matching contribution feature, it will generally apply without distinction to traditional deferrals and Roth deferrals. Therefore adding a Roth feature does not add to the plan's cost (other than administrative costs, which will be modest), and does not in any other way impose a hardship on the plan sponsor.

Which participants are likely to find Roth 401(k)s attractive? It is generally thought that higher income participants, who have the extra funds to pay a current income tax on the distribution that they would otherwise make, would find it attractive to have at least a portion of their deferrals in an after tax status. In addition, younger participants who are in low tax brackets and therefore do not get much benefit from pretax status, may be willing to pay tax on their deferrals in order to have a Roth account that will never be taxed on growth in the future.

Initially, there was a reluctance to add Roth 401(k)s to existing plans. It may have been primarily a learning process. Some larger employers might have initially concluded that the process of educating employees about this additional complexity outweighed the added flexibility it gives to participants. But by 2016, an increasing number of sponsors have added a Roth 401(k) option to their 401(k) programs. Congress has added an additional incentive for adding a Roth 401(k) feature, by allowing an in plan "rollover" of any previously untaxed amounts to the Roth 401(k) subaccount. The rolled over amount will be subject to immediate taxation, but thereafter will have all the benefits available to Roth 401(k) deferrals.

Chapter X

A POET'S GUIDE TO NON-QUALIFIED DEFERRED COMPENSATION

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An underlying premise of the system established by Congress to encourage broad based qualified retirement plans is that, without specific encouragement, employers would be more likely to provide benefits for a select few than for the broad base of their employees, and that this select few would consist mainly of highly-compensated employees. While the system that Congress established has been successful in encouraging the implementation of broad based retirement plans, it has not eliminated the provision of extra or substitute deferred compensation to that select few. These programs are often collectively referred to as “non-qualified deferred compensation”, to note that the very special tax provisions applicable to qualified plans do not apply to these programs. The goal of this article is to give a non-technical overview (hence the title) of the law regarding non-qualified deferred compensation plans.

These programs come in many shapes and sizes. This article will focus primarily on programs that mimic qualified plans, either in defined benefit or defined contribution form. Two other benefit categories which conceptually should be viewed as deferred compensation will also be touched upon. First, equity based compensation, in the form of stock options or grants of stock, is a very important component of compensation, for both large corporations and, even more so, for small start-up companies in the technology field. These programs have their own set of tax rules, separate and apart from those that deal with more traditional non-qualified deferred compensation. The other category of “deferred compensation” is life insurance. Whole life insurance, that is life insurance which has both an insurance component and an investment component, is sometimes used as a method of transferring value from an employer to an employee over a deferred period. We will examine stock options and grants and life insurance, and their unique legal rules, at the end of this article; keep in mind that most of the following discussion of deferred compensation does not apply to them.

1. How the Law Views Non-Qualified Deferred Compensation

The law governing deferred compensation plays a critical role in shaping the forms of non-qualified deferred compensation that are offered. It is therefore useful to briefly review the legal overlay as a starting point. Both ERISA and the Internal Revenue Code impact deferred compensation.

The ERISA overlay

Title I of ERISA applies to all “employee pension benefit plans”, whether or not qualified under the Internal Revenue Code. In general, ERISA requires that every employee pension benefit plan have a trust, and satisfy minimum vesting requirements which are identical to those set forth in Section 411 of the Code. In addition, ERISA imposes on all employee pension benefit plans participation requirements (1 year and age 21) identical to Section 410(a) of the Code. Notably, however, ERISA does not impose non-discrimination rules (of the nature contained in Sections 410(b) and 401(a)(4) of the Code) on employee pension benefit plans.

There is one major exception to the general applicability of ERISA. It is an exception for an unfunded plan providing benefits only to a select group of management and highly compensated employees. This type of plan is not subject to the above stated requirements or the fiduciary rules of Part 4 of Title I of ERISA. This important exception, contained in Sections 201(2), 301(3) and 401(a)(1) of ERISA, has come to be known as the “top hat plan” exception. It is taken advantage of by virtually every non-qualified deferred compensation plan, for reasons that will be explained soon.

Despite the fact that ERISA was promulgated in 1974, and the top hat plan exception has been very important almost from the outset, the Department of Labor somehow let the 20th Century slip away without ever giving helpful guidance on which employees constitute “management and highly-compensated employees.” The view was expressed that the Department of Labor would not rely on the definition of “highly compensated” in Section 414(q) of the Code (which itself has changed over the years). Yet no alternative definition was ever articulated. Practitioners have been left to apply a good faith interpretation to this rule, and this has led to a fair amount of variation, ranging from using the Code Section 401(a)(17) cap (\$265,000 in the year 2015) to using the Code definition of “highly compensated” (for 2015, \$115,000 in the prior plan year) despite the Department of Labor’s admonition to the contrary. It has not been uncommon for top hat plan participation to dip well below the \$115,000 mark on a selective basis, although this is probably not an advisable course of action.

Probably the wisest approach to complying with the limitation to “management and highly-compensated employees” is to examine the probable reasons for the exception and the limitations on it, and then to apply them in the context of the particular company involved. It seems likely that the reason an exception was carved out was to acknowledge that some employees are sophisticated and do not need help from the federal government. These employees can assess the pluses and minuses

of non-qualified deferred compensation programs, and understand the weaknesses and risks inherent in unfunded compensation. See ERISA Advisory Opinion 90-14A. Therefore, the term “management and highly-compensated employees” is really measuring a level of sophistication consistent with understanding the risks of an unfunded plan. The salary level at which this sophistication level exists must be determined by an individual employer, with the help of counsel, on a case by case basis.

To the best of this author’s knowledge, there has been virtually no enforcement by the Department of Labor regarding the breadth of coverage of top hat plans, despite the fact that the Department must be well aware of the prevalence of such plans. It is fair to say that it would be difficult for the Department of Labor to suddenly start enforcing a strict interpretation of this rule after so many years of total neglect.

The Internal Revenue Code overlay

To understand why the top hat plan exception of ERISA is so important, it is necessary to examine the rules imposed by the Code, as interpreted by the Treasury, on non-qualified deferred compensation.

Law prior to October 2004

Prior to October 2004, the key principles were set forth in two sections of the Code, Section 402(b) and Section 451. Section 402(b) of the Code provides that deferred compensation which is not qualified is taxable when it is no longer subject to a substantial risk of forfeiture. (It does this by cross-referencing Section 83 of the Code, so the Code language is not quite so clear.) The regulations under Section 451 provide that compensation will be taxable when it is “actually or constructively received”, the so called constructive receipt rule.

The Treasury Department interpreted these two rules in a very important revenue ruling, Rev. Rul. 60-31. Probably the most important part of this ruling was the conclusion that a mere unfunded promise to pay would not be the receipt of taxable income even if the taxpayer was vested in such promise. This revenue ruling has been supplemented by other revenue rulings, a large number of private letter rulings, and revenue procedures promulgated by the IRS. See Rev. Proc. 92-65. As a result of this guidance, a generally accepted body of law has developed over the years which guides practitioners in the design of non-qualified deferred compensation. We briefly examine below the two basic principles of this body of law: “economic benefit” and “constructive receipt”.

- i. Economic Benefit. As noted above, the basic premise that guides practitioners is that a participant in a top hat plan will not be taxed on a mere unfunded promise to pay. As long as

the participant is willing to take the risk that he or she has nothing more than a promise from an employer, taxation can be avoided until receipt or constructive receipt of the benefit. However, any attempt to set a fund aside, other than the employer's own assets, will undermine this protection and result in taxation as soon as the participant is no longer subject to a substantial risk of forfeiture, i.e. as soon as he or she is vested. Thus, the establishment of a trust fund, the purchase of an annuity contract in the name of the employee, the obtaining of a letter of credit in favor of the employee, all will result in immediate taxation of the benefit to the extent the benefit is vested. This is known as the economic benefit rule.

- ii. Constructive Receipt. The constructive receipt rule is separate and distinct from the economic benefit rule. A non-qualified deferred compensation plan must successfully negotiate both rules to avoid taxation. Under the Section 451 regulations, a taxpayer is taxed on compensation as soon as it is made available, even if not received in a taxable year. Therefore, if a taxpayer has the right to receive a deferred bonus or to continue to defer it, there is immediate taxation because there is constructive receipt. Similarly, if a taxpayer has the right to receive a bonus in an immediate lump sum or in ten equal annual installments, the taxpayer is taxed immediately on the lump sum value even if the taxpayer chooses the ten years of installments. This is because the taxpayer had the right to immediately receive all of the funds. In applying the constructive receipt rule, it is irrelevant whether property was set aside or whether we are dealing only with the employer's unfunded promise to pay. Once there is an immediate right to cash in on the unfunded promise, it is taxable.
- iii. Tax treatment of the employer. The focus of this discussion has been on when the employee is taxed. The employer gets a deduction only in the year that the employee is taxed. Code § 404(a)(5). Therefore, the employer pays a price for having a non-qualified plan, namely the loss of an immediate deduction.

Effective on and after October 2004

In October 2004, Congress added a new provision to the Code, Section 409A. Section 409A added a number of restrictions for non-qualified deferred compensation that accrues after December 31, 2004, and in some cases prior thereto. The primary focus is on constructive receipt, adding a number of statutory restrictions including the following:

1. An election to defer compensation must be made prior to the beginning of the calendar year in which the compensation otherwise would be taxable.
2. The deferral election must specifically identify the times or events to which the taxation of the compensation is deferred, which can only be termination of employment, death, disability, a specified date, extreme hardship or a change in the control of the employer.
3. Once the deferral election is made, the time for payment of the compensation can never be accelerated. It can be further extended, but only for a minimum of 5 years from the date otherwise payable, and subject to the satisfaction of other conditions.

Section 409A also added some restrictions on the ability to use a Rabbi Trust (see below), although its primary focus is on constructive receipt. The consequences of failing to satisfy the requirements of Section 409A are onerous: immediate taxation, the payment of back interest, and the payment of what is in effect a 20% penalty on the tax.

One interesting provision that accompanied Section 409A, and is elsewhere in the Code, is that compensation that is deferred eventually will have to be reported on Form W-2 in the year earned, even though the tax is deferred. This will be a new burden on employers, but will provide the IRS with information on deferred compensation that until now has not been available. This requirement too has been put off repeatedly, and was still not in effect as of 2009.

Section 409A has had an enormous impact on the way practitioners draft and review executive compensation agreements, even though the provision did not fundamentally change the basic deferred compensation concepts discussed in this article.

Putting ERISA and the Code together

As noted above, ERISA requires all employee pension benefit plans, other than top hat plans, to have a trust fund. The Code, on the other hand, taxes non-qualified deferred compensation immediately if a fund has been set aside and the participant has a right to that fund which is not subject to a substantial risk of forfeiture. Therefore, any employee pension benefit plan which complies with ERISA, other than an unfunded top hat plan, will be taxed immediately upon vesting, and will not be a deferred compensation plan at all. As a practical matter, therefore, non-qualified deferred compensation for rank and file employees cannot work. Either ERISA will be violated (because of the absence of a trust) or immediate taxation will result after vesting (because of the existence of a

trust). (Vesting in such a plan would have to occur no later than 5 years out, and perhaps even sooner, under the vesting rules set forth in Section 411.) Thus, as a practical matter, all non-qualified deferred compensation is provided in top hat plans and is limited to “management and highly-compensated employees”.

2. Design and Implementation of Non-Qualified Deferred Compensation Plans

Non-qualified plans are much like qualified plans in their design. They can use either a defined benefit or a defined contribution model, and within each of those models can track closely the various alternative design configurations used in qualified plans. The plan document generally is far shorter, because it does not need to include the substantial number of mandated rules, caps and “boiler plate” provisions that a qualified plan requires. Keep in mind, however, that effective in 2005, Section 409A requires certain “boilerplate” provisions regarding the time of deferral to be included in the plan document.

Non-qualified plans generally will cover a relatively small number of participants because of the top hat limitation. It is quite common for such a plan to only cover one participant. There has been some debate as to whether a program covering only one participant, for example the chief executive officer, is a plan at all, or only an employment agreement, but Section 409A has set forth a broad and inclusive definition of what constitutes deferred compensation. Since the same tax principles apply in any event, we will assume for this article that even a one person program is a top hat plan for all purposes.

Defined Benefit Plans

The most common use of a non-qualified deferred compensation plan of the defined benefit variety is as a supplement to a qualified defined benefit plan. Typically, the purpose is to extend the benefit beyond the Section 401(a)(17) cap (\$270,000 in 2017), and beyond the Section 415 limits (these tend to apply to many fewer people than the 401(a)(17) cap). These plans are often referred to as supplemental retirement plans or SERPS. They are quite simple in that they do not state an independent benefit, but simply indicate that the benefit to be provided under the SERP is:

(i) the benefit that would have been paid under the qualified defined benefit plan were it not for the caps;

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(ii) the amount that is actually paid under the defined benefit plan.

In other respects, the SERP is usually a clone of the qualified plan, although because of constructive receipt concerns there are more restrictions on when the participant must elect the form of benefit and timing of benefit commencement (see *Designing distribution provisions in non-qualified deferred compensation*).

However, a top hat defined benefit plan need not be an adjunct of the qualified plan. It can have its own formula and can be offered by a company that does not have a qualified defined benefit plan. There are no restrictions on the form or amount of benefit, no non-discrimination rules, and no requirements as to vesting. One might say that compared to the highly regimented world of the qualified plan, the non-qualified world is the wild wild west.

Defined Contribution Plans

Many of the observations in (a) above regarding defined benefit plans also apply to defined contribution plans. The design of non-qualified defined contribution plans is a bit trickier. This is because there is an investment component that appears, at first blush, to be inconsistent with the fact that the plan must not be funded. In fact, this simply presents a drafting challenge which is usually surmounted by drafting the plans in terms of “deemed investments”. For example, if a non-qualified defined contribution plan is designed to credit a participant with a contribution of 5% of compensation over the 401(a)(17) limit, the plan can provide that the contribution is credited to a book entry account in the name of the employee which is “deemed” to be invested in certain designated investments. The earnings on those deemed investments are then credited to the participant’s book entry account. No actual investments will be made on behalf of the participant. However, the employer can invest its own money in the identical investments to make sure that it will have sufficient funds to pay up on the unfunded promise. None of this violates the “economic benefit rule” because in fact the participant has received nothing more than an unfunded promise to pay an amount equal to the book entry account (credited contributions plus deemed earnings).

Because of the popularity of 401(k) plans, companies have sought to establish “SERPS” which will supplement 401(k) deferrals which will be limited to the cap imposed by Section 402(g) (\$18,000 in 2017). The SERP will require a separate election, made before the commencement of the year, but it often allow for the deferrals to be deemed invested in the same investments that were actually made in the 401(k) plan.

It should be noted that when a participant elects to defer his or her own compensation into a non-qualified deferred compensation plan, he or she is taking an economic risk, since this election essentially amounts to

giving compensation back to the employer who paid it in the first place, and assuming that the employer will be solvent and able to pay it again later.

Designing distribution provisions in non-qualified deferred compensation

The constructive receipt rule severely limits the flexibility of distribution provisions in top hat plans. While a qualified plan can permit distribution on demand, at least after termination of employment, and can offer a choice of a lump sum, installments or an annuity right up until the commencement date, non-qualified plans would violate the constructive receipt rules if they contained such provisions.

Prior to the passage of Section 409A, the official IRS position, that the benefit commencement date and the form of benefit should be fixed before the services with respect to which they are paid have been performed, was contained in a revenue procedure, Rev. Proc. 92-65. The rule set forth therein was that if an election was permitted, it must be made at the commencement of participation.

Many plan drafters did not design their plans this strictly, taking comfort from the more liberal, although relatively sparse, case law. Some plans required elections up front, but permitted changes if they were made prior to a set period (at least 6 months and usually a year) before termination of employment. Some plans provided that the benefit would be the same as the elected form of qualified plan benefit (a “mirror form.”) (This author believed that such a provision might create constructive receipt issues, because accelerated payment could be payable on demand by making a qualified plan election.) Some plans allowed an accelerated lump sum in return for a “hair cut” (a modest reduction, 5 to 10 percent, of the benefit), the theory being that the hair cut was a sufficient penalty to keep constructive receipt from being applied. All of the design ideas involved business risks, because they were inconsistent with the official IRS position, but nevertheless they were common.

Section 409A changed the design of distribution provisions for deferrals that occur after December 31, 2004. For such deferrals, the specific provisions of Section 409A, set forth above, must be incorporated in the plan document and complied with, or onerous tax consequences will result.

Reporting and disclosure

One of the joys of top hat plans is that they are subject to virtually no reporting requirements. The only filing requirement is a one time “registration” with the Department of Labor that contains almost no

substantive information. There are no Form 5500 annual reports to be filed with the IRS or the Department of Labor, and no summary plan description requirement. As noted above, however, eventually (once rules are promulgated), deferred compensation will have to be reported on Form W-2 in the year of deferral.

Golden Parachutes

It is quite common for corporations to promise executives additional deferred compensation which is contingent on a change of control (such as a merger or acquisition the effect of which will be that the current management is no longer in control). These extra benefits are colloquially referred to as golden parachutes. The theory behind offering executives golden parachutes is that it helps establish an “even playing field” whereby management can make a dispassionate judgment about whether an acquisition is a good idea without worrying about whether it will adversely impact their own lives.

Congress was concerned that there were some abuses in the practice of offering large golden parachutes, and in 1984, passed two statutes (Code §§ 280G & 4999) which impose an extra 20% tax on “excess parachute payments”. Whether an excess parachute payment exists is determined by adding up all of the extra benefits payable as a result of a change of control, and comparing them to the executive’s final average compensation. If the total parachute package is greater than 3 times final average compensation, then, with respect to everything over 1 times the final average compensation, (i) a deduction is denied to the employer, and (ii) a 20% tax is imposed on the executive. The above is the short plain language explanation, but in fact, the rules are very complicated, and leave a fair number of questions unresolved.

One might have thought that the promulgation of these statutes would have resulted in few corporations offering golden parachutes in excess of 3 times final average compensation. While some corporations have reacted in this way, many others have continued to offer golden parachutes in excess of these limits, agreeing to pay, in addition to the golden parachutes, all of the excess parachute taxes that will be imposed on the executive, and a gross up payment to fund the extra income tax the executive will have to pay as a result of the corporation’s payment of the excess parachute tax. This result is probably not what Congress envisioned. Instead, it demonstrates the reality that when top management “negotiates” a deferred compensation package with its corporate employer, there may not be the kind of arm’s length bargaining that controls costs on behalf of shareholders.

3. Funding the Unfunded Promise – The Rabbi Trust

The requirement that a top hat plan be unfunded is a serious negative aspect of such plans. For small employers in service businesses, which do not have a great deal of capital, it may be too great a risk for an executive to assume that when the deferral period ends, there will be sufficient funds to pay the benefit. Even in larger, better capitalized companies, executives become concerned when they realize how little assurance they have that a benefit will ultimately be paid.

For this reason, practitioners have explored the extent to which some kind of security can be achieved without causing the plan to be funded and thereby lose its top hat status. Remarkably, it was a religious institution, a Jewish synagogue, that “devised” what has become the most common device for “funding” the unfunded promise, namely the Rabbi Trust.

A Rabbi Trust is a grantor trust (that is, a trust which is treated as if it were the employer’s asset) pursuant to which the trustee holds the assets and distributes them to the participants in accordance with the terms of the underlying top hat plan. Typically, the trust is irrevocable, that is once the funds have been contributed by the employer they cannot be withdrawn. The one catch, and an important one, is that if the employer becomes insolvent, the assets of the trust will be used to pay all creditors of the employer rather than the participants of the top hat plan.

The pioneer “Rabbi Trust” was submitted for a private letter ruling, asking the Treasury to find that, because the funds would be available to creditors in the event of insolvency, it was as if there was nothing more than an unfunded promise to pay, and therefore neither the economic benefit principle nor the constructive receipt principle was violated. The Treasury agreed, and the Rabbi Trust was born. The Treasury has subsequently issued a revenue procedure, and a model Rabbi Trust, and it is now quite common for companies to routinely institute Rabbi Trusts to go along with their top hat plans.

In recent years, it has become common for the third party administrators who offer 401(k) programs to also offer top hat 401(k) SERPS which incorporate Rabbi Trusts. The two plans are integrated seamlessly, with the same investments being used for each program. It can almost seem as if an executive’s 401(k) assets and top hat assets are of the same nature. If the executive reads the fine print, however, she or he will realize that the top hat assets are held in a Rabbi Trust, subject to the claims of the employer’s creditors in the event of an insolvency.

Section 409A, discussed above, added some very modest restrictions on the use of Rabbi Trusts. First, it made the funding of a Rabbi Trust with off shore assets a violation of Section 409A. Second, it

eliminated a design feature whereby a Rabbi Trust would automatically become a fully funded taxable trust if the employer's financial results fell below a certain level. Neither of these practices was common, so the impact of these provisions is very minimal.

If Rabbi Trusts do not protect participants in the event of the employer's insolvency, and insolvency is the most significant risk for an unsecured creditor, then why are they popular? One answer is that they protect against a solvent but recalcitrant employer, eliminating the need to bring a lawsuit to collect benefits. Another answer is that they provide some emotional comfort, even though from a rational, analytical point of view, they may not be worth the trouble.

4. Equity Based Compensation

As mentioned at the outset of this article, for many corporations, compensation which is based on the value of the stock of that entity may be a critical part of the total compensation package. The most typical form of equity based compensation is the stock option. This is a right to purchase a certain number of shares of stock at a set price (the "strike price") for a certain period of time. For example, on March 1, 2016, an employee of XYZ Corp. might be granted an option to buy 100 shares of XYZ stock for \$50.00 per share (the market price on March 1, 2016) at any time up to February 28, 2021. The value, of course, is that if that price increases, the employee can buy for a discounted price.

The Code permits two different types of stock option programs, commonly known as Incentive Stock Options and Non-Qualified Stock Options. Incentive Stock Options are subject to relatively strict regimentation under Code Section 422. The legal requirements are substantial, and include the following:

1. A formal plan approved by shareholders; under which options may be granted not later than 11 years after adoption;
2. A maximum exercisability period of ten years from date of grant;
3. A strike price not less than the fair market value on the date of grant; and
4. A minimum (1-2 years) holding period for stock purchased.

The tax treatment of Incentive Stock Options is quite attractive. The grant of the option is not a taxable event. Similarly, upon exercise of the option (that is the purchase of the share at the strike price), there is no taxable event, rather the tax basis of the purchased share is the price paid. Then, upon sale, there is a taxable capital gain. In other words, by

exercising the Incentive Stock Option, but not selling the shares, the employee can defer income indefinitely.

Non-Qualified Stock Options are not subject to the restrictions applicable to Incentive Stock Options. Notably, the strike price can be less than the fair market value, the duration can be longer than 10 years, and there is no requirement of shareholder approval. The tax treatment of non-qualified stock options, however, is less favorable. There is no taxation upon the grant of the option. However, when the option is exercised, the difference between the strike price and the then fair market value is immediately taxed as ordinary income. Any further gain is treated as capital gain, and is only taxed when the shares are sold.

Section 409A, discussed above, does not apply to stock options if the strike price is not less than the fair market value of the stock on the date of grant. Otherwise, Section 409A does apply, and the effect is an automatic violation of Section 409A because the exercise of a stock option can be elected at the discretion of the employee. As a result, stock options granted with a strike price that is “in the money” will almost certainly disappear.

Stock options are not the only form of equity based compensation. An outright grant of stock is also a possibility. In the case of a grant, there is no special tax deferral; ordinary income tax occurs on the date the shares are granted. Any further gain is treated as capital gain, and is deferred until there is a sale.

There are several reasons why stock options have been a favored form of deferred compensation. First, the accounting consequences of stock options have been more favorable than other forms of non-qualified deferred compensation; unlike the forms of deferred compensation discussed earlier, the transfer of value does not need to be shown as a liability on the employer’s financial statement. This treatment was being changed however, and stock options have to be “expensed like other forms of deferred compensation.” A second reason is that shareholders are more willing to let executives amass valuable benefits if the amassing is in conjunction with the rising value of the stock of the employer. Finally, for tech, internet and IPO companies, they appear to be a major way (perhaps THE major way) of attracting talent.

5. Life Insurance - No Longer an Effective Deferral Tool

The final form of deferred compensation that we will examine is life insurance. Most people think of life insurance as a contract with an insurance company to pay a benefit upon the death of the insured. In fact, however, in many life insurance policies known as “whole life” or “universal life”, this promise to pay a death benefit is combined with an investment fund, sometimes known as “cash value”. Generally, the

owner of a life insurance policy has the right to name a beneficiary who will get the death benefit, and also has the right to take certain actions to make use of the cash value that builds up over the years.

Prior to 2004, life insurance could be used as an effective means of providing deferred compensation by having an employer and an executive enter into an agreement known as a split-dollar life insurance agreement. Essentially, the ownership of the policy, both with regard to the death benefit and the cash value, was split up. In a typical split-dollar arrangement, known as equity split dollar, the employer would pay the entire premium, and would have the right at all times to receive back the aggregate premiums it had paid, either from the death proceeds if death occurred, or from the cash value that built up. The executive was given the right to name a beneficiary for that portion of the death benefit which exceeds the aggregate premiums (generally this is most of the death benefit), and in addition would have the right to any cash value in excess of the aggregate premium.

In the initial years of an equity split dollar agreement, there generally was not much excess cash value, but as the years went on, the cash value could become much greater than the aggregate premiums. Thus, after 20 years, for example, the executive might find that the excess cash value was a huge amount which the employer had paid for, but which was now the executive's property, even though no tax had been assessed. (There was a relatively small tax on the current insurance protection, but none on the cash build up.) This certainly looked a lot like deferred compensation, but the government viewed it as life insurance, and did not tax it as deferred compensation (the principles of economic benefit and constructive receipt do not apply to life insurance).

An obvious question was, when, if ever, the executive would be taxed on this build-up of cash value. The answer was elusive. If the policy was cashed in, and the executive actually gets the excess cash value, there is no question that the excess is subject to income taxation. If, however, the executive accessed the excess cash value by taking loans as permitted under the policy, it might be that income taxation never occurred. At death, the death proceeds pay off any loans, and the remaining insurance proceeds go to the employer (to pay back the premiums) and to the beneficiary, in each case income tax free.

Split-dollar life insurance arrangements were widely used by "for profit" corporations, often not as an alternative to deferred compensation, but as an adjunct to it. For non-profit corporations, which have fewer options for providing deferred compensation (see the discussion of Section 457 below), equity split dollar agreements, as described above, were an attractive alternative.

The IRS had made noises about changing the split dollar rules for a long time, but finally in 2003 issued regulations that essentially have closed down this form of compensation for new arrangements (those entered into after January 28, 2002.) As a result, now one of two treatments will apply. Either the employer will be seen as having made a tax free loan of the premium to the employee (resulting in immediate taxation each year), or the equity build up will be currently taxable each year. Neither is an attractive result for deferred compensation planning. Curiously, the IRS has left all of the prior ambiguity in place as to the treatment of split dollar arrangements entered into prior before January 28, 2002, so the above description may still be relevant with respect to many split dollar arrangements.

6. The Special Problems of Non-Profit Corporations and Governments

While “for profit” corporations can offer executives top hat plans, as described in the previous sections of this article, non-profit corporations and government entities are subject to stricter rules. Presumably, this is because Congress perceives that in the case of “for profit” corporations, there is a natural tension between the executive’s desire to defer income and the corporation’s desire to obtain a current deduction, and that this tension keeps both parties honest in negotiating the extent to which compensation is deferred. With non-profits and governments, however, deductions are of no importance, and therefore Congress perceived the need to have stricter restrictions on the deferral of income. This goal was achieved by the enactment of Section 457 of the Code, which established strict limits on the extent to which income can be deferred by employees of non-profit organizations.

In general, under Section 457(b), the annual amount deferred per individual cannot exceed an amount equal to the Section 402(g) cap (\$18,000 in 2017) and it must be deferred in accordance with the regimented requirements set forth in Section 457, which are not consistent with the kind of deferrals that executives desire. Section 457 covers all deferred compensation offered by non-profits and governments, whether in defined benefit or defined contribution form. Section 457(b) “plans” for non-profits share some features with the Section 457(b) plans that are available to government employees. But there are important differences, including that the governmental plans are funded with a trust and available to all employees, while non-profit 457(b) plans are unfunded and limited to management and highly compensated employees.

Other than 457(b) plans, Section 457 offers a narrow corridor within which executive deferred compensation may be granted. Under that section, if a deferred compensation plan does not comply with the statutory requirements, commonly referred to as “Section 457(f) plans”,

taxation will occur as soon as the promised benefits are no longer subject to a risk of forfeiture, in other words when vested. Even an unfunded promise to pay, once vested, is immediately taxable. The narrow corridor, therefore, is to design a plan that delays vesting until payment is to be made. While this is workable in some circumstances, it requires an executive to take the risk that she or he will terminate employment prior to vesting, and never get the benefit.

The limitations on non-qualified deferred compensation for non-profit entities that have highly paid executives (universities, hospitals, large foundations and the like) have caused these entities to struggle with these restrictions. They have had to use a variety of make-shift devices to provide their executives with any close equivalent of what private sector executives can receive in the way of non-qualified deferred compensation. Among the tools used are benefits that do not vest until paid (discussed above), severance programs which make substantial payments upon involuntary termination, split-dollar life insurance (discussed above) and stock options (discussed above). The use of stock options may seem surprising, since non-profit entities of course do not have stock. Instead the non-profit offers an executive options in someone else's securities, either the stock of another corporation or mutual fund shares.

Guidance in recent years from the IRS has eliminated the utility of split-dollar life insurance and stock options, and Section 409A and the guidance issued thereunder have made it more difficult to design a program that relies on delaying the risk of forfeiture. At least in this regard, executives of non-profit entities remain a disfavored class compared to their peers in the for profit world.

7. Conclusion

In a perfect world, from Congress' perspective, the special incentives it has embedded in the Internal Revenue Code for qualified plans would render non-qualified deferred compensation extinct. But instead, the numerous restrictions, tests and caps it has imposed on qualified plans have encouraged the growth of discriminatory top hat plans. Has Congress achieved the right balance, or would it be better off relaxing the caps and getting executives more focused on qualified plans, as they were in the distant past? This is a very difficult question to answer, but one that is worth pondering.

Chapter XI

A POET'S GUIDE TO PREEMPTION

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1. Introduction

In this chapter, we will examine ERISA's so-called preemption provision and the impact it has had on employee benefits law. As a starting point, it is useful to remember that whenever a federal statute is passed, it will automatically supersede any state law that is inconsistent with its provisions. This result flows from the Supremacy Clause of the United States Constitution.

Therefore, when Congress chose to add a specific preemption provision to ERISA in 1974, it presumably chose to go beyond the automatic effect of the Supremacy Clause. Congress included, in ERISA, Section 514 of Title I, a provision that on its face appears somewhat innocent and uncontroversial. The fact is that it has resulted in a tremendous amount of litigation over the years, and has impacted the way that employee benefit plans, especially medical [welfare benefits/healthcare] plans, have developed over the last 3 decades.

2. Section 514

The actual preemption rule appears in Subsection (a) of Section 514, which provides that the provisions of Title I and Title IV of ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan...." For purposes of the provision, "State law" is defined to include "all laws, decisions, rules, regulations, or other State action having the effect of law, of any State." Notably, this definition includes a state's common law as well as its statutes and regulations. We will discuss below the impact of the inclusion of common law on ERISA litigation.

The remainder of Section 514 contains a number of exceptions. The most important exception, relating to insurance, banking and securities laws, Section 514(b)(2), will be discussed below. Other exceptions include the generally applicable criminal laws of a state, Section 514(b)(4), and qualified domestic relations orders issued in a state proceeding, Section 514(b)(7). We will discuss qualified domestic relations orders in a separate chapter.

The preemption of state law on its face is broad and sweeping, rendering ineffective any state law that "relates" to an employee

benefit plan. Since ERISA, while fairly comprehensive, does not proactively govern all aspects of employee benefit plans, Section 514, read literally, keeps states from governing even those aspects of employee benefit plans that are left ungoverned by federal law. In the sections below, we will examine briefly the actual impact of Section 514 on state law to see how literally Section 514 has been interpreted.

3. Impact - State Law Regulating Employee Benefit Plans

The simplest application of Section 514 is to state statutes specifically intended to govern any aspects of employee benefit plans. With one major exception, these laws are ineffective. A search for state statutes governing pension plans, 401(k) plans, deferred compensation programs, or severance programs, will generally come up empty, or only produce old statutes that are no longer enforced.

This exception also applies to health and life insurance programs, an area where state laws are still relevant and enforced. This is because of a specific statutory exception contained in Section 514(b)(2). Section 514(b)(2)(A) provides that "nothing in this title shall be construed to exempt or relieve any person from any law of any State which regulates insurance, banking, or securities." This has been an important exception because traditionally, two of the most important benefits generally provided by employers, health insurance and life insurance, were provided by insurance, and therefore would still be subject to state law. Specifically, Section 514(b)(2) allows states to continue to regulate the procedural and substantive aspects of health insurance and life insurance programs. State regulation of insurance is not theoretical; most states have a great deal of statutory material regarding the way health and life insurance programs are provided, including provisions relating to the content of such insurance, e.g. mandating the inclusion of mental health coverage in a health insurance program.

The insurance exception described above has an important exception, sometimes referred to as the "deemer" clause and contained in Section 514(b)(2)(B). This exception provides that an employee benefit plan shall not "be deemed to be an insurance company or other insurer, bank, trust company, or investment company or to be engaged in the business of insurance or banking for purposes of any law of any State purporting to regulate insurance companies, insurance contracts, banks, trust companies, or investment companies." This somewhat wordy exception to the insurance exception means that while a state can regulate insurance without running afoul of ERISA's preemption provision, it cannot regulate benefit plans merely because those plans have some aspects of providing insurance. Translated into practical terms, if a health plan

is self-insured, i.e. does not enter into an insurance contract with an insurance provider, then it cannot be regulated by state law.

The most important effect of the insurance exception contained in Section 514(b)(2)(A) and the exception to that exception contained in Section 514(b)(2)(B) has been to bifurcate health insurance plans into programs that utilize traditional insurance and those that are self-insured. The former are subject to state governance, and the latter are not. Many people in the health care business refer to self-insured plans as "ERISA plans" to signify that they are only subject to governance by ERISA and not by state law. This is a misnomer since insured plans are also ERISA plans in that they too are governed by ERISA. They are simply subject to state law in addition to ERISA.

Over the three decades since the passage of ERISA, there has been a significant trend toward self-insured health plans. While seeking freedom from state law and regulation may not be the only reason for this trend, it is certainly a significant factor.

4. Application of Preemption to Statutes with a More General Purpose

Section 514(a) is crafted in such a way that, in application, it sweeps beyond state laws designed to govern or regulate employee benefit plans. Thus, for example, statutes dealing with:

- whether the right to reimbursement of an individual covered by health insurance can be subject to subrogation by an automobile insurer;
- whether benefit payments under an employee benefit plan are subject to escheat by a state when the participant cannot be found; and
- whether taxes can be imposed on the sponsor of, or the assets of, an employee benefit plan;

have all been the subject of preemption litigation. While the case law is voluminous, and not easily rationalized, some sweeping generalizations are helpful even if they cannot be totally defended.

Until 1995, the general attitude toward preemption, evidenced in several U.S. Supreme Court decisions, was that Section 514(a) was intended to be interpreted very broadly, rendering ineffective any statute "related to" an employee benefit plan. These cases interpreted "related to" to mean having any "reference to" an employee benefit

plan, or "connection with" an employee benefit plan. Under this rationale, statutes with focuses that were broader and more general than just employee benefit plans could still be caught in the ambit of Section 514(a) because they had a "connection with" the operation of an employee benefit plan.

In 1995, the U.S. Supreme Court decided New York Conf. v. Travelers Ins. Co., 514 U.S. 645. At issue was a New York statute which required hospitals to collect surcharges from patients covered by commercial health insurers but not from patients insured from Blue Cross/Blue Shield plans. The surcharge statute was a very important element in the way in which New York funded health care for the indigent. Both the District Court and the Court of Appeals, relying on earlier decisions of the U.S. Supreme Court, held that the statute was preempted because it "related to" employee benefit plans. Taking a different approach, the Supreme Court, in a unanimous decision overriding the lower courts and upholding the statute, declared that its previous analysis of the phrase was unhelpful, and announced that instead courts must look to ERISA's objectives as a guide to the scope of the state laws that Congress intended to preempt.

The New York Conf. v. Travelers Ins. Co. decision is of tremendous significance. While the area still may be murky, there is now a much greater chance that state legislation that is not specifically focused on controlling the operation or substance of employee benefit plans will be permitted to escape Section 514(a) preemption.

5. Impact on Common Law

As noted above, Section 514(a), in preempting "State law", preempts not only state statutes and regulations, but also preempts the common law of the state. This means that where cases relating to employee benefit plans plead causes of action based on state common law principles or ask for state common law remedies, those causes of action and remedies are preempted. Plaintiffs are instead limited to the causes of action and remedies provided under Title I of ERISA.

We will wait until a subsequent chapter to discuss in more detail the causes of action and remedies permitted under ERISA (notably Section 502 of ERISA which addresses this subject), but suffice it to say that the ERISA rules on who may be a plaintiff, who may be a defendant, and what causes of action and remedies are permitted, are all extremely limiting.

The limitations on suits and remedies contained in ERISA, combined with the application of the preemption doctrine, leave many a "worthy" plaintiff with no effective cause of action or remedy.

Over the last thirty years, courts have struggled with questions such as whether a non-fiduciary can be sued at all in the context of the operation of an employee benefit plan, and whether malpractice suits against doctors, lawyers, accountants and actuaries, in the context of employee benefit plans, are prohibited. Believe it or not, after almost three decades, there are still a lot of gray areas regarding these and other litigation issues, all caused in part by the seemingly innocuous language of Section 514(a) of ERISA.

6. Concluding Thoughts

As noted earlier in this text, ERISA was a comprehensive statute designed to address abuses and shortcomings in the provision of employee benefits by employers to employees. In many ways, it has been a great success. Yet the inclusion of Section 514(a) ironically appears to have worked in the opposite direction. First, it has limited the ability of states to protect employees, even in areas like health care where ERISA did little in the way of governing the content of such plans. Second, it has eliminated many useful state causes of action, leaving only ERISA causes of action whose narrowness appear to have been more protective of plan sponsors than plan participants.

It is hard to imagine that the proponents of ERISA had this effect in mind. Yet it is worth noting that Congress has had almost thirty years to make changes to Section 514, and has only done so around the fringes. Whether the preemption rule of Section 514(a) is benign or destructive is a politically charged issue best left up to the individual reader. The only safe prediction for the future is that there will continue to be a lot of case law regarding the scope of Section 514.

Chapter XII

A POET'S GUIDE TO WELFARE BENEFIT PLANS AND CAFETERIA PLANS

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This article will focus on the portion of an employee benefit package which is neither a pension benefit nor deferred compensation. It is a broad and amorphous category, although the important components are quite narrow: health benefits, dependent care benefits and life insurance. We will first examine the coverage of welfare benefit plans under Title I of ERISA, and then the treatment of the same programs under the Internal Revenue Code. Unlike the pension area, where there is a fair amount of coordination between Title I and the Code, for welfare benefit plans these worlds are totally separate. Finally, we will examine the very important topic of the Section 125 cafeteria plan, a unique feature of the Internal Revenue Code which permits employees to pick and choose among welfare benefit plans without incurring adverse tax consequences.

1. Welfare Benefit Plans Under ERISA

Title I of ERISA defines an employee welfare benefit plan to include, among other programs, medical plans, group life insurance plans, and dependent care programs. The statutory definition is very broad. Regulations have been promulgated to narrow the scope of the definition to exclude items that are simply payroll practices, on-site facilities, holiday gifts and remembrance funds.

While Title I of ERISA defines welfare benefit plans, it does very little in the way of regulating them. Certain reporting and disclosure requirements apply to welfare plans. Summary plan descriptions must be provided, and Form 5500s must be filed, although typically only if the plan has more than 100 employees. In addition, the fiduciary rules in Part 4 of Title I and the rules regarding causes of action and liability in Part 5 apply to welfare plans. Finally, the preemption rules of Part 5 apply to welfare plans to the same extent that they apply to pension plans, and this has caused a tremendous amount of litigation over the decades since the passage of ERISA.

Congress chose, however, to avoid most substantive issues of welfare plan design in Title I. Notably, neither funding, vesting or discrimination is addressed. There is no requirement that a welfare plan be funded. Welfare plans can be provided through insurance or they can be self-insured. If they are self-insured, then the benefits can be provided out of the employee's own funds without setting up a trust. Presumably,

if the plan is funded then a trust must be established, although in practice the Department of Labor has not required a trust even in the very common situation where employees voluntarily reduce salary to take part in welfare plans.

Next, there are no rules regarding the vesting of welfare benefits. Section 510, which prohibits an employer from interfering with the attainment of a right under a plan, has been found in case law to be applicable to welfare plans. Yet the almost universal consensus is that welfare benefit rights do not vest, and that Congress' silence on the matter of vesting rights meant that there are no such rights.

Finally, Congress chose to stay away from regulating participation or coverage in Title I of ERISA. These issues are covered to some extent under the Internal Revenue Code, and as we shall see, the rules vary significantly from one type of welfare plan to another.

2. Welfare Plans and the Internal Revenue Code

The Internal Revenue Code does not use the term “welfare plan” but instead offers tax incentives with respect to a variety of these programs, as well as requirements that must be met to take advantage of the incentives. There is no uniformity, and very little coordination, among the various rules that will be discussed in this section. In the late 1980s, a flawed attempt was made to promulgate a comprehensive non-discrimination rule that would apply to the aggregate of all welfare benefit programs offered by an employer. Congress actually passed a statute, embodied in Section 89 of the Internal Revenue Code, and the Treasury spent a great deal of energy promulgating regulations to implement the rules contained in Section 89. As the effective date of January 1, 1989 approached, it became apparent to everyone, except perhaps the Treasury, that these rules were far too complex for mere mortals to understand and obey. In what amounted to a virtual taxpayer revolt (although it looked much more like a sophisticated lobbying effort than the Boston Tea Party), Congress repealed Section 89 before it ever came into effect. While initially it was thought that a follow-up attempt might be made to implement a simpler uniform non-discrimination rule, this never happened. We are therefore left with separate uncoordinated rules for separate programs.

Medical Programs

Sections 105 and 106 of the Code provide a very significant tax subsidy for medical programs (this term includes medical insurance, dental insurance and eye care.) Section 105 provides that amounts used to pay for covered medical expenses, whether paid by a third party (such as an insurer) pursuant to an employer sponsored medical program, or

directly by the employer, and whether paid directly to a provider or to an employee to reimburse her or him for payments to a provider, are NOT included in taxable income. Section 106 of the Code provides that an employer's payments to a medical program are not included in gross income. Together, these two sections provide an exclusion from gross income for the value provided by an employer towards medical coverage, whether it is the premiums or the actual medical payments.

This tax benefit should not be taken for granted. It is an exception to the general rule that any property of value provided by an employer to an employee is included in gross income. This exclusion, or subsidy, actually results in the second largest loss of revenue under the federal income tax system, second only to the pension subsidy. It is larger than the home mortgage deduction or the reduced capital gains rate.

Section 105 of the Code contains a non-discrimination rule with respect to medical plans that is easy to state, but hard to understand and apply to the current world of medical benefits. The rule is that insured plans are not subject to any non-discrimination rules, either with respect to eligibility or coverage, but that self-insured plans cannot discriminate in favor of highly compensated individuals. This limited non-discrimination rule with respect to self-insured plans was promulgated in 1979, and has been virtually unchanged since that time. Regulations are fairly clear to the effect that a plan which is self-insured up to a stop loss, and insured over that amount, is considered a self-insured plan.

To understand the rationale for the above non-discrimination rule, it is important to remember that in 1979, virtually all medical plans were insured. The self-insured programs that this special non-discrimination rule sought to attack were very limited programs established by small businesses such as law firms and accounting firms which were trying to get a special tax break for medical payments that would otherwise have been made out of pocket by the owners.

The rule provides that if either eligibility or benefits are discriminatory, then the benefits received by highly compensated individuals are taxable. The mechanics of the discrimination test are beyond the scope of this article, but suffice it to say that many of the concepts (for example the definition of "highly compensated individual" and the way in which the eligibility discrimination test is run) are out of sync with the current nondiscrimination tests that are used for pension plans.

The problem with this special limited nondiscrimination rule is that the universe to which it applies is no longer very limited. A great many broad-based medical plans today are self-insured. Probably most of these plans would pass the eligibility non-discrimination test set out in Section 105. In addition, most of these broad-based plans do not provide

an extra level of benefits for any individuals, let alone highly compensated individuals, and therefore would pass the nondiscriminatory benefits test as well. It does appear, however, that this is a test that is not being run every year by every company, and that the IRS does not appear to be reviewing employer compliance with the provision.

Dependent Care Assistance Programs

Tax incentives for dependent care expenses are a more recent addition to the Internal Revenue Code. A tax credit, now under Section 21, was added in 1976, and an exclusion from gross income of payments made by an employer, pursuant to Section 129, was added in 1982. These incentives have become more and more important: 13 million children are now in daycare, and 2/3 of all mothers with children under age 6 are in the workforce. Both the tax credit and the exclusion from income relate to payments for daycare that are made with respect to children under the age of 13, other dependents who are physically or mentally incapable of caring for themselves, and the spouse of the taxpayer if such spouse is physically or mentally incapable of caring for him or herself. The expenditures must be made for the purpose of enabling the taxpayer to be gainfully employed. There are a plethora of rules regarding what type of care will be eligible for the exemption or the exclusion; these are beyond the scope of this article.

The tax credit, which can be as high as 30% (35% beginning in 2003) of the amount expended (if the taxpayer's adjusted gross income is \$10,000 or less) but gradually descends (by 1% for each \$2,000 of additional adjusted gross income) to as low as 20% is generally more favorable for taxpayers in the lowest tax brackets. In any event, the amount of expenses that can be used to compute the credit is limited to \$2,400 (\$3,000 in 2003) if there is one dependent, and \$4,800 (\$6,000 in 2003) if there are two or more dependents. The amount of the credit (for example 20% of \$4,800 equals \$960) is simply subtracted from the tax that would otherwise be paid by the taxpayer.

The exclusion from income provided under Section 129 of the Code will be of greater value to the majority of taxpayers who use paid dependent care. In order for a taxpayer to get this exclusion, the employer must adopt a dependent care assistance program pursuant to which the employer uses its funds to reimburse dependent care expenses. The maximum amount that may be excluded from income for dependent care services provided during a taxable year is \$5,000. In other words, if the employer provides more than \$5,000 toward dependent care, the employee will incur taxable income for such excess.

An employer sponsored dependent care assistance program must satisfy four distinct non-discrimination tests in order for the exclusion

from income to apply. Two of these are general in nature, and two are quite specific.

1. The group of employees who are eligible to participate under the plan must not discriminate in favor of highly compensated employees (the pension plan definition of highly compensated employee is used for Section 129.)
2. The contributions or benefits provided under the plan may not discriminate in favor of highly compensated employees.
3. Not more than 25% of the amounts paid or incurred by the employer during the year may be provided for individuals who are 5% owners, or their spouses or dependents. Note that this non-discrimination test focuses on ownership, rather than compensation levels.
4. The average benefits provided to employees who are not highly compensated employees must be at least 55% of the average benefits provided to highly compensated employees. This test will generally be met by providing that any amounts paid which turn out to be over the limit for highly compensated employees will be taxable income not subject to the exclusion. If benefits are provided through a salary reduction agreement, non-highly compensated employees whose compensation is less than \$25,000 may be excluded from this test.

While the first two of these tests generally can be met by simply designing the plan on an egalitarian basis, the last two tests are result-specific and definitely can impact the extent to which benefits can be provided to highly compensated employees and owners.

Group Term Life Insurance

A third type of welfare benefit program that gets a special tax advantage under the Code is group term life insurance. This incentive, which predates ERISA by many years, is very limited in scope. Essentially, Section 79 provides that an employee is only taxed on the excess over the cost of \$50,000 of such insurance; the cost of the first \$50,000 is excluded from income. The Treasury provides tables for the cost of such insurance, and that table cost, rather than the actual cost, is used to determine the amount that is taxable.

There is an elaborate non-discrimination rule that prohibits discrimination in favor of key employees (as defined in the top-heavy rules of Section 416 of the Code), with respect to either eligibility to

participate in a group life program, or the type and amount of benefits available under such program.

In the real world, group term insurance is typically provided either automatically as a multiple of compensation (for example, “2 times compensation”), or on an elective basis in a cafeteria plan, as described below. In either event, the first \$50,000 is excluded from income, and the balance is included, but at the cost provided in the Treasury tables. The individual’s W-2 income is “grossed up” to reflect the Treasury table cost of the excess insurance.

Other Tax Favored Benefits

The three benefits listed above are the most typical ones included in a benefits program, and, as we shall see, in cafeteria plans. There are other tax advantaged welfare benefits under the Code, such as group long term care insurance and group legal services programs. It is possible that these will become more popular in the future, but for the present time they tend not to be an important component of the benefits package.

3. Cafeteria Plans

What is a Cafeteria Plan?

Having reviewed the major categories of tax advantaged welfare plans, we are now ready to discuss the cafeteria plan. A cafeteria plan is not an employee benefit plan at all, but rather a mechanism for allowing a participant to choose among one or more non-taxable benefits and cash or taxable benefits. It is governed by Section 125 of the Internal Revenue Code and goes under a number of different names: “cafeteria plan”, “Section 125 plan”, “flex plan”, “premium reduction plan” and “flexible spending arrangement.” No matter what name is given, the plan will be governed by Section 125, which gives the official title “cafeteria plan” to such plans.

Constructive Receipt

Cafeteria plans would not need to exist except for the concept of constructive receipt, so to understand cafeteria plans it is essential to first understand constructive receipt. Pursuant to the regulations under Code Section 451, a taxpayer is taxed on compensation as soon as it is made available, even if it is not received. Therefore, if a taxpayer has a right to receive cash, and instead, makes an election to use it for some other purpose, the taxpayer will be taxed even though he has not currently received it, and may never receive it. Without a special rule, therefore, an employee who elects not to receive cash compensation but instead to use such compensation for a contribution towards non-taxable welfare

benefits would be taxed on the amount in the year the employee could have received it.

Section 125 provides the sole exception to the constructive receipt rule with respect to such an election. If the provisions of Section 125 are complied with, then an election to have an amount which could otherwise be paid in cash used instead to pay for a non-taxable welfare benefit will result in the avoidance of taxation. This is sometimes referred to as “using pre-tax dollars” because the amounts used to pay for the non-taxable benefits are never subject to taxation.

By contrast, any election to reduce income and instead use the amount of the reduction for non-taxable welfare benefits which is made outside of a cafeteria plan will result in taxable income even if the election is made prior to the year in which the reduction occurs. This is a more rigorous application of the constructive receipt rule than the one used in the deferred compensation world (where constructive receipt is apparently avoided if the deferral election is made before the income is earned), but it is specifically provided in the proposed regulations relating to cafeteria plans. Proposed Reg. 125-2, Q&A 2. The bottom line is that a cafeteria plan is the only way to allow an elective reduction of otherwise taxable income to obtain welfare benefits.

Section 125 Requirements – Formalities

To comply with Section 125, a cafeteria plan must be a written plan document. This requirement is separate and apart from the requirement, in Part 4 of Title I of ERISA, that the welfare plans themselves must be written plan documents. The document should describe the nature and scope of the election offered. Generally, cafeteria plan documents tend to be standardized in nature, and as a result may be taken for granted. In this author’s experience, it is not unusual for a company to be unable to locate a copy of its cafeteria plan, and this is not good, especially on audit by the IRS.

Section 125 Requirements – Limitation on Benefits Which Can be Offered

Section 125 provides that the benefits which can be offered under a cafeteria plan are benefits which are not includible in gross income by reason of an express provision of the Internal Revenue Code. The most common categories are health and accident plans (including traditional medical, dental and vision plans as well as long term disability programs which are less commonly offered under a cafeteria plan), group term life insurance and dependent care programs. Interestingly, long term care insurance, which has recently been added to the list of the welfare

programs that can be excluded from income (see Code § 7702B), is not permitted to be included in a cafeteria plan.

While Section 125 does not specifically state that taxable benefits can be included, the regulations indicate that since cash is an acceptable alternative, a taxable benefit can be included as long as the plan treats it as the equivalent of a cash distribution. See Treas. Reg. § 1.125-2 Q&A 4(b). Of course, the election of such a benefit will result in income taxation as if the participant elected cash.

Interestingly, an elective deferral to a 401(k) plan is a permissible option to be included in a cafeteria plan. In practice, one hardly ever sees a cafeteria plan that includes 401(k) deferrals as an election.

Section 125 Requirements – No Deferral of Compensation

Section 125 of the Code contains the following sentence: “The term ‘cafeteria plan’ does not include any plan which provides for deferred compensation.” Congress clearly articulated its intent that a cafeteria plan is to provide an option between taxable income and non-taxable benefits, not an option to defer income. (As noted above, the permissibility of a Section 401(k) deferral option is an exception.) The regulations make it clear that any design feature which has the effect of deferring the use of the dollars covered by the plan from one taxable year into another will disqualify the cafeteria plan. This is the case even if the deferred amount could only be used for non-taxable benefits in the subsequent year. Essentially, every cafeteria plan must close its books at the end of the year and start fresh at the beginning of the next year. Note: healthcare flexible spending accounts have a limited exception, permitting participants to use funds to reimburse expenses incurred for up to 2 ½ months after the end of the year - see *infra*.

Section 125 Requirements – Non-Discrimination

There are 3 distinct non-discrimination rules in Section 125, one of which relates to key employees (a term borrowed from Section 416, relating to top heavy plans) and two of which relate to highly compensated individuals. Section 125 does not use the qualified plan definition of “highly compensated individual”, but instead has its own statutory definition, which includes officers, 5% owners, anyone who is “highly compensated” (a term which is not otherwise defined, and therefore is somewhat subjective), and the spouses or dependents of any of the foregoing.

The key employee test provides that the non-taxable benefits provided to key employees (see Chapter 3, Section 13 on Top Heavy Plans) cannot exceed 25% of the aggregate of such benefits for all

employees. This is a relatively easy test to apply, and will impact primarily owner-dominated companies.

The highly compensated non-discrimination rules require that the plan not discriminate in favor of highly compensated individuals either as to eligibility to participate, or as to contributions and benefits. These are not precise numerical tests. There are some statutory provisions relating to the application of each of these tests, but these are beyond the scope of this article. Suffice it to say that in the vast majority of cases, cafeteria plans provide for eligibility, and for contributions and benefits, on a non-discriminatory basis, and therefore most companies do not spend a lot of time applying these tests. In addition, it does not appear that the IRS has spent a great deal of effort enforcing compliance with these non-discrimination tests.

The failure to meet any of these tests (key employee or highly compensated) does not result in disqualification of the cafeteria plan, but instead results in the inclusion in income of the elected benefits. While such a result may still have serious consequences, it is an important contrast with qualified pension plans, where a test failure can jeopardize the tax-exempt status of the program.

Salary Reduction Agreements

The employer contributions as to which cafeteria plan elections will be made can be provided in 2 different ways. First, the employer can make a non-elective contribution to the program, and allow each employee to elect whether to use that amount for qualified benefits or to take it in cash. A second and a more common way in which employer contributions are made is by salary reduction agreement. In a manner that is very similar to 401(k) plans, the employee elects, prior to the beginning of the plan year, to reduce his/her salary and have the amount go into the cafeteria plan, where it is used for a qualified benefit. It is this rather extraordinary election, to turn what would otherwise be taxable income in the subsequent year into non-taxable benefits, that is the heart of most cafeteria plans.

Irrevocability of Elections

The regulations under Section 125 go into great detail regarding the requirements for avoiding constructive receipt. Specifically, in order to avoid constructive receipt, elections between cash and qualified benefits must be made before the beginning of the year in which the qualified benefit is provided, and such elections must be irrevocable. This is in contrast to a 401(k) plan which permits elections to be made and changed during the course of the year.

Accordingly, in a cafeteria plan great care is taken to receive all elections prior to the beginning of the plan year, and except as provided below, not to permit any changes in elections thereafter. This is the case whether the election is with respect to an insurance program such as health care or group life insurance or a spending account, see below.

An exception to this rule permits a mid-year change in election for certain changes in family status or in the cost or extent of coverage. These exceptions are governed by comprehensive regulations issued in 2000 and 2001 which offer broad exceptions to the irrevocability rule in almost all of the situations where it would be unjust to deny relief.

Flexible Spending Accounts - General

As previously discussed, the qualified benefits that can be offered in a cafeteria plan include some that are traditionally funded by insurance, and some that are more like defined contribution plans. Among the former, the most typical examples are medical, dental and vision plans, where there is generally a flat amount that the employee must pay as an annual premium, with the employer paying the balance on a non-elective basis. No account is established for the employee in the cafeteria plan; the elected amount is simply reduced from salary by the salary reduction agreement and paid to the provider of the benefit (or to the employer if the benefit is self-funded.) The cafeteria plan is merely a mechanism for delivering the employee's required contribution to what can be described as a defined benefit welfare program: there is no account, and it is the benefit, rather than the employer's contribution, that is defined.

In contrast, it is possible to design a defined contribution welfare plan, where an account is established in a participant's name, from which payments for a particular welfare benefit are made until the account is exhausted. Plans of this nature were rather unusual until the cafeteria plan came along. As we shall see below, the combination of the defined contribution concept and the salary reduction election under Section 125 has proved to be a very attractive combination. The two common examples of defined contribution type programs offered under a cafeteria plan are the dependent care spending account and the health care spending account. Keep in mind that with respect to these programs, there is still an underlying welfare benefit plan, and a cafeteria plan which provides elective funds that go into that program.

Flexible Spending Accounts – Dependent Care

As discussed previously, a dependent care program under Section 129 permits an employer to provide benefits for dependent care assistance that will not result in taxable income. Combined with a cafeteria plan, the program permits an employee to make an election, before the beginning

of the plan year, to reduce his or her salary and have the reduction used to fund dependent care. The reduced amounts will not be subject to taxation if the program satisfies both the cafeteria plan rules and the dependent care rules.

In order to satisfy the cafeteria plan rules, the election to reduce salary and have the amounts go into a dependent care spending account must be made prior to the beginning of the plan year and be irrevocable (unless one of the special rules permitting a change, discussed above, is applicable.) During the course of the year, the amounts reduced from compensation are credited to the dependent care account. The participant submits requests for reimbursement for dependent care expenses as they are incurred during the plan year, and the plan administrator reviews the submissions and pays them if they comply with the requirements of Section 129. Once the salary reduction amounts are credited to the account, they can only be used to pay for dependent care and not for any other purpose. Furthermore, they can only be used to pay for dependent care that is incurred during the plan year of the cafeteria plan. (The actual payment may be made after the end of the plan year.) If any amount is left over, it is lost to that employee and can be used by the employer to fund benefits generally (but not specifically for the employee who lost the money) for the next taxable year. Finally, if a request for reimbursement exceeds the amount in the account at any time, the plan administrator can, and almost always will, refuse to make the payment. In other words, there is no promise to provide coverage beyond the amount in the account at any point in time.

Flexible Spending Accounts – Healthcare

A healthcare flexible spending account operates very much like a dependent care flexible spending account described above. Again, what must be stressed is that the underlying plan must satisfy Section 105 as a healthcare plan. Unlike typical healthcare plans, however, this is a defined contribution plan where the promise by the employer is to reimburse medical expenses only up to the amount which the employee elects to fund prior to the beginning of the year. Note that starting in 2013, the election became limited to a specific dollar amount, the first time that any limitation has been imposed. For 2013, it was \$2,500. For 2015, it increased to \$2,550. For 2017, it has increased to \$2,600. In practice, when the participant incurs a medical expense that would be deductible under Section 213 if it exceeded the 7.5% adjusted gross income threshold, the employee submits such expense for reimbursement and the plan administrator, after reviewing the expense, makes the reimbursement. Prior to 2011, expenses for over the counter medicines could be reimbursed even though such expenses would not be deductible under Section 213 in any event. But commencing in 2011, such

medications could only be reimbursed by an FSA if they were obtained with a prescription.

Like the dependent care flexible spending account, the election to fund the healthcare spending account, once made, is irrevocable (and only some of the special rules permitting a change in election, those relating to change in status rather than change in cost or coverage, apply.). Furthermore, the medical expenses must be incurred during the plan year, although payment can be made after the end of the plan year. Finally, any amount left over in the account at the end of the plan year, or 2 ½ months after the end of the plan year if the plan allows, is lost to the participant, and can be used by the employer to fund the next year's benefits generally (but not specifically for the employee who lost the money).

In one important respect, healthcare flexible spending accounts differ from dependent care flexible spending accounts. Notably, a healthcare flexible spending account must permit the employee to obtain reimbursement for medical expenses up to the full anticipated annual funding of the account, even if the reimbursement request is made at a time when the account does not yet have that amount of money because the salary reduction has not yet occurred. For example, if a participant elects to reduce compensation by \$1,200 for the plan year, or \$100 each month, and then in February has an unreimbursed medical expense of \$1,000, the participant is entitled to have the full \$1,000 reimbursed even though the account, at that point, will only contain \$200. Essentially, the employer becomes an insurer for the balance. The Treasury was concerned that a medical spending account might be perceived as simply a way to get around the rule that personal medical expenses are not deductible until the 7.5% of AGI threshold was exceeded. Apparently, the imposition of this "insurance risk" element at an employer level, along with the requirements that an irrevocable election must be made prior to the beginning of the year and that any balance left at the end of the year must be lost, was felt by the Treasury to constitute a sufficient differentiation from payment of medical expenses by an individual on an "as incurred" basis.

Defined Contribution Health Plans

A flexible spending health care account (FSA) is an example of a defined contribution health care plan, but it is not the only example. In recent years, there has been increased interest in designing health care programs using defined contribution concepts, probably as an attempt to control costs.

In 2002, the IRS indicated that a defined contribution health care plan could meet the requirements of Sections 105 and 106 of the Code. In Notice 2002-45 and Revenue Ruling 2002-41, the IRS described and

blessed a program that utilized an employer funded account that would be used to cover health care expenses until depleted, after which (with an appropriate gap that would be funded by the employee) traditional defined benefit coverage would kick in. The IRS gave a name to this account, a “health reimbursement account” or HRA. An HRA differs from an FSA in that it is funded solely by the employer, and can roll over into a subsequent year if it is not fully depleted.

Health care plans that utilize an HRA and a high deductible defined benefit program are sometimes referred to a “consumer driven” plans. The idea is that the consumer, given a certain amount of money in a fund, will shop for lower prices and generally exercise prudent restraint about spending the account. These products are brand new, and it is too soon to see if they will be successful.

In late 2003, Congress further muddied the waters by adding a new account, a Health Savings Account (“HSA”). It is governed by Section 223 of the Code, and explained in several notices and revenue rulings issued by the IRS and Treasury: Notice 2004-2, Notice 2004-50; Rev. Rul. 2004-38. See also IRS Publication 969.

HSAs are funded tax exempt vehicles, kind of like IRAs. Annual contributions can be made, on a pretax basis, by the insured or by the insured’s employer, or by a combination. If the funds are used for medical expenses, either currently or in the future, they are not taxed when distributed. Anything left over at death is passed along to a beneficiary. If the beneficiary is a spouse, the HSA is added to or becomes the spouse’s HSA. If the beneficiary is not the spouse, the HSA is immediately taxed, like an IRA that pays out immediately.

The biggest drawback is that in order to be eligible, the individual must be covered by a high deductible health plan (HDHP). This is a health plan with, for 2014, at least a \$1,250 deductible for single coverage, and at least a \$2,500 for family coverage. While these high deductible plans are still in their early youth, they seem very interesting, and may change employers’ ideas about what kinds of coverage to offer.

The annual contribution limit to an HSA is set annually, and for 2014 is \$3,300 for single coverage, and \$6,550 for family coverage. For years through 2006, there was a second limit on contributions to an HSA, namely that such contribution could not exceed the deductible. So if the minimum deductibles (\$1,100 and \$2,200 for 2007) were used, those would be the limits. For 2007 and thereafter, a contribution up to the full HSA limit can be made regardless of the amount of the deductible, as long as it meets the minimum. In addition, there is a catch up for those over 55 (\$1,000 for 2014.)

In Notice 2004-50, the IRS issued detailed guidance on how HSAs will coordinate with FSAs and HRAs, and many other technical subjects. Time will tell how these various tools will be integrated with traditional defined benefit programs to provide the health care programs of the future.

FICA Tax

Elective reductions of compensation to fund a cafeteria plan have the effect of reducing FICA tax. In other words, if an employee elects to defer \$1,000 from what would otherwise be taxable income, that \$1,000 is subject to neither income tax nor FICA tax. This is in contrast to salary reduction under a 401(k) program, where the amount, although not subject to income tax, is subject to FICA tax. This distinction probably results from the fact that in a 401(k) plan there is only a deferral of income that eventually will be taxed, while in a cafeteria plan, the elective amount will never be subject to taxation and therefore probably should not be subject to FICA tax either.

Final Thoughts – Comparison to 401(k) Programs

It is very tempting to look at 401(k) programs and 125 programs as twins. In each program, the significant tax favored benefit is being provided with employee dollars (gross salary) rather than employer dollars. The salary reduction agreement turns the employee's salary into employer funding for tax purposes, but the employer does not have to take on any additional liabilities. Also in each program, there are elections which must be carefully made and carefully administered to avoid the imposition of the constructive receipt rule. In these ways, the programs really are twins.

Nevertheless, there is one significant difference. A 401(k) plan defers income. Taxation will occur, but it will occur at a later time. Cafeteria plans, by contrast, eliminate taxation. An employee's election to defer compensation into a cafeteria plan results in the elimination of taxation on that amount. This is because the benefits in the underlying programs – group life insurance, medical programs and dependent care – are excluded from taxation. In that way, the election under 125 is more valuable because it eliminates taxation entirely. Perhaps it is for this reason that there seem to be much stricter rules on changing elections during the year.

To be continued - the Affordable Care Act a/k/a Obamacare

Anyone not living under a rock knows that the health coverage world was irrevocably changed by the Affordable Care Act, a/k/a

Obamacare. The impact of that law on health care coverage as an employee benefit will be covered in the next chapter.

Chapter XIII

A Poet's Guide to the Affordable Care Act

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In 2010, Congress passed, and President Obama signed into law, an enormously complex new law called the Patient Protection and Affordable Care Act. It is sometimes referred to as the Affordable Care Act (ACA), and sometimes as “Obamacare.” It will be referred to as ACA in this chapter. ACA impacts many different aspects of health care and health insurance, and a complete study is beyond the scope of this guide. This chapter will limit its focus to how ACA impacts health insurance as an employee benefit.

1. The View From 40,000 Feet

A primary goal of ACA is to provide health care coverage to all Americans. Since many Americans were already covered by either employer plans or governmental programs such as Medicare and Medicaid, ACA's general approach was to leave existing coverage alone, while providing a mechanism for everyone else to obtain health insurance.

This was accomplished by giving Americans access to health insurance “exchanges”, or online marketplaces where individuals can shop for coverage. The ACA envisioned these exchanges to be created and maintained by each state, with the federal government stepping in to run an exchange if a state declined. The exchanges offer a variety of insurance options. Although the options, which are ranked on a metal system from bronze to platinum, vary in terms of cost and how comprehensive the coverage is, all options meet a certain minimum standard referred to as “essential health coverage.”

To ensure that all Americans would have coverage, ACA imposes a penalty on Americans who are not covered by an employer plan, Medicare, Medicaid or a plan offered on an exchange. To make the exchange plans affordable, Americans whose household income is between 1 times and 4 times the poverty level are given credits and subsidies that gradually get smaller as the income level rises.

So as a general rule, ACA's goals did not include intruding on existing employer provided health care coverage. But there are many exceptions to this general rule.

2. Intrusion Into the Design of Employer Provided Coverage

Between 2010 and 2014, ACA imposed a number of requirements on health care coverage provided by employers. Some of the most important as of 2014 are highlighted below.

a. Coverage of adult children up to 26 years of age. If a plan offers dependent coverage, it must continue that coverage until the child reaches age 26.

b. Elimination of dollar limits. As of 2014, dollar caps, either annual or lifetime, were eliminated. Prior to ACA, some employers offered only insurance coverage with strict dollar caps (sometimes called “mini med” plans). These plans are no longer permitted. Similarly, an employer cannot offer an “HRA only” plan, where it funds an HRA with \$x, and leaves it up to the employee as to how to spend it.

c. Preventive care. All plans must cover certain identified preventive care without any deductibles or copays. The list of the covered services is determined by certain task forces and published by the Department of Health and Human Services (HHS). This seemed like an uncontroversial provision until 2012, when a number of additional women’s health care services were added, including FDA approved contraceptive devices. This inclusion has led to a number of legal challenges by employers, based on the right to freedom of religion under the Constitution. Modifications were made as a result of these court challenges, but the issue remains controversial..

d. Prohibition on exclusion for preexisting conditions. Effective in 2014, a plan could no longer prohibit coverage for preexisting conditions. Existing law already had provided restrictions on such prohibitions for some employees who changed from one plan to another, but now there is a universal prohibition on such restrictions, for both employer plans and individual coverage available from exchanges.

e. Mental health parity. A different federal law, not ACA, provides for mental health parity in employer plans. This law requires that if an employer plan covers mental health at all, it must provide it on a basis that is not more restrictive than other types of coverage. It is included in this list even though it is not an ACA provision because it is another intrusion of the federal government into the content of coverage, an area that had traditionally been regulated by the states.

3. Additional Intrusions

A few additional intrusions were made by ACA regarding employer plans.

a. Restrictions on FSAs. Flexible spending accounts (FSAs), already restricted with respect to high deductible plans with HSAs, incurred some other limitations. First, in 2011, non-prescription drugs were removed from the list of items that could be paid for out of an FSA. Then, in 2013, the maximum annual amount of an FSA was limited to \$2,500.

b. Nondiscrimination testing. Before ACA, only self-funded plans were subject to nondiscrimination testing under section 105(h) of the Code. ACA extends this nondiscrimination testing to all employer health care plans, insured or self-funded. This change will not be effective until regulations are issued, and as of January 1, 2017 none have been issued.

4. The Employer Mandate

By far the most sweeping change for employer provided coverage is the so-called employer mandate, which was supposed to go into effect on January 1, 2014, but was pushed back to January 1, 2016. Here are the basics.

a. Employers with over 50 full time equivalent employees are covered. Smaller employers are not subject to the employer mandate. The regulations explaining how to compute full time equivalent employees are still a work in progress.

b. Mandate to cover full-time employees - “play or pay.” An employer will have to offer health care coverage to all of its full-time employees, or pay a penalty. The penalty is \$2,000 per full time employee in excess of 30. This penalty applies to an employer who chooses not to offer any coverage, but it applies equally to an employer who, for whatever reason, covers less than 90% of its full time employees. The regulations explaining how to compute full time employees are also still a work in progress.

c. Mandate to provide coverage that has “minimum value” and is “affordable.” Even if an employer provides coverage, it may still have to pay a penalty. Here is how the rules work.

i. Coverage has “minimum value” if it pays at least 60% of the total cost of benefits. This will be determined by using a safe harbor or a calculator provided by HHS.

- ii. “Affordable” is determined on an employee by employee basis. Coverage is not affordable when it costs more than 9.5% of the employee’s household income. (An employer can use an employee’s W-2 income to determine if the coverage it is providing is affordable).
 - iii. If a covered employee can show that her coverage does not have minimum value and is not affordable, then she can buy coverage on the exchange and get the credits and subsidies that normally would not be available to employees with employer coverage.
 - iv. For each such employee getting credits and subsidies from the exchange, the employer will have to pay a penalty of \$3,000. But the employer will never have to pay a greater aggregate penalty than it would have to pay if it offered no coverage at all.
- d. The employer mandate has proven to be a challenge for employers to understand and comply with.

5. Will ACA Change Employer Behavior?

The biggest question is whether ACA will change employer behavior. It is quite clear that the underlying premise of ACA is that most employers would continue to offer coverage that would be relatively unchanged.

On the surface, it would appear tempting for employers to terminate coverage, pay a penalty of \$2,000 and allow employees to purchase coverage on the exchange, with credits and subsidies if they qualified. But it should be kept in mind that only employer provided coverage gets the income exclusion for both employer and employee payments, under sections 105, 106 and 125 of the Code. Coverage on the exchange will be paid with after tax dollars. Employers may be reluctant to take a step that will cause their employees, including highly compensated employees, to lose a valuable tax benefit that is paid for by the federal government.

In any event, the answer to this important question will only become evident over time.

Chapter XVI

A POET'S GUIDE TO SPOUSAL RIGHTS IN EMPLOYEE BENEFITS

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1. Introduction

It goes without saying that the relationship between spouses is given unique treatment under the law. Most of the applicable law is state law, which governs the family relationship, divorces, and inheritance. Federal law, however, also contains rules that are unique to the marital relationship. One need only start with different tax brackets for married couples. In this article, we will be examining the special treatment that the federal government gives to spouses in the area of employee benefits. We will look primarily at pension benefit plans, and then briefly at welfare benefit plans. Finally, I will make some brief observations about the roadblocks to delivering similar benefits to domestic partners.

2. Pension Benefit Plans

Non-Assignability Versus Spousal Rights

The Internal Revenue Code and ERISA both require a pension plan to contain a provision that the benefits provided thereunder are not subject to assignment or alienation. (We will refer to the Code provision, which is contained in Section 401(a)(13).) In other words, a participant's right to benefits cannot be transferred voluntarily or involuntarily. As noted in another chapter, the ERISA provision has led the Supreme Court to conclude that pension benefits are not property of the participant in the participant's bankruptcy proceeding.

There are some exceptions to this requirement, and in the context of the spousal relationship, the relevant one is for qualified domestic relations orders (QDROs), as defined in Section 414(p) of the Code. A QDRO is an order issued in conjunction with a divorce decree that gives the divorced spouse an interest in a participant's pension benefits. We will discuss QDROs in detail later in this chapter.

The Code and ERISA also provide important death benefit rights for spouses. (We will refer to the Code provision, which is contained in Section 401(a)(11).) Although Section 401(a)(11) is not identified as an exception to the anti-alienation rule of 401(a)(13), in effect it mandates an alienation to a third party, namely the spouse, of some of the important rights that a participant has with respect to a pension benefit. In some

cases, it takes away the participant's unfettered right to choose a form of benefit. In other cases, it takes away a participant's sole right to name a death beneficiary.

It is noteworthy that Congress, having walled off pension benefits from assignment or alienation, then chose to carve out special rights for spouses (Section 401(a)(11)) and former spouses (Section 414(p)). We will now examine the way in which Congress did its carving.

Spousal Rights: Distinction between pension and profit sharing plans

Section 401(a)(11) establishes a general rule regarding the rights that must be accorded to spouses of participants, and then creates an exception to that general rule. The net effect of the rule and the exception is to divide the world of pension plans into two parts: the part that must fully comply with the general rule contained in Sections 401(a)(11) and 417; and the part that can take advantage of an exception to full compliance by providing that the spouse will be the sole death beneficiary. The general rule applies to all plans that are subject to the funding requirements of Section 412 of the Code. This group includes all defined benefit plans, and the small subgroup of defined contribution plans that provide a fixed employer contribution, namely money purchase pension plans and target benefit pension plans. The group that can take advantage of the exception includes all defined contribution plans that are not in the narrow class that is subject to Section 412, namely all profit sharing plans and stock bonus plans, including 401(k) plans. The exception is permissive, and not mandatory, so that if a plan does not avail itself of the exception then it is subject to the general rule. In the sections below, we will look first at the general rule, and then at the exception.

The general rule: Spousal right to QJSA and QPSA

Sections 401(a)(11) and 417 together promulgate a comprehensive system for the protection of spouses with respect to pension benefits in the event of the death of the participant. Under this system, a spouse is given the right to a qualified joint and survivor annuity (QJSA) and a qualified pre-retirement survivor annuity (QPSA).

(i) QJSA. The QJSA right derives from a restriction on the form of distribution that can be elected by a participant as of the benefit commencement date. Sections 401(a)(11) and 417 require a plan to provide that the standard form of benefit for a married participant is a qualified joint and survivor annuity, which provides an annuity payable to the participant during the participant's lifetime, followed by a survivor annuity, equal to at

least 50% of the annuity paid during the participant's life, payable to the spouse during the spouse's remaining life. Since the normal benefit form in a plan is usually expressed as a straight life annuity or a lump sum, the QJSA must be at least the actuarial equivalent of that normal form.

Example: If A (a married participant) is entitled to a straight life annuity at age 65 of \$20,000 a year, the QJSA might be an annuity of \$17,000 a year during the participant's life, followed by a 50% survivor annuity of \$8,500 a year for the spouse during the spouse's remaining life. The exact amounts will depend on the spouse's age and the plan's actuarial assumptions (sometimes called conversion factors.)

The QJSA does not give the spouse any protection during the participant's lifetime, since the lifetime distributions will still go directly to the participant. A QJSA does insure, however, that there will be something left over if the participant predeceases the spouse. What is really being provided to the spouse, therefore, is death benefit protection after a participant's benefit commencement date.

Section 417 contains detailed rules that will apply if a plan provides the participant with an opportunity to elect out of the QJSA and into another form of benefit. Most plans do provide this flexibility, and therefore must comply with the detailed rules. The rules require that the plan administrator provide a written notice that explains to the participant and the spouse how the QJSA works, and the effect of electing out of it. After receiving that notice, the participant can elect out of the QJSA, but only if the spouse consents. Specifically, Section 417 provides that the election out of the QJSA is not effective unless the spouse consents to it in a written document that is either notarized or witnessed by a plan representative. This requirement effectively puts the spouse in the "driver's seat." If the post-retirement death protection is important to the spouse, then the spouse can refuse to consent to a participant's alternate election, and the benefit will be paid in the form of a QJSA.

Traditional defined benefit plans typically did not provide a lump sum option, and therefore the common alternatives to a QJSA for a married participant were (i) a straight life annuity, and (ii) an annuity with a guaranteed minimum number of payments (for example, a "ten year certain" annuity.) The recent trend has been to add a lump sum option to a defined benefit plan. This is

especially the case in the new type of defined benefit plan known as a cash balance plan. Where a lump sum alternative is available, there will probably be a lot of pressure on the spouse to waive out of the QJSA so that the lump sum form can be elected. It appears that this issue is of some concern to the IRS, since in late 2002, it issued proposed regulations that, if promulgated, would beef up the notice that must go to the participant and spouse, including, among other things, a dollar for dollar comparison of the present value of the QJSA and the lump sum distribution.

(ii) QPSA. The qualified preretirement survivor annuity (QPSA), unlike the QJSA, provides death protection to the spouse for the period prior to the benefit commencement date. Sections 401(a)(11) and 417 require that, in the event of a participant's death prior to the benefit commencement date, a death benefit annuity (a QPSA) must be provided to the spouse. Specifically, the QPSA is the survivor portion of the hypothetical qualified joint and 50% survivor annuity that would have gone into effect if the participant, instead of dying prior to commencing benefits, had elected to retire and commence benefits on the date of the participant's death, and then died immediately thereafter. In the event that the participant died prior to a date when the participant could have elected to commence benefits, the QPSA does not have to start making payments to the spouse until the earlier of the earliest date the participant could have commenced benefits or the date the participant would have attained age 50.

What the QPSA provides to the spouse is death benefit protection prior to the commencement of benefits. When taken together with the QJSA, which provides protection for the period after the commencement of benefits, the system established by Sections 401(a)(11) and 417 provides that a spouse is always entitled to a 50% survivor annuity if the spouse outlives the participant.

Like the QJSA, the QPSA can be waived if the plan provides for other alternatives. The most common alternative gives participants the ability to name a death beneficiary other than the spouse. Only some plans provide this alternative. If an alternative is available, it requires a written notice, an election by the participant to name an alternate beneficiary, and a spousal consent to the naming of an alternative beneficiary in a written document that is either notarized or witnessed by a plan representative. The rules closely track the ones that apply to waiving the QJSA.

It is fairly common for a plan that offers a lump sum distribution to permit the spouse who is entitled to a QPSA to elect an equivalent lump sum distribution. This election can be made after the participant's death, without the participant having made an election regarding the form of benefit.

(iii) A warning about complexity. The QJSA/QPSA system established by Sections 401(a)(11) and 417 is quite complex, both in the benefits it mandates for spouses and the procedures it sets forth regarding notices and waivers. This short description is by necessity an oversimplification and should be relied on only to understand the basic structure and the policy goals.

The exception for profit sharing and stock bonus plans: Spousal right to account balance

The exception to the requirement of providing a QJSA and QPSA, set forth in Section 401(a)(11), has 4 requirements. The plan:

(i) must be a defined contribution plan not subject to the minimum funding rules, in other words a profit sharing or stock bonus plan;

(ii) must provide that a death benefit equal to the entire vested balance of the participant's account be payable to the spouse of a married participant unless the spouse consents to another beneficiary;

(iii) must not offer an annuity as an optional form of benefit (if it does, the QJSA and QPSA rules will apply to those participants who chose an annuity); and

(iv) must not consist of assets transferred from a plan to which the exception would not be available.

It should be noted that condition (ii) to the exception in effect is an alternate type of protection for a spouse. Instead of providing a QPSA, which is a right to a survivor annuity upon the occurrence of death prior to the benefit commencement date, a plan taking advantage of the exception must provide the spouse with a death benefit prior to the benefit commencement date that equals the entire vested account balance. This is actually more valuable than the QPSA, which is worth less than half the value of the account. (A defined contribution plan that provides a QPSA can provide that the balance of the account go to any named beneficiary, but this kind of design can be quite complicated. Ordinarily, a plan that provides the entire account as a death benefit and is subject to the QPSA

rules will simply provide that the spouse gets the value of the entire account as a survivor annuity.)

Like the QJSA and the QPSA, the death benefit to the spouse under the exception can be waived by the spouse. In fact, Section 401(a)(11)(B)(iii)(I) provides that the same QJSA/QPSA formalities are required for a waiver by the spouse, namely a notice explaining the spouse's rights, an election of an alternative beneficiary by the participant, and a consent to an alternate beneficiary signed by the spouse and either notarized or witnessed by a plan representative.

The spousal protection offered to plans that take advantage of the exception differs from the spousal protection provided by the QJSA and QPSA under the general rule in one important way. Under the general rule, a spouse can control the manner in which distributions commence to a participant. The spouse can refuse to consent to anything other than a QJSA. In plans that take advantage of the exception, in contrast, a participant can elect a form of benefit without spousal consent. This is an important exception, since in a plan that takes advantage of the exception, a participant can take a lump sum distribution, roll it into an IRA, and then have a continued tax shelter free and clear of any spousal control. In other words, the protections to a spouse under the exception generally last only while the participant is still employed by the plan sponsor. Since most participants in defined contribution plans take distribution prior to death, the spousal protections under the exception are of limited value.

Observations about the 401(a)(11)/417 system

Congress did not establish Sections 401(a)(11) and 417 in their current form until 1984, when it passed the Retirement Equity Act of 1984. This piece of legislation was promoted as providing equity to women. Yet it is obvious, when we examine the statutory sections from a 2003 perspective, that the legislators had in mind a family model with a male spouse who was the primary "breadwinner" and a female spouse who had made career sacrifices and did not have as large a pension. If one substitutes a model where the male and female spouse are equal bread winners, with equal pensions, then this legislation seems unnecessary. If one substitutes a model where a female is the head of a single parent household and is now embarking on a subsequent marriage, the notion that the new husband will automatically derive rights in the pension which will come ahead of the rights of the children who predated the new marriage seems downright counterproductive. One wonders whether this particular legislation would have been promulgated by women's groups in 2010.

A second observation, linked to the first, is that no special protections are provided for children. The single parent who dies in

active service may have no death benefit at all in a defined benefit plan, since Section 401(a)(11) only requires a QPSA for married participants, but no other death benefit. This is not a theoretical issue: many traditional defined benefit plans do not provide a death benefit for unmarried participants. Congress apparently did not have the single parent family in mind in 1984.

A third observation has to do with the distinction between plans that are subject to the general rule, and those that can take advantage of the exception. In 1984, the basic model (at least for large corporations) was a pension plan as the primary retirement vehicle and a profit sharing plan (often a 401(k) plan) as a secondary saving vehicle. In this model, it probably made sense to subject the pension plan to the full panoply of protections for a spouse, namely the QJSA and the QPSA, and to have a simpler, although less protective set of rules for the secondary savings vehicle. The problem, of course, is that over the last 20 years there has been a dramatic shift toward a model where the primary retirement vehicle is a 401(k) plan with a match and possibly a supplemental discretionary employer contribution. Section 401(a)(11), in creating the general rule and the exception, makes no distinction between a profit sharing plan that is the primary retirement vehicle and a profit sharing plan that is a supplemental retirement vehicle. Therefore, in a company where the profit sharing plan is the primary vehicle, the spouse of a participant simply has fewer protections. This cannot be justified as a policy matter. Either the protections are important, in which case they should be provided to every spouse in the primary retirement vehicle regardless of what type of plan it is, or they are unimportant, in which case one wonders why the protections exist at all. The suggestion has been made from time to time that the QJSA and QPSA rules should be extended to all plans, but to date those suggestions have not gathered any legislative momentum.

A final observation is that these rules as a whole do not appear to have caused a tremendous amount of confusion or hardship. Despite their complexity, it appears that they are generally complied with in some manner, and that they do not result in any substantial litigation. Furthermore, from this author's unscientific observations, in the increasing number of defined benefit pension plans that offer lump sum options, most participants take the lump sum option, which means that they somehow convince their spouses to sign the necessary consent forms. One reason for not making any changes to the current system is that no one seems to be complaining. It is not clear whether the lack of complaints means that spouses are being protected, or that they really do not need the protection in the first place.

Qualified Domestic Relations Orders

(i) A Brief History of QDROs. The anti-alienation rule of ERISA (Section 401(a)(13) of the Code and Section 206(d) of ERISA) originally contained no exception for spouses in divorce proceedings. When a court ordered that, as part of a divorce proceeding, a participant's pension plan should be transferred to, or set aside for the benefit of, the former spouse, a multitude of questions would arise. Was the order prohibited by the anti-alienation rule? Was the domestic relations order a state law that was preempted by Section 514 of ERISA? While some case law developed, the confusion remained. Fortunately, as part of the Retirement Equity Act of 1984, Congress came to the rescue by creating an exception to the anti-alienation rule known as the Qualified Domestic Relations Order, or QDRO. In effect, Congress recognized the right of a state court in a divorce proceeding to create a property interest for someone other than the participant – typically a former spouse - without violating the anti-alienation rule or ERISA's preemption rule.

(ii) What is a QDRO? QDRO's are defined in Section 414(p) of the Code. A QDRO is a court order entered in a divorce proceeding (a domestic relations order) which meets a number of requirements which are laid out in Section 414(p), and which is approved by a plan administrator in accordance with procedures which are also set out in Section 414(p).

(iii) Required substantive provisions of a QDRO. The substantive requirements of Section 414(p) generally are crafted to protect the plan and not impose additional requirements or burdens on it. Section 414(p) requires that a QDRO clearly identify the participant and the plan, as well as the person who is getting an interest in the participant's accrued benefit – the "alternate payee". In addition, the QDRO must define the rights that the alternate payee is getting, either by amount, percentage, or some other method. In general, Section 414(p) does not permit the QDRO to create rights for an alternate payee that are not available to the participant. One significant exception is that the QDRO can provide that the alternate payee begin receiving distributions even if the participant is still working, but not before the participant reaches age 50, and not before the participant, if terminated, would be able to begin receiving benefits.

(iv) Procedural requirements. The basic procedure described in Section 414(p) is for the order to be presented to the plan administrator, who will then determine whether the order qualifies, i.e. is a QDRO. If the order provides for immediate

payments, they are to be held up pending a determination with respect to the order. As a practical matter, plan administrators, rather than relying on these procedures, provide the attorneys for the participant and alternate payee with model forms to avoid a long determination period. Beyond this, Section 414(p) does not provide detailed procedural rules, instead it provides that each plan must establish reasonable procedures to determine qualification and administer distributions. Notably, Section 414(p) does not provide a procedure for the period before an order is presented to the plan administrator, although many plan administrators will put a hold on distribution once they have been put on notice that the alternate payee is proceeding to obtain a QDRO.

(v) Design of QDRO. While Section 414(p) imposes some substantive restrictions, it leaves much of the design up to the parties to the proceeding. In part, the design will depend on a whether the plan in question is a defined contribution plan or a defined benefit plan.

A defined contribution plan QDRO typically will give the alternate payee an account balance as of a certain date. The amount may be set forth in the order, or the order may simply say something like “50% of the account balance as of January 1, 2003.” Thereafter, the growth of the account will depend on the investment of the plan. If the plan is a self-directed plan, typically the alternate payee will be given the right to direct investments.

As to the distribution options for the alternate payee, the plan can restrict distributions as permitted in Section 414(p) (the earlier of age 50 or the earliest date that the participant could take a distribution), or it can be more liberal. The plan is not required to give the alternate payee the right to a loan, and it is quite typical to deny this right to a non-participant. Almost invariably, the alternate payee will be given a death benefit, and therefore a right to name a beneficiary. It should be noted, however, that Section 414(p) does not require that the alternate payee have a death benefit, and therefore the QDRO should specifically address the issue of whether the spouse indeed has a death benefit.

The design of a QDRO with respect to a participant’s benefit in the defined benefit plan is far more complex. One possible design is to provide a separate interest for the alternate payee, by breaking the accrued benefit earned up to a specified date into two portions, one for the participant and one for the alternate payee. Thereafter, the alternate payee’s interest is treated as separate and distinct from the participant’s accrued

benefit. The other methodology is to provide the alternate payee with a percentage interest in the participant's benefit. In this design, no separate accrued benefit is established for the alternate payee, but the alternate payee instead continues to share, almost like a co-owner, in the participant's accrued benefit.

In the case of both defined benefit and defined contribution QDROs, it is surprisingly challenging to draft an order that covers all possible contingencies. It is not uncommon to find, long after the QDRO is effective, that an event (for example, death or remarriage) has occurred that was unanticipated, and that the QDRO does not clearly address. When a domestic relations lawyer takes special care in crafting a QDRO, even if it is an additional expense, it is usually a wise investment.

Administering a plan with alternate payees is a hardship to a plan administrator. There is simply one more person to whom account or benefit statements, distribution information, and, if applicable, investment information must be provided. Therefore, it is not uncommon for both defined benefit and defined contribution plans to permit a QDRO to provide for an immediate distribution, even though the plans are not required to do so in most cases. Alternate payees generally take advantage of such a provision, since the distribution can then be rolled over into an IRA pursuant to Section 402(e)(1) of the Code, thereby preserving the tax shelter without the inconvenience of having to deal with the former spouse's employer.

(vi) Final thoughts on QDROs. It is not uncommon for a participant's interest in a retirement program to be the participant's most valuable asset. It can, therefore, become a critical asset in a domestic relations proceeding. The QDRO provisions of the Code permit a tax-free transfer of a plan interest to a former spouse, who will then inherit both the value and the tax consequences of the transferred assets. Section 408(d)(6) of the Code provides a similar rule for transfers of IRA interests, which of course are not subject to the anti-alienation provisions of Section 401(a)(13). These rules are of great utility to a domestic relations lawyer, and every domestic relations lawyer should be enough of a "pension expert" to take advantage of them.

Minimum Distribution Rules – Sections 401(a)(9), 402(c) and 408

In a previous article, we examined the complex rules under Section 401(a)(9), which mandate distribution of pension benefits to ensure that taxation is not deferred for too long. The reader should be reminded that this intricate system favors the spouse, who alone can defer

the commencement of distribution of inherited benefits, and then take distributions over a longer period. In addition, Section 402(c) of the Code permits a spouse to roll over a death distribution from a qualified plan into an IRA, and Section 408, and the rules thereunder, permit a spouse to treat an inherited IRA as the spouse's own IRA. No other beneficiary is given this flexibility with respect to death distributions, although non spouse individual beneficiaries were given a limited rollover right commencing in 2007.

3. Welfare Benefit Plans

Spouses are given significant rights with respect to pension benefit plans, as we have seen above, but they are not given actual accrued benefits. In contrast, spouses and dependents can actually have current benefits under certain welfare benefit plans.

Sections 105 and 106, which provide for the special beneficial tax treatment of employer-sponsored medical plans, extend that treatment to the coverage of not only the employee, but also the employee's spouse and dependents. The decision to enroll the spouse and dependents is the employee's to make, and the premium, if there is one, must come out of the employee's compensation. Once that decision is made, and the premium is paid, the spouse and dependents derive independent coverage rights.

The extent of the independence of the right of the spouse and dependents is illustrated in the COBRA rights granted to covered spouses and dependents. At the termination of participation of a spouse or dependent, each such individual has a right to elect continuation of coverage for a period of 36 months, albeit at full cost. This is a very important right, especially if there is an ongoing medical condition that needs to be covered.

Furthermore, a special right is given to impose continued coverage of children under the medical plan covering the employee. The coverage can be imposed either by a domestic relations order or pursuant to an administrative order. These orders, called Qualified Medical Child Support Orders, are described in Section 609 of ERISA.

4. Treatment of Same Sex Spouses and Domestic Partners

Although several states have moved to recognize same sex marriages or unions of domestic partners in some way, the federal government had made it clear, through the Defense of Marriage Act (DOMA) that the protections provided to spouses do not apply to same sex spouses. Ironically, the unwillingness of governments, federal and state, to deal with this issue was not reflected in corporate America,

where many companies have taken steps to extend benefit programs to same sex spouses and domestic partners. The inability of corporations to extend the special legal protections to employees with same sex spouses and domestic partners created a number of problems.

In the pension benefit area, these problems were not fatal. Same sex spouses and domestic partners could still be named as beneficiaries. They simply did not have the protections afforded to spouses under Sections 401(a)(11) and 417 of the Code. Perhaps more important, at least financially, a same sex spouse or domestic partner named as a beneficiary did not have the rollover rights offered to a spouse. Most significantly, a defined benefit plan that provided no death benefit other than the QPSA required by law provided no death benefit at all to a same sex spouse or domestic partner.

In the medical plan area, the problems were more immediate. A corporation could permit an employee to extend coverage to a same sex spouse or domestic partner, but a corporation could not extend the tax exemption, which applied only to the coverage of spouses and dependents. If an employer subsidized the cost of same sex spouse or domestic partner coverage, the subsidy would be taxable income to the participant. If the cost of domestic partner coverage had to be borne by the participant, it could not be made with pre-tax dollars under a Section 125 plan. Instead, it had to be paid with after-tax dollars. Finally, the same sex spouse or domestic partner could not be afforded rights to continued coverage available under COBRA.

All of this changed with the Supreme Court decision in United States v. Windsor, 570 U.S. 12, in which the Court held DOMA to be unconstitutional in its application to federal laws. Therefore a same sex spouse under state law (but not a domestic partner) is now treated like any other spouse for all of the purposes inventoried above.

Chapter XV

A POET'S GUIDE TO THE INTERPLAY OF ERISA AND INSOLVENCY LAW

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The provisions of ERISA assume that both the employer and employee will remain solvent. Yet another federal law, the Bankruptcy Code, contemplates the possibility of the insolvency of both individuals and businesses. This brief chapter surveys the interrelationship of these two federal systems, as well as the impact of other insolvencies on benefit plans.

1. Bankruptcy of an employee

Before 2005, there was confusion regarding the extent to which Section 206(d) of ERISA and Section 401(a)(13) of the Code, which make the right to a pension benefit inalienable and non-assignable, applied in the event of a bankruptcy. There was even greater confusion with respect to non-ERISA plans, such as IRAs and governmental plans.

This uncertainty was eliminated by 2005 amendments to the Bankruptcy Code. Under Section 522 of the Bankruptcy Code, any retirement funds that are exempt from taxation under Section 401, 403, 408(IRAs), 408A (Roth IRAs) or 457 are exempt from the claims of creditors. There are no dollar limitations, except for IRAs, where there is a cap of \$1,171,650 for funds that are not the result of a rollover from a non-IRA plan.

2. Rights of employee's creditors outside bankruptcy

Outside bankruptcy, uncertainty reigns. In a nutshell, if the funds are in an ERISA plan to which Section 206(d) of ERISA applies, then the funds are inalienable, and any state law to the contrary is preempted. If the funds are not governed by ERISA, then the answer will be provided by state law. Many states provide an exemption for pensions and IRAs, but not all provide an exemption without any dollar limits. See Conn. Gen. Stat. §53-321a and §52-352b(m). It will be important to determine what state law applies, and refer to the exemption statute of that state.

3. Impact of a filing by the employer/plan sponsor.

a. Defined benefit plan. The sponsor of an ERISA defined benefit plan cannot automatically terminate the plan. It must follow the rules under Title IV of ERISA (PBGC provisions) which only allows a distress termination if the employer is liquidating or can demonstrate to the

bankruptcy court that the employer will be unable to reorganize and continue in business. ERISA Section 4041. Keep in mind that the defined benefit plan is an entity separate and apart from the employer, and that the assets of the plan are not subject to the claims of the employer's creditors. The issue of how to classify the claim of the plan against the employer for funding the plan (general unsecured claim or post filing administrative claim) is complex.

b. Defined contribution plan. The sponsor of an ERISA defined contribution plan can terminate the plan, because typically there is no ongoing liability. Keep in mind that the defined contribution plan is an entity separate and apart from the employer, and that the assets of the plan are not subject to the claims of the employer's creditors. The employer may owe money to the plan (a matching contribution for example), in which case there will be an unsecured claim. If the employer has not turned over all 401(k) deferrals, then it has used funds that it does not own, and is subject to penalty for a prohibited transaction.

c. Obligation of a trustee in a liquidating bankruptcy. Section 704(a)(11) of the Bankruptcy Code provides that one of the duties of a liquidating trustee is to continue to perform the duties of the employer as plan administrator.

d. Nonqualified plans. Keep in mind that nonqualified plans almost always are unfunded. This means that when an employer files a bankruptcy petition, the rights of participants are simply unsecured claims. This is true even if there are assets in a rabbi trust.

Chapter XVI

A POET'S GUIDE TO THE FIDUCIARY RESPONSIBILITY PROVISIONS OF ERISA

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1. Introduction

One of Congress' primary goals when it enacted ERISA in 1974 was to establish standards for the conduct of those individuals and entities that had control over plans and plan assets. What emerged from the give and take of the legislative process was Part IV of Title I of ERISA. In this chapter we will review the key provisions of that part, Sections 401-409 of ERISA.

Most of the language that we will consider in this chapter is original ERISA language dating back to 1974. There has not been a lot of tinkering with these sections. The fact that they have not changed much should not be taken as evidence that Congress did an excellent job the first time. In fact, these provisions are poorly drafted, often ambiguous and sometimes repetitious, and have resulted in a system that requires lawyers to often give "gray area" answers to reasonable and specific client questions. The lack of tinkering may instead reflect the fact that these provisions embodied a series of negotiated compromises between government, labor and management, and that Congress may simply not have the stomach to reopen those issues, even to cure clear shortcomings.

The rules set forth in Part IV of Title I of ERISA apply to both pension plans and welfare plans. While many of the fiduciary concepts seem better suited to pension plans, where there are assets to be invested, they apply with equal force to welfare plans.

The provisions of Part IV are under the control of the Department of Labor rather than the Department of the Treasury. While the Department of the Treasury seems to have very little problem knocking out regulations, revenue rulings, notices and the like, the Department of Labor has been somewhat stingy in offering guidance in this area. Therefore, although these laws have been in effect since 1976, regulations and other guidance are often non-existent or perfunctory.

Our discussion of the fiduciary issues will be divided into three parts: required formalities; the general rules of fiduciary conduct; and the prohibited transaction rules. We will cover the general principles of each of these three areas, but certain topics, such as the investment of plan

assets and certain aspects of fiduciary litigation, will be covered in subsequent chapters.

2. Required Plan Formalities

Sections 402 and 403 of ERISA set forth important formalistic requirements with respect to plans. Three of the most important are the requirement of a plan document, the requirement of a trustee, and the requirement of one or more fiduciaries.

Plan Document

Section 402(a)(1) of ERISA requires that every plan be established and maintained pursuant to a written document. The purpose of this provision presumably was to provide employees assurance that, having been promised a benefit, they could look to documentation with respect to the specifics of that promise and could then enforce the promise based on that documentation. Written documents can vary in size and formality, but there should be no such thing as an oral plan.

The requirement of a trustee

Section 403(a) of ERISA requires that with limited exceptions, all assets of an employee benefit plan must be held in trust by one or more trustees. This formalistic requirement will not apply to plans that have no assets, but will apply to all pension plans and funded welfare plans. (There is a limited exception where all plan assets are invested in insurance contracts.) Again, the intent seems clear: plan assets must be held by some entity with trust powers acting on behalf of the beneficiaries of the plan. In a later chapter, we will examine the duties of a trustee with respect to the investment of plan assets. For now, we can simply state that the trustee will be responsible for the safekeeping of plan assets.

The requirement of one or more named fiduciaries.

Section 402(a)(1) of ERISA requires that a written plan document provide for one or more named fiduciaries with authority to control and manage the operation and administration of the plan. Section 401(a)(2) defines “named fiduciary” to mean a fiduciary who is named in the plan document or who is named pursuant to a procedure specified in the plan document. The intent of this provision is clear: with respect to the operation and administration of a plan, there must be an entity or individual with respect to whom it can be said “the buck stops here.”

The term “fiduciary” is probably the most critical term in all of Part IV of Title I of ERISA. All of the burdens of operating the plan properly are placed on the shoulders of the one or more fiduciaries who

must exist with respect to any plan. It is useful, therefore, to examine the tortuously crafted definition of “fiduciary” to see what Congress had in mind.

The definition of “fiduciary” is set forth in Section 3(21). Essentially, a person will be a fiduciary with respect to a plan to the extent that that person falls within one of three categories:

- (i) that person exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets;
- (ii) that person renders investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other properties of such plan, or has any authority or responsibility to do so; or
- (iii) that person has any discretionary authority or discretionary responsibility in the administration of such plan.

The definition is not a model of clarity or succinctness, and should be studied carefully. To oversimplify, any person who exercises discretion with respect to management, administration, or investment will be a fiduciary. With respect to holding assets, the plain reading of the statute appears to be that anyone who holds assets will be a fiduciary, regardless of whether that person exercises any discretion, although the law has developed an apparent exception with respect to a custodian with no discretion.

Another conclusion that can be drawn from the definition is that whether a person is a fiduciary will be determined by the power that person actually has or actually exercises, and not the name that person is given. Thus, although a plan must have at least one named fiduciary, it can, and typically will, have more than one fiduciary, including some who may not have the word “fiduciary” in their title.

A third conclusion that can be drawn from the definition is that a person can be a fiduciary with respect to some actions and not a fiduciary with respect to others. A bank that acts as trustee and third party plan administrator is a fiduciary when it makes investment decisions, but probably not a fiduciary when it performs a year-end nondiscrimination test which consists solely of computing certain mathematical equations based on data provided to it by the employer. Perhaps the plan entity who best illustrates this rule is the employer, who is a fiduciary when it interprets its plan’s provisions, but not a fiduciary when it designs the

plan in the first place. This is described as the settlor/fiduciary distinction, and it is discussed in a number of important ERISA cases.

For several decades, the term “renders investment advice for a fee or other compensation” in part (ii) of the definition was governed by Department of Labor regulations that excluded many advice givers because the advice was not given on a regular basis. In 2016, the Department of Labor promulgated new regulations that include in the definition of “fiduciary” many professionals - notably brokers who sell investment products - who were previously excluded. These regulations, which go into effect during 2017, have proven to be quite controversial.

Why it is important whether a person is a fiduciary? This is a question we will be considering over the next few chapters. Suffice it to say that fiduciaries are held to a particularly high standard of conduct, which will be discussed in this chapter, whereas other individuals who perform services for the plan will only be required to perform their contractual obligations. Furthermore, there is a fairly broad, although not unlimited, empowerment to sue fiduciaries, while the ability to sue non-fiduciaries who have wronged the plan or a participant is much more limited. Because of the importance of fiduciary status, there is a substantial body of case law examining whether, in particular situations, lawyers, actuaries, accountants, stockbrokers and professional plan administrators are fiduciaries. The general rule is that any of these professionals, to the extent they only perform set contractual duties without discretion, or simply give advice to acknowledged fiduciaries who will then exercise discretion, should not be fiduciaries. Nevertheless, there is at least some case law with respect to each of these categories of professionals that has held them to be fiduciaries where they have stepped over the line and taken on greater responsibilities. The line can be a blurry one, sometimes only seen clearly in hindsight, after some damaging event has occurred. The question of fiduciary status can be the most important single issue in a case that arises under Part IV of Title I of ERISA.

3. General Rules of Fiduciary Conduct

The general rules of fiduciary conduct are set forth in Section 404(a)(1) of ERISA. This provision is so important to our discussion that it is appropriate to quote it in full:

[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and –

A. for the exclusive purpose of:

- (i) providing benefits to participants and their beneficiaries; and
 - (ii) defraying reasonable expenses of administering the plan;
- B. with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
- C. by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstance it is clearly prudent not to do so; and
- D. in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provision of this title and Title IV.

This curious sentence provides four duties, in the clauses labeled (A) – (D), each of which we will examine.

Loyalty – 404(a)(1)(A)

We start with the duty of loyalty, which is contained in both the preamble and subparagraph (A). The preamble contains the mandate that the fiduciary “shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries”. Clause (A) of this section requires that the fiduciary act for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying the reasonable expenses of administering the plan. In a way, it sounds like clause (A) is simply repeating what was already said in the preamble, namely that the fiduciary must act solely in the interests of participants and beneficiaries. Clause (A) is not merely repetitious, however, because it adds specificity as to the way in which that loyalty to participants and beneficiaries must be carried out. Essentially, all of the fiduciary’s efforts must be focused on providing benefits under the plan and not any other action that might help participants or beneficiaries (such as saving the jobs of active participants). The exception for defraying reasonable expenses is included to make it clear that paying service providers or reimbursing the employer for its costs is not a violation of this “exclusive purpose” rule.

The rules set out in the preamble and in clause (A) are sometimes referred to as the “exclusive benefit rule”. In fact the same rule is repeated in two other places. Section 403(c)(1) of ERISA provides that

the assets of a plan must never inure to the benefits of the employer and must be held for the “exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan.” This means that with very limited exceptions, the assets of a plan must never be paid back to the employer. In addition, Section 401(a) of the Code, which sets forth the requirements for qualification of a plan, states in the preamble that it only applies to trusts created “for the exclusive benefit” of employees or beneficiaries, and goes on to require, in Section 401(a)(2), that for a plan to be qualified, it must be impossible for any part of the trust to be used for purposes other than the exclusive benefit of employees or beneficiaries. Therefore, if the requirement of clause (A) of Section 404 of ERISA is violated, not only is there a fiduciary breach, but, at least theoretically, a loss of qualified status under the Code.

All of these different phrasings of the “exclusive benefit” rule can be conveniently summarized as the fiduciary’s duty of loyalty to the participants and beneficiaries. The interests of participants and beneficiaries to receive their benefits in the plan cannot conflict with any other interests, and cannot be compromised to achieve any other result. The duty of loyalty is a time honored principle of common law trust law.

Prudence – 404(a)(1)(B)

The second duty set forth in Section 404(a)(1), in clause (B), is that the fiduciary must act with the care, skill, prudence and diligence of a prudent man acting in a like capacity and familiar with such matters. This rule, referred to familiarly as the prudent man or prudent person rule, is also a time-honored principle of common law trust law, and goes hand in hand with the duty of loyalty. A fiduciary must not only be loyal, but must act with intelligence and skill, i.e. prudence.

The Department of Labor adopted a new regulation first applicable in 2012 that imposes an explicit “prudence” duty on fiduciaries of “participant-directed individual account plans”, which are defined contribution plans that allow self-direction in investments. Department of Labor Reg. § 2550.404(a)-5. This is a duty to disclose detailed investment information on an annual basis in a format highly regulated by the Department of Labor. This topic is discussed in more detail in the next chapter.

Diversification – 404(a)(1)(C)

The third duty set forth in Section 404(a)(1), in clause (C), is a bit more confusing. Clause (C) starts off by indicating that there is a duty to diversify investments to minimize the risk of large losses, certainly a reasonable goal. Then, however, a tag line is added: “unless under the

circumstances it is clearly prudent not to do so . . .” Does this tag line mean that the “requirement” of diversification is nothing more than a subcategory of the prudent person rule, and that diversification is only required if it is an aspect of prudence? Or to put it another way, is this “duty” nothing more than a further definition of prudence, namely, that it will usually include diversification of investments, but might not always do so? In any event, most fiduciaries who have control of investments assume that diversification is required, and the case law that exists is not so much about whether diversification is required but rather how diversification is defined.

Compliance with Plan Documents – Section 404(a)(1)(D)

The final rule set forth in Section 404(a)(1), in clause (D), is also peculiar, in that it states that a fiduciary must act in accordance with the documents and instruments governing the plan, but then adds a tag line that it must do so only insofar as such documents and instruments are consistent with the provisions of ERISA. What clause (D) seems to say is that the failure to follow the terms of the documents is a breach of a fiduciary’s duty unless that failure occurs because of an overriding duty to act with prudence and loyalty or to otherwise comply with applicable fiduciary law. Compliance with the documents is still an important principle; it simply does not rise to the same level as loyalty and prudence.

The principles recited in clauses (A) through (D) of Section 404(a)(1) set out a code of conduct which is uncontroversial, and unsurprising in that it tracks closely the duties of a trustee under common law trust law. One can argue that these principles could have sufficed as the only provisions of Part IV of Title I of ERISA. As we will see, however, Congress saw fit to add a second layer of conduct, called the prohibited transaction rules. Obviously, Congress was not convinced that simply setting forth these general standards would adequately protect participants and beneficiaries.

Before we move on to the prohibited transaction rules, a word should be added about Section 405, the co-fiduciary liability rules. This section is an attempt to comprehensively define the interrelationship of fiduciaries, and is far from simple reading. Section 405(a), the heart of the section, sets forth a general principle about the extent to which one plan fiduciary is responsible for the actions of another plan fiduciary. Specifically, a fiduciary will be responsible for the breach of fiduciary responsibility of another fiduciary in three circumstances:

1. If the second fiduciary knowingly participates in an act or omission or knowingly undertakes to conceal it;

2. If the second fiduciary fails to comply with its 404(a)(1) duties and thereby enables the first fiduciary to commit a breach; and
3. If a second fiduciary has knowledge of a breach by the first fiduciary, unless the second fiduciary makes reasonable efforts under the circumstances to remedy the breach.

The first two circumstances describe situations where the second fiduciary has probably engaged in conduct which breaches its own fiduciary duties. The third circumstance is a bit more surprising. The second fiduciary can be an innocent bystander, but once it has knowledge of a breach by the first fiduciary, it must make “reasonable efforts” to remedy the problem. It is important for a fiduciary to understand that to this limited extent, the principle of division of responsibilities among fiduciaries does not govern, and an otherwise innocent fiduciary may have to “stick its nose” into another fiduciary’s business.

4. Prohibited Transaction Rules

Congress, having laid out the ground rules for fiduciaries in Section 404 of ERISA, could have decided that its job was complete. Instead, it added, as part of ERISA, a second layer of rules for fiduciaries, the prohibited transaction rules of Sections 406 and 407. The prohibited transaction rules, many of which are applied in per se fashion (in other words, remedial action and penalties apply without regard to whether the actions were reasonable or unintentional), have proven to be a hugely complicated area of the law, one with a large gray area in which a fiduciary cannot be totally certain that it is in compliance. Again, these rules exist side by side with, but independently of, the fiduciary rules of Section 404. Compliance with both Section 404 and Sections 406 and 407 is required with respect to any fiduciary act or omission.

The prohibited transaction rules of Sections 406 and 407 also appear, in virtually identical form, in Section 4975 of the Code. The discussion below applies to both ERISA and the Code.

The 406(b) prohibited transactions.

Section 406 sets forth two separate sets of prohibited actions, per se prohibitions which are described in Section 406(a), and prohibitions which are applied subjectively as described in Section 406(b). It is simpler to begin with the subjective prohibitions, since they track the Section 404(a)(1) duty of loyalty very closely. We will then move on to the per se violations of Section 406(a).

Section 406(b) states that a fiduciary with respect to a plan shall not:

- a. Deal with the assets of the plan in his own interest or for his own account;
- b. In his individual or in any other capacity act . . . on behalf of a party . . . whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries; or
- c. Receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

What these three overlapping subsets of actions have in common is that each requires a finding that a fiduciary acted other than for the exclusive benefit of the participants and beneficiaries of a plan. One can argue that Section 406(b) was not really needed, since Section 406(a)(1) already prohibits a fiduciary from acting in such a manner. Section 406(b), by adding such actions to the category of prohibited transactions, automatically invokes a penalty to be imposed by the Department of Labor or the Internal Revenue Service on the non-fiduciary party to the transaction. In addition, by adding more specific language in Section 406(b), arguably actions are included which might be deemed not to run afoul of the exclusive benefit rule of Section 404(a)(1).

The 406(a) prohibited transactions.

Section 406(a) has proved more troubling over the years than Section 406(b), because it prohibits, in a per se manner and across the board, a large category of activities. Specifically, Section 406(a) provides that a fiduciary shall not cause the plan to engage in a transaction that constitutes a direct or indirect:

- a. Sale or exchange or leasing of any property between the plan and a party in interest;
- b. Lending of money or other extension of credit between the plan and a party in interest;
- c. Furnishing of goods, services, or facilities between the plan and a party in interest; or
- d. Transfer of plan assets to, or use of plan assets by or for the benefit of, a party in interest.

In each of the transactions described above, there are three parties: a fiduciary; the plan; and a party in interest. (In Section 4975 of the Code, the term “disqualified person” is used instead of “party in interest”. Our discussion below applies equally to both defined terms.) The term “party in interest” is defined in Section 3(14) of ERISA. It is a broad and sweeping definition, involving virtually everyone who has anything to do with the plan. Specifically, it includes every fiduciary, every person providing services to the plan, the employer sponsoring the plan, and the employees, officers, directors and 10% shareholders of the employer sponsoring the plan or of any service provider. This brief description, as broad and sweeping as it is, is incomplete, and the reader is encouraged to read through the definition to see first-hand how all inclusive it is.

The literal effect of Section 406(a) is that a great many innocent transactions involving a plan are prohibited transactions. For example, if a plan enters into a contract with a service provider, a fiduciary is causing the plan to enter into a direct furnishing of services between the plan and the party in interest, since the service provider is, by virtue of the definition in Section 3(14), a party in interest. Similarly, if a bank trustee opens a bank account to enable it to pay benefits to participants by check, a fiduciary is causing the plan to engage in a transaction which is the lending of money between the plan and the party in interest, and hence a prohibited transaction. (A bank account is literally an extension of credit by the person opening the account, here the Plan, and the bank.)

Section 406(a) with its *per se* rule and use of the broad term “party in interest” creates an unworkable situation. Fortunately, Congress enacted Section 408 of ERISA at the same time, and Section 408 provides for a system of exemptions which effectively eliminate most of the unworkable situations created by Section 406(a).

Exemptions from prohibited transactions

Section 408 establishes what has become a three-tier system of exemptions. The first tier, set forth in Section 408(b), is a list of thirteen statutory exemptions. Section 408(a) empowers the Secretary of Labor to issue class exemptions and individual exemptions from the prohibited transaction rules, and these form the basis for the second and third tiers of exemptions. The second tier is a set of class exemptions which cover a wide range of common transactions, essentially permitting plans to engage in the kinds of normal activities that would not have raised eyebrows under the prudent person rule and the duty of loyalty. Finally, the third tier, individual exemptions, are available on the basis of individual applications.

Statutory exemptions. Some of the statutory exemptions are of great importance. Most basically, Section 408(b)(2) states that the

prohibited transaction rules do not apply to contracting with a party in interest for services necessary for the establishment or operation of a plan, if no more than reasonable compensation is paid. Thus, even though every service provider is a party in interest, it is not a prohibited transaction for a fiduciary to have the plan procure such services at a reasonable cost. Until 2011, this result is so uncontroversial that it did not require discussion; it simply illustrated the framework of the prohibited transaction rules, namely, a prohibition that is incredibly broad and sweeping, followed by exemptions that bring it back to a reasonable rule.

Effective in 2011, the path to qualifying for this essential exemption became a great deal more complicated. Department of Labor Reg. § 2550.408b-2(c) now states that a contract will not be deemed reasonable unless there are extensive disclosures as to compensation, including indirect compensation. This regulation resulted from increasing concern that many plan fiduciaries were not aware of the compensation they were paying to investment companies and record keepers because much or all of that compensation was in indirect form, i.e. it reduced the investment return. The Department of Labor determined that it was essential to provide a mechanism to ensure that fiduciaries got the information they needed to make a determination that a particular contractual arrangement was reasonable. This requirement is matched by additional disclosures on the compensation of third parties in the annual filing with the Department of Labor, Form 5500.

Other statutory exemptions include the ability of plan participants to borrow from the plan, 408(b)(1), the ability of plans to open bank accounts in a bank that is a fiduciary or party in interest, 408(b)(4), the providing of ancillary services by a bank which is a plan fiduciary, 408(b)(6), and the investment of plan assets in a bank collective investment fund or an insurance company separate account even if that bank or insurance company is a fiduciary or party in interest, 408(b)(8).

A potentially important new statutory exemption was added by the Pension Protection Act of 2006 to permit a party in interest to give investment advice that otherwise might constitute a prohibited transaction. This exemption, which became effective in 2007, is discussed in greater detail in Chapter XV below.

Class exemptions. The statutory exemptions of Section 408(b) cover a lot of ground, but leave a great many gaps. These gaps have been filled in over the last 26 years by a large number of class exemptions. These exemptions are called prohibited transaction exemptions or “PTEs”, and are numbered by the year of issuance. (For example PTE 77-4 is a prohibited transaction class exemption issued in 1977 which permits a plan to invest in mutual funds sponsored by a plan fiduciary if

certain protective requirements are met.) These class exemptions are beyond the scope of this article, except to note that in the aggregate they allow commerce to proceed as long as conflicts of interest are kept to a minimum. One problem with this method of making the prohibited transaction rules workable is that as financial products evolve, it may be necessary to go back to the Department of Labor and seek new exemptions, and frankly this process can be frustratingly slow and cumbersome.

Individual exemptions. Finally, there is the possibility of obtaining an individual prohibited transaction exemption from the Department of Labor. If, for example, a company believes that the best use of a portion of its defined benefit trust is to make a loan to the company on a secured basis, it can go to the Department of Labor and make its argument that such a transaction is in the best interests of plan participants and beneficiaries even though it is a 406(a) (and possibly 406(b)) prohibited transaction. If the Department of Labor agrees, it will publish a proposed exemption in the Federal Register, and then, after reviewing comments from any party that makes them, the Department of Labor will make its final decision. The problem with this process is that it is slow and expensive, and therefore as a general rule is limited to major initiatives of large plans.

Consequences of engaging in a prohibited transaction.

Section 502(i) of ERISA and Section 4975(a) of the Code both provide for a penalty tax on the party in interest who engages in the prohibited transaction. The Code penalty is 15% per year of the amount involved, increasing to 100% if the transaction is not corrected after official notice is received. The ERISA penalty, which is similar in structure, starts at 5% and is only imposed to the extent that the Code penalty is not imposed. (This is possible because the definitions of disqualified person (Code definition) and party in interest (ERISA definition) are not precisely the same.) Although these penalties are imposed on the party in interest who engaged in the transaction, the fiduciary who permitted it is not off the hook since allowing the prohibited transaction to occur is a breach of duty for which the fiduciary can be liable to the plan under Section 409 of ERISA. The bottom line is that the occurrence of a prohibited transaction is expensive, and not always easy to undo. Furthermore, Form 5500, which must be filed annually, asks the question whether any prohibited transactions have occurred, so the plan sponsor is under an annual obligation to make a sworn statement regarding the absence of prohibited transactions.

Special rules regarding employer securities.

Congress added an additional layer of complexity to the prohibited transaction rules when it dealt with the question of a plan investing in employer securities or employer real estate. We will run briefly through the rules now as they apply to employer securities, and then revisit them in a separate chapter on plan investments. While we will not focus on real estate, the rules are quite similar to the securities rules.

Section 406(a) of ERISA makes it a prohibited transaction for a plan to acquire employer securities in violation of Section 407(a) of ERISA. Section 407(a) limits the type of securities that can be acquired by a plan (“qualifying employer securities”), and sets a general limit of 10% of the fair market value of the assets of the plan. However, Section 407 goes on to indicate that the 10% limit does not apply to an “eligible individual account plan”, which means that profit sharing plans, including 401(k) plans, can invest up to 100% of their assets in qualifying employer securities without causing a prohibited transaction. (There is a limited and rather meaningless exception that effectively prohibits 401(k) plans from requiring elective deferrals to be invested in employer securities.)

The upshot of Section 407 is that while defined benefit plans and money purchase plans are limited to investing not more than 10% of their assets in employer securities, profit sharing plans can invest an unlimited percentage in employer securities. Furthermore, there is a special exemption in Section 408 that effectively permits a qualified plan to purchase employer securities from a party in interest (i.e. the employer itself or a major shareholder of the employer) without engaging in a prohibited transaction. See ERISA § 408(e). Note that such exemption only applies to eligible individual account plans.

In addition to this special relief from prohibited transactions, Congress also created a special exception to the general diversification rule of Section 404 of ERISA, providing that in the case of an eligible individual account plan the diversification rules are not violated by the acquisition or holding of employer securities. ERISA § 404(a)(2).

Putting together all of these exceptions, it is clear that Congress wanted to encourage, rather than discourage, the holding of employer securities in eligible individual account plans. We will examine the consequences of this encouragement when we deal with the investment of plan assets in a later chapter.

Chapter XVII

A POET'S GUIDE TO ERISA'S GOVERNANCE OF THE INVESTMENT OF PENSION PLAN ASSETS¹

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1. Introduction – The Investment of Plan Assets

The investment of plan assets is among the most significant of fiduciary duties for a pension plan fiduciary. Once funds have been contributed to a pension trust, the manner in which those funds will be invested, sometimes over a period of many years, will be a critical component in determining whether in fact the system has worked to provide employees with adequate retirement benefits. While the fiduciary rules promulgated under ERISA, primarily in Sections 401 through 408 of ERISA, are crafted to govern the conduct of all fiduciaries in all types of plans, both pension and welfare, there is no question that many of these rules seem particularly focused on the investment of plan assets, a topic which almost exclusively is limited to pension plans. In this article, we will examine how these rules are applied to the investment of pension plan assets.

2. Defined Benefit vs. Defined Contribution Plans

The general rules we examine in this article apply to both types of pension plans, defined benefit and defined contribution, although we will see that there are particular rules that only apply to each type of plan. While these same general rules will be enforced against fiduciaries of each type of plan, it is worth reflecting on the difference between who is being protected in the enforcement of these rules in each case.

In the case of defined contribution plans, the investment risk is on the participant, and therefore the enforcement of these rules protects the participant. The success of plan investments directly correlates to the size of the participant's pension benefit.

In contrast, in a defined benefit plan, the participant's benefit is intended to be the same regardless of the success of plan investments. Therefore, in the first instance, the enforcement of the fiduciary rules with regard to investments is for the benefit of the employer, the entity that must contribute an adequate amount to fund the defined benefits. Under the complicated funding rules of Section 412 of the Code, the contribution

^{1 1} Portions of this article are taken from an earlier article entitled "Potential Liability for Investment of Assets in Defined Contribution Plans", by the author and Suzanne O'Connor, written in 1999. The author wishes to thank and give attribution to Ms. O'Connor for her role in the formulation of ideas contained in this article.

required by an employer will correlate to the investment results of the trust. Of course, there is always the possibility that the employer will not have the funds to make the required contributions, in which case two other entities, the Pension Benefit Guaranty Corporation and the participants, may be at risk. The Pension Benefits Guaranty Corporation guarantees the bulk of defined benefit pensions, and therefore it is a beneficiary of the enforcement of the fiduciary rules with respect to investments. The PBGC however, does not guaranty all pension benefits. Notably, there is a cap beyond which benefits are not guaranteed (\$59,320.00 per year in 2014), and in addition, there is a phase in on insurance of benefits provided by an increase in a plan formulas. For these gap pensions, the individual participant is at risk.

While there have been no material changes in the way in which defined benefit investments are made since the passage of ERISA, there has been a monumental change in the way defined contribution plan assets are invested. In the early 1980's, most defined contribution plans were invested either by professional managers or by the designee of the employer. Most plans gave participants no power to direct plan investments. A small percentage of defined contribution plans gave participants a limited power to allocate investments among a small number of funds, which power could be exercised one to four times per year.

By the turn of the century, by contrast, the norm had shifted to participant investment direction among a wide variety of funds, with the option of changing existing investment and the allocation of future contributions on a daily basis. This current defined contribution model is very popular from the perspective of both the participant and the employer. The participant feels empowered and the employer perceives that all of the responsibility has been lifted from its shoulders. This model has come under scrutiny in the last few years, perhaps because of a downturn in the stock market, controversy about including employer stock as an investment option, and increased concern about hidden charges in various investment options. Therefore, while this article will focus on both defined benefit and defined contribution plans, there will be a particular emphasis on the rules as they apply to "self directed" defined contribution plans.

3. The Plan Trustee

With one very limited exception (relating to plans all of whose assets are invested in insurance contracts), every pension plan governed by ERISA must have a trustee. The trustee can be a corporation with trust powers, or it may be any individual. The trustee will be governed by a written document which will either be part of the pension plan or a separate trust agreement.

Section 403 of ERISA, which sets forth the requirement that there be a trustee, does not define the role that a trustee must serve. Traditionally, a pension plan trustee would have two major functions. The first, which is

probably the basic function which cannot be assigned or eliminated, is holding legal title to, and safeguarding, the assets of the trust. This means knowing what those assets are, and accounting for them (directly or perhaps by delegation) on some periodic basis. Even the most “directed” or “passive” of trustees must perform this role. The second basic function of a traditional pension plan trustee is the investment of plan assets. Section 403 of ERISA deals specifically with the investment role, and we will examine it in depth below.

4. Other Fiduciaries

ERISA defines a fiduciary to be anyone who has discretionary power with respect to a plan. The trustee is probably always a fiduciary, even if its powers are stripped down. Another typical fiduciary is the employer, who generally cannot avoid having discretion for the interpretation of the plan (the terms used in ERISA are “management” and “administration”). Depending upon how the employer goes about managing and administering the plan, it may very well be that specific employees of the employer are also fiduciaries. In many small plans, there will be no other entities or individuals who are intended to be fiduciaries, although in a litigation context, record keepers, lawyers, accountants, and stockbrokers may all be accused of being fiduciaries (they will vigorously contest the accusation) because they allegedly exercise discretion with respect to the management or administration of the plan.

5. Investing Assets: The Standard to Which Investment Decisions are Held

Regardless of who makes the decision as to how plan assets should be invested, those investment decisions will be held to a standard which is set forth very specifically in Section 404 of ERISA. Basically, in making investment decisions, the fiduciary must comply with the duty of loyalty, the duty of prudence, and the duty to act in accordance with plan documents.

The duty of loyalty is defined in ERISA as the duty to act “solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries.” Essentially, this means that there cannot be conflicting or self-interested motives for making a particular investment decision. Typical examples of the violation of this duty would be the decision by a fiduciary to invest assets in an investment which benefits an employee, a friend, or a client. Even an investment that benefits the employer (and therefore indirectly the employees who are plan participants) will violate this duty if it puts the assets of the plan at risk.

The duty of prudence (written into ERISA before the consciousness of Congress was raised with respect to gender neutral language) is defined in ERISA as the duty to invest assets “with the care, skill, prudence, and

diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” The duty of prudence is specifically deemed to include the diversification of investments “unless under the circumstances it is clearly prudent not to” diversify.

The final duty is to act in accordance with the plan documents if they in turn are consistent with ERISA. This is an important third limitation, since some plans express limits on the types of investments that can be made.

Every fiduciary who has investment responsibility, whether a trustee, an investment manager, or a named fiduciary, is held to this same standard.

6. Assignment of Investment Responsibility

Section 403(a) of ERISA states a basic rule that the trustee of a plan shall have exclusive authority and direction to manage the assets of the plan. The law then goes on to provide three different exceptions to the general rule:

- a) Authority can be delegated to one or more investment managers (Section 403(a)(2));
- b) The plan can expressly provide that the trustee is subject to the direction of a named fiduciary who is not a trustee, in which case a trustee will be subject to proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to ERISA (Section 403(a)(1)); and
- c) In the case of an individual account plan which permits a participant to exercise control over assets in his or her own account, the trustee will not be liable for the results of such exercise of power (Section 404(c)).

In the absence of satisfying one of these exceptions, the trustee is, so to speak, on the hook. As we will see in the discussion below, each of these exceptions has its pitfalls with respect to compliance, and even where compliance has occurred, the exception may only partially, as opposed to totally, let the trustee off the hook.

7. The Investment Manager Exception

To understand the investment manager exception, one must take a whirlwind tour around Title I of ERISA. In order to come within the exception, the authority to invest plan assets must be delegated to an investment manager. ERISA § 403(a)(2). For the delegation to be effective, the plan document must provide that a named fiduciary be empowered to appoint an investment manager. ERISA § 402(c)(3). An entity will come

within the definition of “investment manager”, set forth in ERISA Section 3(38), only if it is either an investment advisor under the Investment Advisors Act of 1940, a bank, or an insurance company, and only if it has acknowledged in writing that it is a fiduciary with respect to the plan.

This exception works very well as long it is strictly complied with. It is generally used in defined benefit plans, or in defined contribution plans that do not provide participant direction.

It is probably helpful to describe a typical investment manager scenario.

A Fortune 500 company, Associated Widget, has a large defined benefit plan with 3 billion dollars of assets. Mega Bank is the trustee of that plan, and until 1999, has had the responsibility for investing all assets. Commencing in 1999, the plan is amended to specifically provide that Associated Widget, Inc. has the power to appoint an investment manager with respect to some or all of the assets of the plan. Associated Widget decides to hire the Perfection Investment Group, a registered investment advisor under the Investment Advisor Act of 1940, to manage 1 billion dollars of the plan assets. Associated Widget then enters into a written agreement with Perfection pursuant to which Perfection agrees to manage the assets and acknowledges that it will be a plan fiduciary with respect to the management of those assets. A copy of the written agreement is furnished to Mega Bank. At that point, Mega Bank will be protected in relying upon the direction of Perfection with respect to investments of those 1 billion dollars. It need not question that direction, even if it appears to be imprudent. (See ERISA § 405(d)(1), which carves out a special exception to the co-fiduciary liability rules that would otherwise apply.)

Probably the biggest potential pitfall with respect to the investment manager exception is the situation where the trustee relies on someone it perceives to be an investment manager, but who turns out not to be an investment manager either because the plan did not provide for the appointment of an investment manager or because the entity never executed a document acknowledging that it is a fiduciary. In such a situation, the trustee is on the hook and responsible for compliance with ERISA's investment rules.

8. The “Direction by a Named Fiduciary” Exception

The second exception to the general rule that a trustee is responsible for investment decisions is where it is directed by a named fiduciary. Section 403(a)(1) of ERISA states the exception as follows:

To the extent that the plan expressly provides that the Trustee [is] subject to the direction of a named fiduciary who is not a trustee . . . the trustee shall be subject to proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to [ERISA]. (Emphasis added)

This exception is used with respect to both defined benefit and defined contribution plans. A typical scenario in which this Section would be used is where the employer itself has a sophisticated finance department and desires the finance department to make its investment decisions. The plan document will provide that the employer has the right to direct the trustee with respect to investments, thereby making the employer a named fiduciary. On an ongoing basis, thereafter, the employer communicates investment directions to the trustee who effectuates those directions.

The potential pitfalls with respect to this exception are far more serious. As the quoted language above shows, the trustee is only subject to a proper direction of a fiduciary, and presumably not an improper direction. In addition, the trustee is only subject to directions which are not contrary to ERISA. As we have discussed, ERISA requires that investment decisions must be prudent, loyal and in accordance with the plan documents. Accordingly, if the employer and named fiduciary directs that an investment be made in the stock of an important customer, in order to enhance that customer relationship, that direction presumably is not proper nor is it in accordance with ERISA. Similarly, if the named fiduciary, with the most loyal of intentions, directs the trustee to invest a large block of its pension assets in the stock of a risky internet company, it may not be prudent or sufficiently diversified, and thereby be neither proper nor in accordance with ERISA.

If the trustee needs to fully monitor every decision directed by the named fiduciary to see whether it is prudent and loyal, then this exception is virtually meaningless, since the trustee will be exercising the same degree of fiduciary responsibility it would exercise if there was no direction. Presumably some lesser standard is meant to apply. There never has been a satisfactory resolution of this dilemma. The Department of Labor, in Field Assistance Bulletin No. 2004-03, has made it clear that it believes the directed trustee retains this residual fiduciary duty, but has acknowledged that Section 403(a)(1) significantly limits such duty.

Many trustees, in response to this confusion, have shied away from accepting direction from any entity other than an investment manager. Other trustees have agreed to be directed by an employer where they are confident that that employer is sophisticated both with respect to investments and the prudence and loyalty rules of ERISA. While it is unlikely that a court would impose upon a trustee that same standard of prudence and loyalty that it would have if it were not directed, it is conceivable, although probably not

likely, that the court might impose a monitoring or oversight responsibility on the directed trustee, and find that that responsibility was breached, if the decisions that were being made were obviously contrary to ERISA.

While this discussion may not seem relevant to the self-directed 401(k) plan, we note here, and discuss in more detail below, that typically the selection of the investment options available to participants is made by the employer as named fiduciary and that the trustee acts as a directed trustee in permitting those funds to be offered.

9. The Exception for Self Direction

The final exception to the general rule that the trustee is responsible for plan investments, the so-called “self-direction” exception, is contained in Section 404(c) of ERISA, and by its terms is limited to “individual account plans” (defined contribution plans). This section provides that if such a plan permits a participant or beneficiary to exercise control over assets in his or her account, and a participant or beneficiary in fact exercises control over those assets, then “no person who is otherwise a fiduciary shall be liable . . . for any loss, or by reason of any breach, which results from such participant’s or beneficiary’s exercise of control.” The statute does not answer the question of what the exercise of control means, but instead leaves that to regulations. But the statute is clear that if this exercise of control is offered to a participant or beneficiary, and the participant or beneficiary partakes in it, then the trustee is again off the hook, but only with respect to the results of that exercise of control.

10. What the Self Direction Exception Does Not Cover

We will examine the regulations defining the exercise of control over assets shortly. Before we get into the minutia of the regulations, however, it is useful to underline the point that this exception only lets the trustee partly off the hook. In the abstract, if a plan were to provide that a participant has complete control of his or her account, and could invest in any asset that he or she desired from the entire universe (or at least a good part of it), then the trustee would probably be completely off the hook. If a participant is offered an individual brokerage account (an option which is now in its infancy) with respect to the entire account, then Section 404(c) might be almost a complete protection against a trustee’s liability for bad investment performance.

In the typical 401(k) plan, however, self-direction is offered among a limited set of options, generally mutual funds. Some fiduciary must decide which options are to be available, and then monitor them on an ongoing basis. In other words, in this situation there is a two-step process. Step 1, the choosing, and ongoing monitoring, of the options, is a decision made by some fiduciary. Step 2, the choice of investments among those options, may vary

well come within the exception provided in Section 404(c) and thereby let the trustee off the hook.

The Department of Labor has consistently taken the position that Step 1, the prudent selection and monitoring of designated investment alternatives offered under a plan, is a fiduciary obligation that must be exercised even if a participant is given a choice of investments. This rule is now set forth in Department of Labor Reg. § 2550.404(a)-5(f).

Who makes the Step 1 decision with respect to the choice and monitoring of investment options? It is virtually never the trustee, but instead the employer, who makes these decisions. (It would be possible for the employer to appoint an investment manager to perform that function, but it is rarely if ever done.) The Plan or Trust document should specifically state who has this responsibility. A representative prototype document that we have examined has the following provision, which we believe is a good model for all plans.

. . . each Participant may individually direct the Trustee (or Custodian, if applicable) regarding the investment of part or all of his or her Individual Account. To the extent so directed by Participants, the Employer, Plan Administrator, Trustee (or Custodian) and all other fiduciaries are relieved of their fiduciary responsibility under Section 404 of ERISA, provided that it shall be the Employer's responsibility to direct the Trustee as to permissible investments into which Participants may direct their individual investments.

If responsibility for Step 1 is assigned to a named fiduciary, is the trustee off the hook? We are thrown back to the second exception discussed above, the direction by a named fiduciary which is proper and not contrary to ERISA. Since the universe of options which is offered to the employer typically has been pre-screened by the sponsor of the prototype program, it can be argued that the choice of almost any fund will be a proper direction which is not contrary to ERISA. Because of the somewhat vague language used in this exception, however, it is conceivable that in the event of a lawsuit alleging that one or more of the investment options offered to the participants and beneficiaries was either imprudent or disloyal, the trustee could be named as a defendant.

11. How does the named fiduciary satisfy its fiduciary responsibility with respect to choosing the options?

When an employer first establishes a 401(k) program, there will typically be a meeting to decide how many, and which, funds to offer. The typical number of funds offered used to be between 3 and 5, but the number has now frequently ballooned to 10 or 15, and in a number of cases has gone much higher than that. While the named fiduciary (the employer) can rely on

the fact that full information and disclosure will enable a participant to decide whether a particular fund is appropriate for him or her, and take some comfort from Section 404(c), it is probably prudent for the employer to avoid funds that are not appropriate to most of the work force. Generally there will be some financial data available to the employer, and an effort should be made to review that data prior to the meeting and then choose funds based on adequacy of performance. There is no case law indicating that it is essential to limit choices to funds that are in the top quartile or top two quartiles. In fact it would be difficult to achieve this result, since only a quarter of all funds (by dollar amount) can be in the top quartile. Nevertheless, the employer cannot be oblivious to poor performance.

This fiduciary function should include not only the initial determination, but also a process to periodically review the selected options. The right questions need to be asked periodically, with some formality, and a written record should be kept that those questions were asked. A semi-annual meeting, with minutes, would be ideal. While the substance of such a meeting, i.e. what data is reviewed, and whether it is properly digested and evaluated, is of course important, the mere fact that such periodic meetings occur may be the most critical factor in determining the employer's compliance with its fiduciary duties regarding the selection of investment options. Although this advice is intuitive, it is, to no one's great surprise, often ignored.

Commencing in 2010, there is an additional obligation - a disclosure obligation - that must be complied with to satisfy Section 404(a). In brief, the plan administrator must take steps to ensure that participants, on a regular basis, are informed of their rights and duties with respect to investments, and are provided with information regarding plan investments, including fees and expenses, to enable them to make informed decisions. The Department of Labor issued detailed regulations on the form and content of the annual disclosure that is required. See Department of Labor Reg. § 2550.404(a)-5.

12. Compliance with Section 404(c) - The 404(c) Regulations – Overview

Once the investment options are selected, Step 2, the duty to choose among these options, may be shifted to participants, by complying with Section 404(c), thereby eliminating fiduciary responsibility for any fiduciary regarding the participant-by-participant selection. Until the late 1980s, there was no guidance on how to comply with Section 404(c). After several controversial sets of proposed regulations, the Department of Labor issued final regulations under Section 404(c) effective in 1992.

The regulations set forth a three-part analysis to determine whether the 404(c) exception applies. First, the plan must provide the participant an opportunity to exercise control. Second, the opportunity must be among a

broad range of investment alternatives. Finally, the participant must actually exercise control. Each of these concepts is examined in detail under the regulations.

13. The 404(c) Regulations – Opportunity to Exercise Control

This portion of the regulations focuses extensively on the information that must be provided, automatically and on request, in order to conclude that the participant had a real opportunity. A lot of information must be disseminated automatically, including upon initial investment in a mutual fund, a copy of the most recent prospectus. The participant must be informed that the plan intends to comply with Section 404(c), and that accordingly fiduciaries will be relieved of liability. A description of the control process, the investments, and all fees must be given, as well as the description of what additional information is available upon request (see below). A responsible plan fiduciary must be identified. There are special rules for required information on employer securities and the pass through of voting rights. Upon request, additional information, such as prospectuses, annual operating expenses of an investment, and a list of plan assets must be provided. There appears to have been little audit or enforcement in the area of dissemination of information, and therefore little knowledge with respect to compliance or non-compliance. It seems safe to say that many small employers have been lax in complying with these rules.

This section of the regulations also sets forth the rules on the frequency with which the opportunity to change investments must be given. The basic rule is that an opportunity with respect to broad-based investments must be provided at least once in any 3 month period. For more volatile investments, the opportunity must be provided more frequently. While the frequency rules are actually quite complex, they have become almost irrelevant in an environment where most programs offer daily investment changes among all investments. Where there are restrictions on unlimited transferability (for example a restriction on a transfer from a bond fund to a money market fund), however, these rules must be analyzed for compliance.

14. The 404(c) Regulations – Broad Range of Alternatives

This portion of the regulations was the most controversial in 1992, because it sought to establish rules regarding what types of options had to be offered. In the pre-1990 world where there were often only 2 or 3 options, one of which was the “general account” of an insurance company, this area was a political minefield. In 1999, where 8 or 10 options is the norm, the rule promulgated by the regulations seems to be met automatically in most cases. The rule is that there must be at least 3 options (1) each of which is diversified, (2) each of which has materially different risk and return characteristics, (3) which in the aggregate enable a participant to achieve a portfolio with risk and return characteristics appropriate for that participant,

and (4) which together minimize through diversification the participant's risk. If these 3 options are offered, then other investments which do not meet these criteria may also be offered.

15. The 404(c) Regulations – Exercise of Control

The last step of the 404(c) analysis is that the exception will apply only if control is actually exercised. The main point here is that there has to be an actual direction, rather than the application of a default rule, and that the exercise must have occurred independently.

16. 404(c) – Effect of Applicability

Assuming full compliance, the question remains how valuable is the protection that results. It is worthwhile to give an example of a situation where 404(c) might help a fiduciary. Assume a plan offers four funds (an S&P fund, a stock fund, a balanced fund, and a bond fund). A participant, age 55, chose to invest 100% in the stock fund, and it goes down 35%. The participant brings suit against the trustee and the employer or fiduciary for not protecting him from his own decision. If 404(c) had been complied with, all fiduciaries would be relieved of liability. If, however, there has not been compliance with 404(c), the participant could argue that the employer or the trustee, as a fiduciary complying with the prudent person rule, should have stepped in and prevented the participant from electing to invest 100% in the stock fund. Would a court actually reach such a conclusion simply because there had not been compliance with the regulations issued under Section 404(c)? There is virtually no guidance on this issue.

17. Applicability of 404(c) to Default Investment Options

The Pension Protection Act, enacted in 2006, made several enhancements to the protections offered to plan sponsors under Section 404(c). Most important, 404(c) protection applies to a “default investment” that is made automatically in accordance with plan provisions if a participant has not made an investment election despite having an opportunity to do so. In addition, there is coverage for a blackout period caused by an administrative change to a plan, and coverage for changes in investment options.

There are several reasons that a plan may need to provide a default investment option. If a 401(k) arrangement provides for automatic enrollment, the automatically enrolled participants may not have completed an enrollment procedure. In addition, if a plan provides for an employer non-match contribution and for self-directed investment of the account containing such contribution, then the receiving participant may never have completed an enrollment procedure.

Before the Pension Protection Act, it was typical for plan sponsors to use a money market fund or a stable value fund as the default investment option, to eliminate the possibility of any losses occurring. In addition, some employers were reluctant to provide for automatic enrollment because of the risk of liability for the investment of those contributions if the automatically enrolled participant did not choose an investment election.

The Pension Protection Act provided a safe harbor set of rules on default investments. If these rules are followed, beginning in 2008 there will be 404(c) protection for a plan sponsor to the same extent as if investments had been affirmatively directed by the participant. The rules include the following: 1) the assets are invested in a “qualified default investment alternative”; 2) the participant had the right to direct among broad investment alternatives but did not do so; 3) the participant receives a notice promptly upon becoming a participant, and then annually thereafter, explaining the default investment and the right of the participant to change his or her investments or deferral percentages.

The determination of what would be a “qualified default investment alternative” generated a fair amount of controversy. Notably, money market funds and stable value investments do not qualify (except for limited grandfathering purposes.) Instead, the alternative must be either a) a balanced investment fund including a mix of fixed and equity investments “with a target level of risk appropriate for participants in the plan as a whole”; b) a balanced investment fund including a mix of fixed and equity investments with the mix targeted to a particular participant’s age, expected retirement date or life expectancy, sometimes called “Life Cycle Funds” or “Target Retirement Date Funds”; or c) a managed investment service offering a portfolio similar to that in b.

Interestingly, the Department of Labor, while certainly not wanting to give investment advice, has made a statement by issuing these regulations, namely that in the long run an investment in exclusively fixed investments is an investment strategy that will not be given safe harbor status. Their thinking, apparently, is that these default investments could continue for a participant’s entire career, and that while some fixed income investments offer short term safety, as a long term strategy they sacrifice too much of the upside offered by equity investments.

As noted at the outset of this section, the Pension Protection Act also provided relief for sponsors who make changes in their plan that results in a minor exception to self direction. First, when there is a “blackout”, i.e. a short period when self direction of investments is suspended to permit a change in record keepers, 404(c) will be deemed to continue to apply if certain notice requirements and time limits contained elsewhere in ERISA are satisfied.

More important, relief is given when an investment option is phased out. As we have seen above, the plan sponsor or some other fiduciary must review investments offered to participants to determine whether they continue to be appropriate. When a fiduciary decides to phase out an investment, typically those who use that investment will be “mapped” into a similar investment and notified that they can make other choices. If rules to this effect set out in Section 404(c) are followed, 404(c) protection will continue even though the participant never affirmatively directed the investment of funds in the new investment option.

18. Education vs. Advice

A fiduciary has no obligation under ERISA section 404(c) to provide investment advice to a participant or beneficiary. However, the increasing number of participant directed individual account plans, and the growth in investment options, has increased the importance of providing participants with guidance on investment decisions. This raises concerns that providing such guidance may be viewed in some circumstances as rendering “investment advice for a fee or other compensation” within the meaning of ERISA and thereby giving rise to fiduciary status and potential liability for the consequences of a participant’s investment decisions.

Employer response to this genuine need has come in several stages over the last 20 years. At first, most employers followed the risk averse approach of not doing anything that could be interpreted as investment advice. Employees were simply provided with prospectuses, and left to make their own choices. While this might have been a legally safe approach, it was not helpful in the least.

As 401(k) programs grew, and the investment options provided became more numerous, two developments occurred. First of all, many of the large investment companies that offer integrated 401(k) services, including investment in their proprietary funds, began providing general investment education, in the form of newsletters and annual seminars. At the same time the Department of Labor issued an interpretive bulletin, Interpretive Bulletin Section 2509.96-1, which stated the obvious: that offering general investment education to plan participants would not be deemed the rendering of advice. The DOL indicated that one could go as far as providing general asset allocation models, and interactive investment materials, as long as appropriate disclaimers were made and the underlying assumptions were specified.

The fact of the matter is that the vast majority of 401(k) plan participants are not going to be educated investors no matter how much general information is provided to them, and this reality has led to a third stage of development, the independent fiduciary who offers investment advice for a fee. There are several companies that now offer such services, on a contractual basis, to 401(k) programs. These companies have made the

determination that acknowledging fiduciary status for limited investment advice simply is not a risky business. These companies will provide questionnaires, and then suggest proposed investment strategies based on the investment alternatives offered under the program. While this industry is still in its youth, it has made some substantial strides.

The next stage of development is now in its infancy. The same large investment companies that offer integrated 401(k) services, including investment in their proprietary funds, have long wanted to offer investment advice. Because they already offer other services for a fee, however, there would be complicated prohibited transaction problems for them to provide this additional fiduciary service. A potentially important new statutory exemption was added by the Pension Protection Act of 2006 to permit such parties in interest to give investment advice that otherwise might constitute a prohibited transaction.

The exemption offers two distinct routes to offer investment advice and steer clear of a prohibited transaction. The first is to offer advice that will not impact the fee charged regardless of the investment decisions made on the basis of that advice. In most cases, the servicer already gets compensation as a result of investments, and that compensation can vary depending on which investments are chosen. This route is unlikely to be popular unless the rule is interpreted to apply only to the fees for advice, and not to the aggregate fees collected by the servicer/adviser.

The second route is to establish a computer model investment program. This program, which has many specific statutory requirements that have not yet been fully explained, would provide advice based on an objective computer model. The idea behind this option is that because a computer, and not the servicer/adviser, is giving the advice, there will be no potential conflict of interest even though the following of such advice could impact the fees received by the servicer/adviser. It remains to be seen whether this new exemption will be useful to the large investment companies who dominate this business. If so, it could result in a useful service being offered to participants who are overwhelmed by the obligation to make investment decisions that can have a significant impact over the long term.

19. The Special Case of Investment in Employer Securities

A great deal of attention has been given recently to the question of whether it is appropriate to permit or require the investment of qualified plan assets in employer stock. As a starting point, it is safe to conclude that in the absence of any special statutory language regarding employer securities, the fiduciary rules of Section 404 would prohibit the investment of qualified plan assets in employer stock. The diversification requirement alone would be very hard to satisfy in any circumstances, and conflicts of interest issues would loom in addition.

The fact is, however, that there are a number of special statutory rules which override the above conclusion, restoring neutrality, and perhaps even giving encouragement, to the question of whether to invest qualified plan assets in employer stock.

We start with Section 407 of ERISA. Section 407 defines the term “qualifying employer security” to include virtually any common stock of the employer, and then sets forth the rule that a plan may not acquire any qualifying employer securities if after such acquisition the aggregate fair market value of the employer securities would exceed 10% of the fair market value of the assets of the plan. Stated simply, every qualified plan can invest up to 10% of the fair market value of the assets, as determined on the date of acquisition, in employer stock without violating Section 407.

A further relaxation is provided for an “eligible individual account plan”, a term which effectively is defined as a profit sharing plan (including a plan with a section 401(k) arrangement) that specifically provides for the acquisition and holding of employer securities. Basically, the 10% cap does not apply at all to such plans. See ERISA § 407(b). Section 407(b) contains a prohibition against requiring elective deferrals to be invested in employer securities, but other than this limitation, a plan could mandate that all other assets, including matching contributions, be invested in employer securities, and not violate Section 407.

Does compliance with Section 407 assure compliance with Section 406 and Section 404? Section 406 states that the acquisition of employer stock in violation of Section 407(a) is a prohibited transaction, but does not say that the acquisition of employer securities in accordance with Section 407(a) is per se not a prohibited transaction. Nevertheless, it is fair to infer that an acquisition of employer stock in accordance with Section 407 will not be a prohibited transaction. (See below with respect to acquisition of employer stock from a related party.)

With respect to Section 404, the situation is a bit more complicated. Section 404(a)(2) provides that in the case of an eligible individual account plan, the diversification requirements contained in Section 404(a)(1) are not violated by the acquisition of or holding of qualifying employer securities. Therefore, to the extent the criticism of investment in employer securities is that it is imprudent to invest a large percentage of a qualified plan account in employer securities, Congress has specifically spoken by making the diversification requirements of ERISA inapplicable to employer stock.

Otherwise, the provisions of Section 404 are applicable. Therefore, when a fiduciary is deciding whether a qualified plan should invest, or permit investment, in employer securities, that fiduciary must make a determination that such investment is prudent, and that the decision is being made for the

exclusive benefit of employees for providing benefits to them. Presumably, this decision must be reevaluated on a regular basis.

Congress also addressed the situation of how plans could acquire employer securities. In many cases, those securities can be obtained on the open market in transactions that are not prohibited transactions. Congress went further, and carved out an exception which permits acquisition of employer securities from, or sale of employer securities to, parties in interest. This exception, contained in Section 408(e), permits a transaction with a party in interest (for example, a large shareholder) as long as the transaction is for adequate consideration, no commission is charged, and the plan is either an eligible individual account plan or the transaction is not violative of the 10% cap applicable to all other plans.

When one digests all of the above rules, one must conclude that Congress has tilted the playing field in favor of the acquisition of employer securities by plans. The reaction to the Enron debacle illustrates how entrenched the holding of employer securities has become in the qualified plans area. While there was an initial outcry about the imprudence of having a large portion of someone's retirement benefit invested in the stock of his or her employer, the follow-up has been an acknowledgement that there is no politically realistic way of cutting back on the use of employer securities in individual account plans. In fact, many employers now make the matching contribution of a 401(k) program in employer securities, and arguably might not make a matching contribution if they were forced to make it in cash. While one can debate the wisdom of the situation that now exists with respect to employer securities, Congress undeniably played a knowing role in allowing, and even encouraging, this situation to develop.

Chapter XVIII

A POET'S GUIDE TO ERISA CAUSES OF ACTION

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One of ERISA's many goals was to establish rules that would standardize litigation involving employee benefit plans. A previous chapter has already examined one step in reaching this goal - the preemption rule of Section 514 of ERISA, which eliminated state law cause of action. The second necessary step was to establish the parameters for ERISA causes of action, and this was accomplished by Section 502(a) of ERISA. This chapter briefly examines Section 502(a), the breath and limits of which have been established by case law, largely Supreme Court cases. It may be helpful to refer to the chart in Appendix B, which sorts out the various subsections of Section 502(a). The case references are to cases which are in the course materials.

1. We start with a quote from Great-West v. Knudson, 122 S.Ct. 708 (2002); the same language appears in many of the 502(a) cases:

ERISA is a “comprehensive and reticulated’ statute, the product of a decade of congressional study of the Nation’s private employee benefit system.” Mertens quoting Nachman. We have therefore been especially “reluctant to tamper with the enforcement scheme” embodied in the statute by extending remedies not specifically authorized by its text. Russell. Indeed, we have noted that ERISA’s “carefully crafted and detailed enforcement scheme provides ‘strong evidence that Congress did not intend to authorize other remedies that it simply forgot to incorporate expressly.’”

2. Section 502(a) has three provisions that will most often be used. Section 502(a)(1)(B) allows a participant or beneficiary to sue a plan to receive benefits that are due or to clarify a right to future benefits. Section 502(a)(2) permits a participant, beneficiary or fiduciary to sue a fiduciary for breach of fiduciary duty under Section 409 of ERISA. Section 502(a)(3) allows a participant, beneficiary or fiduciary to seek “other appropriate relief” for an act or practice that violates ERISA or the terms of the plan.

3. In Massachusetts Life Ins. Co. v. Russell 473 U.S. 134 (1985), the Supreme Court addressed Section 502(a)(2) and Section 409, and concluded that Section 502(a)(2) provides remedies only for the entire plan, not for individuals; that recovery under this subsection must inure to the benefit of the plan as a whole, and not to particular persons with rights under the plan.

4. In Mertens v. Hewitt Associates, 508 U.S. 248 (1993), the Court considered whether a participant could sue a non-fiduciary party in interest (here an actuary) who allegedly cause damage to a plan for damages. The Court held that Section 502(a)(3), if it provided the right to sue at all, limited the recovery to “appropriate equitable relief.” Cash damages did not come within the phrase “equitable relief.”

5. In Varity v. Howe, 516 U.S. 489 (1996), the Court held that participants and beneficiaries could sue a fiduciary under Section 502(a)(3) for equitable relief, even though Section 502(a)(2) would provide them no relief because relief under that provision was limited to relief to the plan as a whole. The equitable relief in that case was enrollment in the Massey-Ferguson plan, although the Court does not address the issue of what constitutes equitable relief.

6. In Harris Trust v. Salomon Smithbarney, 120 S. Ct. 2180 (2000), the Court addresses a question left ambiguous in Mertens, namely whether Section 502(a)(3) provides a cause of action against a non-fiduciary party in interest that causes harm to a plan. The Court found that Section 502(a)(3) covers a suit against a non-fiduciary if the equitable relief sought is appropriate to redress the violation of ERISA. In this case, the violation was a prohibited transaction caused by a fiduciary, but the remedy was sought against the non-fiduciary who profited as a result of the prohibited transaction. The remedy was to give back the lost profits - disgorgement or restitution - which is an equitable remedy rather than money damages.

7. In Great-West v. Knudson, 122 S.Ct. 708 (2002) a participant was contractually subject to the subrogation rights of an insurance company, Great West, but instead the funds were paid out to a trust for the benefit of the participant.. Great West sued for the funds that failed to reach Great West. The Court held that such a suit was brought under Section 502(a)(3), and yet sought money damages. Therefore no cause of action could proceed. The Court went through a detailed analysis of what constitutes equitable relief, and read it strictly to exclude anything that was not an equitable cause of action. Therefore while a suit could be brought for return of funds (restitution or disgorgement) but not for money damages if the funds have already been spent or disposed of.

8. In LaRue v. DeWolff, 552 U.S. 248 (2008), a participant in a defined contribution plan sued the fiduciary who failed to execute his investment decision, a failure that resulted in a significant loss (or a lack of gain.) The fiduciary argued that Section 502(a)(2) only allowed claims for the benefit of the entire plan, citing Russell. The majority held that Section 502(a)(2) permits a suit for the benefit of an individual participant in a defined contribution plan, thereby limiting the scope of the Russell precedent.

9. In CIGNA v. Amara, 131 S. Ct. 1886 (2011), the Court appeared to expand on the scope of equitable remedies under Section 502(a)(3), concluding (although arguably in dicta) that in appropriate cases the equitable remedies of reformation and surcharge could be used to virtually rewrite a plan's benefit provisions to provide far more generous benefits than the plan language stated. The decision has been interpreted to be favorable to plaintiffs, opening up the possibility of getting financial relief that appeared to be unavailable based on Mertens.

Appendix A
IRS Retirement Plan Limits

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		IRS or PBGC Retirement Plan Limits			
Issue	Code Section	2017	2016	2015	2014
401(k) & 403(b) Elective Deferrals	§ 402(g)(1)	\$18,000	\$18,000	\$18,000	\$17,500
Catch-Up Elective Deferrals	§ 414(v)(2)(B)(i)	\$6,000	\$6,000	\$6,000	\$5,500
Defined Benefit Plan Benefit	§ 415(b)(1)(A)	\$215,000	\$210,000	\$210,000	\$210,000
Defined Contribution Plan Contribution	§ 415(c)(1)(A)	\$54,000	\$53,000	\$53,000	\$52,000
Annual Compensation Limit	§ 401(a)(17) & § 404(1)	\$270,000	\$265,000	\$265,000	\$260,000
457(b) Deferral	§ 457(e)(15)	\$18,000	\$18,000	\$18,000	\$17,500
Highly Compensated Employee*	§ 414(q)(1)(B)	\$120,000	\$120,000	\$120,000	\$115,000
PBGC Monthly Maximum Guarantee**	N/A	\$5,369	\$5,011	\$5,011	\$4,943
Social Security Tax Wage Base	§ 3121(a)(1)	\$127,200	\$118,500	\$118,500	\$117,000
Key Employee Officer Compensation	§ 416(i)(1)(A)(i)	\$175,000	\$170,000	\$170,000	\$170,000

* Highly compensated employee determination uses a “look-back” approach. For example, an employee is highly compensated for the 2015 plan year if the employee’s compensation was \$115,000 or greater in 2014.

** Assumes a single life annuity beginning at age 65. The maximum is adjusted downward for retirees younger than age 65 and upward for retirees older than age 65. Separate figures apply for joint and 50% survivor annuities.

Appendix B
ERISA §502(a)(1)-(3)

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<u>§</u>	<u>Who Can Sue</u>	<u>Who Can Be Sued</u>	<u>Basis of Suit</u>	<u>Relief</u>
502(a)(1)(A)	Participant [§3(7)] or Beneficiary [§3(8)]	Plan administrator [§3(16)(A)] <u>See also</u> Plan sponsor [§3(16)(B)] (but not Employer [§3(5)] as such)	Plan administrator's failure to furnish information required by §502(c)	\$110 a day Other relief that court in its discretion deems proper
502(a)(1)(B)	Participant or Beneficiary	Plan [§§3(1), §3(2), §3(3)]	To recover benefits due To clarify rights to future benefits	Plan benefits (ERISA permits suits to recover benefits only against the plan as an entity as the obligation to pay benefits is that of the plan. <u>See also</u> §502(d)(2) (judgment against a plan enforceable only against the plan as an entity).)
502(a)(1)(B)	Participant or Beneficiary	Plan administrator Plan trustee Plan fiduciary	To enforce rights under terms of plan	Declaratory relief Injunctive relief
502(a)(2)	Secretary [§3(13)] Participant, Beneficiary, or Fiduciary [§3(21)]	Fiduciary (<u>See also</u> co-fiduciary liability under §405)	Breach of fiduciary duty under §409	Relief necessary to "make good to such plan any losses <u>to the plan</u> resulting from each such breach." (§409) <u>Russell</u> : relief to the plan only Removal of fiduciary Other equitable or remedial relief, as appropriate
502(a)(3)(A)	Participant, Beneficiary, or Fiduciary	No limit on universe of defendants <u>See Harris Trust v. Salomon</u>	Acts or practices that violate ERISA or terms of the plan	Injunctive relief
502(a)(3)(B)	Participant, Beneficiary, or Fiduciary	No limit on universe of defendants <u>See Harris Trust v. Salomon</u> Includes fiduciaries; <u>See Varsity</u>	Acts or practices that violate ERISA or terms of the plan Enforce ERISA or terms of the plan	Other appropriate equitable relief <u>See Mertens and Knudson</u> : only traditional equitable relief (not damages) <u>Varsity</u> : relief includes individual claims; not limited to relief to the plan

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