

ERISA AUDIT REPORT

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Message From The Firm

It's January, and for our ERISA Department that means we've made it through another busy holiday season of helping plan sponsors and their advisors wrap up their employee welfare and benefit plan issues for 2005, and finalize their plans for 2006. January also marks a change in my responsibilities for the American Society of Pension Professionals and Actuaries (ASPPA). I have now completed my year of service on ASPPA's Executive Committee and as the General Co-Chair of Conferences, and I am returning to ASPPA's Government Affairs Committee as a Co-Chair of the Administrative Relations Committee.

Our ERISA attorneys continue to assist plan sponsors and their advisors with IRS audits, Department of Labor (DOL) investigations and correction of compliance defects. In this issue, Nick Waddles discusses the changes made this year to the DOL's Voluntary Fiduciary Correction (VFC) Program. The DOL has characterized the changes as resulting in both an expansion and a simplification of the program. Nevertheless, Nick explains why the revised program won't necessarily result in greater use by—or availability to—plan sponsors, and why this places a premium on self-audits and correction. Marty Heming's article highlights the value of seeking qualified professional advice before implementing certain types of retirement plan investment strategies. Marty focuses on a case involving a DOL investigation and determination that a real estate investment was a prohibited transaction. The cost of correction was substantial and had to be borne by the plan sponsor.

As always, we welcome your comments and questions. Please let us know if we can be of assistance to you or your clients. We hope you had a great holiday season and we wish you the best for the new year!

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The DOL Expands Voluntary Compliance Program... or Not?

By Nicholas Waddles (NickWaddles@Reish.com)



Since the last issue of our ERISA Audit Report, the Department of Labor (DOL) amended and restated the Voluntary Fiduciary Correction (VFC) Program. According to the DOL, the purpose of the VFC Program is to encourage voluntary compliance with the fiduciary rules of the Employee Retirement Income Security Act of 1974 (ERISA) by offering a self-correction program for employers. Prior to the restatement, VFC was available to correct fifteen specific transactions that are arguably breaches of fiduciary duty. The revisions were issued in preliminary form in the April 6, 2005 Federal Register and were available for written comments through June 6, 2005. The April 2005 revisions have not yet been finalized and plan sponsors are permitted to correct consistent with those revisions or the prior version adopted in March 2002.

The stated purposes for the revisions to VFC were the expansion and simplification for the program and an increase in the transactions eligible for correction. By now, much has been written about the fact that the revisions were designed to expand and simplify VFC. However, one change may result in VFC being available to fewer plan sponsors. The following is a summary of the major changes to the program and a more in-depth discussion of the "minor" change that may have "major" implications for many plan sponsors.

Inclusion of Model Application Form. The DOL states that it designed a model application form to avoid common application errors that often resulted in processing delays or rejections of submission. The use of the model form is voluntary but the DOL believes its use will enable it to provide a more expedient and consistent review of applications. However, the DOL cautions that the use of the model form is not a substitute for a thorough review of the VFC conditions and requirements.

Reduction of Supporting Documentation. Previously, VFC required that the submitting plan sponsor include proof of a fidelity bond - this requirement has been eliminated. In addition, for applications submitted to correct delinquent employee deferrals to a 401(k) plan that involve amounts less than \$50,000 or amounts greater than \$50,000 that were remitted within 180 calendar days of receipt by the employer, summary documentation may be submitted with the application. Prior to the revision, applications addressing this issue had to be accompanied by extensive supporting documentation, including accounting and payroll records, cancelled checks, proof of wire transfers and/or bank statements from the plan's account.

Simplified Connection Amounts And Use of Online Calculator. Correcting certain transactions under VFC

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Correcting PTs During a DOL Investigation Can Be Costly



By Marty Heming (MartyHeming@Reish.com)

On many occasions a retirement plan fiduciary makes an investment of plan assets with the best of intentions, only to find the investment inadvertently constitutes a prohibited transaction. When this prohibited transaction continues for many years before being discovered during either an IRS audit or an Employee Benefits Security Administration (EBSA) investigation, the cost to the fiduciary is likely to be very significant. Depending on the exact terms of your contract as advisor with the plan sponsor, you may be responsible for discovering the existence of the prohibited transaction and advising your client with respect thereto.

A case in point occurred recently. In 2004, EBSA opened an investigation of a qualified plan. The plan sponsor was responsible for investment of the assets and they decided to handle the investigation without involving a third party administrator or an ERISA attorney. We were told later the reason for this approach was that the sponsor "knew it had done nothing wrong." When EBSA sent the plan a voluntary compliance letter outlining its view of the prohibited transactions that had occurred, the fiduciary was shocked.

The facts of the case were simple. The plan was a defined contribution plan with pooled investments. The plan had been around for many years and had built up a substantial asset base. In order to get a better return on the plan's investments the plan's fiduciary decided to invest about 10 percent of its assets in real property and lease the property back to the sponsor. The sponsoring company's advisors believed that this transaction met the statutory exception for prohibited

transactions for qualified employer real property (QERP) found in ERISA. Accordingly, the plan fiduciary caused the plan to purchase a parcel of property that contained office space. The plan then leased the property to the sponsor using a long term lease with a fixed annual rent.

The building cost about one million dollars. 80 percent of the purchase price was paid for by a loan from a bank to the plan, with no guaranty by the company. The note to the bank required annual payment of principal, and interest at 8.5 percent per annum. The plan sponsor paid rent on the building. The rent was fixed at an amount that permitted the Plan to make the payments on the note. No appraisal of the fair rental value of the building was conducted at the time the plan leased the property. About 2/3 of the way through the lease term, the DOL opened its investigation of the plan.

EBSA's position can be summarized as follows:

- a) The lease wasn't issued pursuant to the QERP exception.
- b) The company sponsoring the plan failed to pay fair rental for the rent of the property.
- c) The lease was a prohibited transaction and, therefore, had to be corrected immediately.

Unfortunately for the employer, EBSA's position was correct. The lease by the employer of property owned by the plan was a prohibited transaction. No statutory exception was available. Under ERISA 407(c)(4) in order to be qualifying employer real property, (i) there must be more than one parcel of property leased by the employer, (ii) the parcels must be geographically dispersed, (iii)

each parcel must be suitable for more than one purpose without substantial renovation. In addition, it must (i) comply with the diversification rules, (ii) be rented at the fair rental value and (iii) the plan must be an individual account plan or meet the 10 percent restriction. Out of the six requirements, only the diversification rule and the individual account plan requirements had clearly been met.

Accordingly, the employer decided to make correction voluntarily. Step one was to obtain an independent appraiser with appropriate credentials to appraise the fair rental value of the property. Two appraisals were required, one as of the date of the original lease which was about 9 years ago and the second in 2005 when the lease was prematurely terminated to make correction of the PT. Two appraisals are required because unless both appraisals showed that the building rent was at fair rental value, the correction required is for the fiduciary to pay the Plan the difference between the actual rent and the higher of the two fair rental values. Treas. Reg. 53.4941(e)-1(c)(4). See Treas. Reg. 141.4975-13 which provides that Treas. Reg. 4941(e)-1 is controlling in defining the correction required under IRC Section 4975.

The appraisals revealed that the rent specified in the lease was at fair rental value when the lease was initially written. However, at the time of the termination of the lease in 2005 the fair rental value was higher than the annual lease amount paid. Because the lease was in effect for 9 years, the employer was required to pay the plan the difference between the now fair rental value and the lease rent for each year of the 9 years. [It is interesting to note that, under ERISA, if the fair rental value had been less than the amount specified in the lease, then upon termination of the lease mid-term, the employer would have had to pay the plan the excess of the lease amount over the fair rental value for the remainder of the lease term.] This is a

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DOL Expands

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requires the fiduciary to provide the plan with make-up contributions equal to the greater of the lost earnings or the amount necessary to restore profits. In the past, calculating lost earnings or restoration of profits was a complicated process. In order to streamline the calculation, the revised program allows plan sponsors to use an online calculator to automatically calculate lost earnings and interest, and any interest amount for restoration of profits. The calculator can be found on the DOL's web site at <http://www.dol.gov/ebsa/calculator/main.html>.

Addition of New Eligible Transactions. Previously, VFC was available to correct fifteen specific transactions. Added to that list are three new transactions, one of which involves illiquid plan assets sold to interested parties. In certain circumstances, the plan may now be permitted to divest itself of such asset, rather than continue to hold it in its portfolio. The other two newly eligible transactions involve participant loans that are delinquent and participant loans that exceed the maximum duration and/or Code section 72(p) limit.

Other Changes. There are other minor amendments to VFC including a modification of the penalty of perjury statement and a specific statement in the program that the DOL reserves the right to request additional supplementary documentation necessary for a complete examination of the application.

Expanded Definition of "Under Investigation." Submitting an application under VFC is voluntary and, thus, not available to plan sponsors and fiduciaries that are "under investigation." Previously, a plan sponsor or fiduciary was "under investigation" only if they were subject to a DOL investigation under section 504 of ERISA or a criminal statute involving a transaction affecting the plan.

The 2005 revision expands the definition of "under investigation" to include *any* investigation or examination by *any* federal agency - criminal or civil - in connection with an act or transaction involving the plan. This includes notice of a federal agency's intent to conduct an investigation. Thus, while mere contact by an agency official is generally insufficient to constitute such notice, the DOL explicitly states in the revised program that communications notifying the parties of a federal agency's *intent* to conduct an investigation or examination should be viewed in the same manner as if the investigation had actually commenced.

The expanded definition of "under investigation" means that plan sponsors will have to carefully consider inquiries from other government agencies concerning the plan before filing an application under VFC. Previously, plan sponsors only needed to consider whether they had received notice of an investigation by the DOL before filing an application. If no such notice had been received, a plan sponsor was free to use the program. Under the expanded definition of "under investigation," the number of plan sponsors eligible to participate in VFC may be greatly reduced because of actual or *intended* investigations by other government agencies.

For example, as the Securities and Exchange Commission increases its scrutiny of federal securities issues in retirement plans and the IRS continues to expand its audit program, it is reasonable to assume that more and more retirement plans, plan sponsors and fiduciaries will come within the new definition of "under investigation." Thus, an unintended consequence of the expansion of the definition is that it may actually reduce the number of plan sponsors eligible for VFC.

Conclusion. While the changes to VFC were publicized as an expansion and simplification of the program, they may

in fact have the opposite result. The subtlety of this change highlights the value of retaining qualified retirement plan advisors to conduct compliance reviews on a proactive basis, so as to preserve the option to make appropriate corrections on a voluntary basis. We will continue to keep you apprised of developments in the voluntary compliance area. ❖

Upcoming Conferences

Los Angeles Benefits Conference January 26-27, 2006—Universal City

The Los Angeles Benefits Conference provides a forum to discuss employee benefits issues with colleagues as well as with government representatives from the IRS and DOL. Our employee benefits attorneys have been actively involved in planning or speaking at the conference since its inception. This year is no exception.

Fred Reish will be a panel speaker at the session on "DOL Guidance and Recent Developments on Fiduciary Compliance." Bruce Ashton, Conference Executive Committee Co-Chair, will be a panelist at the session on "Non-qualified Deferred Compensation After 409A." Marty Heming, member of the Conference Executive Committee, will moderate a session on "Prohibited Transactions from the DOL's Perspective." Nick White will moderate a pre-conference session regarding the Employee Plans Division's enforcement activities and initiatives.

ASPPA 401(k) Summit February 26-28, 2006—Orlando

The 401(k) Summit is a unique forum for retirement sales and investment professionals to learn from industry leaders about trends and economic factors impacting the ever-changing 401(k) marketplace. Involved in the creation of the Summit, Fred Reish has continued to support the conference. At this year's Summit, Fred will present a workshop on "Are 401(k) Advisors Plan Fiduciaries? New Insights and Best Practices." Bruce Ashton will co-present a workshop on "Your Worst Nightmare: Meet the Attorney Who Sues Financial Advisors." Bruce will take the point of view of the attorney representing the advisor.

Correcting PTs

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very steep price to pay for a lease that was at fair rental when issued and that earned over 8 percent per year for 9 years, and was the best performing of all of the assets in the Plan over the affected period. In addition to paying this correction price to the Plan, the lease between the Plan and the plan sponsor had to be terminated immediately in order to correct the prohibited transaction.

In this case, the plan fiduciary decided to sell the building to an unrelated third party for fair market value and to have the company sponsoring the plan terminate the lease. In carrying out this method of correction, the fiduciary had to act prudently and exclusively for the benefit of the participants in the plan. For in-

stance, if the fiduciary had decided to sell the building to a third party but not terminate the lease, this could cause the Plan to lose money on the sale because the lease was at less than fair rental value. In addition to correcting the prohibited transaction and making restitution to the plan, the disqualified person must pay the excise tax imposed by IRC 4975.

Of course, EBSA doesn't impose an excise tax. However, EBSA will refer the case to the IRS for that purpose. For that reason, the employer decided to pay the excise tax voluntarily before the IRS audited the Plan. By voluntarily paying the excise tax, the late filing penalty may be waived by the IRS. In this case, the excise tax ranged between 5 percent and 15 percent of the amount involved, because the rate was changed during the time the prohibited transaction was outstanding. The excise tax that had to be

paid was significant, because it had to be imposed on the difference between the lease amount and the fair rental value for each year during the period in which the prohibited transaction existed.

How is this case important to you? As advisors to pension plan sponsors, it is critical to understand the complex rules governing prohibited transactions. Moreover, it is important to realize how costly it can be to correct a prohibited transaction and pay the excise tax. The prohibited transaction rules are not based on fairness or common sense, but on strict and inflexible rules. Therefore, it is important that the fiduciaries you work with understand and appreciate this, and do not make investments without first obtaining qualified advice.



Around the Firm

Speeches: Mark Terman, who heads our Labor & Employment Law Practice Group, presented on January 18, 2006, to the Los Angeles Compensation and Benefits Association a program on "New Employment Laws that Employers Need to Know for 2006." Fred Reish will present a workshop on "DOL Guidance and Recent Developments on Fiduciary Compliance" at the Los Angeles Benefits Conference taking place January 26-27 in Universal City. Bruce Ashton will speak at the Conference on the topic of "Non-qualified Deferred Compensation After 409A." Marty Heming will present at the conference on the topic of "Prohibited Transactions from the DOL's Perspective." And, Nick White will moderate a pre-conference session regarding "IRS Examination activities and EPCRS." In February, Fred will present a workshop at the ASPPA 401(k) Summit on the topic "Are 401(k) Advisors Plan Fiduciaries? New Insights and Best Practices." Bruce will co-present a workshop at the Summit on "Your Worst Nightmare: Meet the Attorney Who Sues Financial Advisors." In March, Nick White will present "Fiduciary Issues in Retirement Plans: The Duty to Protect Participants" at the ASPPA Benefits Council of South Florida.

Articles: Marty wrote an article on "What is a Pick-up Plan and Who Cares?" that was published in the Fall 2005 issue of *Plan Horizons*. Fred's column in the December issue of *Plan Sponsor* magazine addressed "How Much Is Enough: The Challenges of Putting Together a Diverse Retirement Plan Menu?" Fred and Bruce co-wrote a 401(k) investments column in the Autumn 2005 issue of the *Journal of Pension Benefits* on "ERISA Section 404(c) Protection: Myths, Mistakes, and Answers About ERISA's 'Insurance Policy' for Fiduciaries."

Quotes: Fred was quoted in the November 15th issue of the *BNA Pension & Benefits Reporter* in the article "Fiduciary Responsibility Emphasis on Fiduciary Duties Will Increase Even More in the Future, Practitioner Says."