

Message From The Firm

Seven of our benefits attorneys recently participated in the 15th Los Angeles Benefits Conference, jointly sponsored by the IRS and private-sector professional groups. Held at the end of January, it is the first venue at which the practitioner community has an opportunity to hear the latest news from the regulators. This year was no exception, and this Bulletin highlights some of the most interesting developments.

We may have a unique perspective, because Marty Heming and I served as co-chairs of this year's Conference, and Fred Reish, Marty and I were active participants with government speakers on panels addressing, respectively, fiduciary issues related to revenue sharing, DOL investigations and IRS enforcement activities. Nick White and Debra Davis moderated sessions on plan document updates and health and welfare issues. Equally important, we were all able to attend the conference and glean the gems that always seem to come out at this event.

Debra's article addresses developments in IRS and DOL enforcement activities and expected guidance on developing issues. Fred provides insights on current and upcoming requirements for the disclosure and reporting of fees, expenses and revenue sharing. Stephanie Bennett lays out developments and anticipated guidance for tax exempt and government entity plans, and Heather Abrigo discusses what we can expect from Congress this year on various retirement and health plan issues. Finally, Fred addresses the DOL guidance on QDIAs (qualified default investment arrangements)

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The IRS and DOL Provide Insight Into Their Operations



By Debra Davis, Esq. (DebraDavis@Reish.com)

The Internal Revenue Service and U.S. Department of Labor provided audiences at the Los Angeles Benefits Conference with insight into their operations and projects. In particular, the IRS and DOL shared with us their activities regarding (i) IRS audits; (ii) Voluntary Correction Program (VCP) applications; and (iii) default investment guidance.

- **IRS Audits.** An IRS official indicated that the IRS would like to increase the number of employee benefit plan audits. The IRS anticipates that the audits will be more focused than in prior years. The IRS official stated that they will evaluate whether a plan is well run and determine if violations with respect to specific issues have occurred. In the event the plan appears to be operated properly, the IRS would not delve deeper into the plan's operations. Thus, although the number of audits will increase, they should take less time.
- **VCP Applications.** The Employee Plans Compliance Resolution System (EPCRS) allows employers to submit applications to the IRS under its Voluntary Correction Program to correct mistakes relating to retirement plans. Typically, the IRS would take over a year to process the VCP application and issue a compliance statement. However, an IRS official indicated that they have dramatically reduced the

open inventory of VCP applications. By the end of the year, the IRS anticipates that the average duration for a VCP application will be 6 months. Their goal is to ultimately reduce the length of time to 120 days.

- **Default Investment Guidance.** For participant-directed plans, ERISA section 404(c) provides fiduciaries with protection from participants' investment choices if certain requirements are satisfied. The Pension Protection Act of 2006 (PPA) extends this protection to the accounts of participants who do not select investments if the accounts are placed in a "qualified default investment alternative" (also known as a "QDIA"). The DOL has issued proposed regulations that generally provide that the plan's fiduciaries may select as the QDIA: (i) age-based lifecycle funds, (ii) a balanced fund that is appropriate for the participants in the plan as a whole (for this purpose, the definition of a balanced fund includes risk-based lifestyle funds), or (iii) managed accounts. The final regulations were expected by mid-February 2007, but have not yet been issued.

Some commentators had argued that investments that protect principal, such as money market accounts or stable value investments, should also be allowed as QDIAs. A DOL official

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Disclosure of Conflicting Revenues



By Fred Reish, Esq. (FredReish@Reish.com)

At the LABC, I participated on a panel that discussed current and upcoming requirements for the disclosure and reporting of fees, expenses and revenue sharing.

It is clear that, by the end of this year, plan expenses and revenue sharing will be on everybody's radar screen and the requirements for reporting and disclosure will be much greater than they are today. That is because of the recent rash of lawsuits against plan sponsors and providers and because of two or three pieces of guidance that the Department of Labor will issue this year.

The three guidance projects are:

- reporting of fees, expenses and revenue sharing on the Schedule C to the 2008 Form 5500;
- the issuance of a model notice under the fiduciary adviser provisions in the PPA; and
- the 408(b)(2) point-of-sale disclosure regulation.

Of the three, the 408(b)(2) regulation will have the greatest impact. Let me give you some background.

Under 408(b)(2), a plan can only pay its providers, including advisers, "reasonable compensation." That should not be a surprise. . . . we have heard about the reasonable compensation requirement repeatedly in recent years. However, there has been little focus on the fact that 408(b)(2) also says that plans cannot enter into agreements or relationships with providers or advisers

unless it is a "reasonable arrangement." There is almost no information about the definition of a reasonable arrangement. (One existing piece of guidance is a regulation that says that it is a prohibited transaction for a provider to charge a penalty to a plan.)

In the 408(b)(2) project, it is contemplated that the DOL will define the meaning of "reasonable arrangement" to require full disclosure by providers and advisers of all fees, expenses and revenue sharing. That would likely include 12b-1 fees, finder's fees, bonus arrangements, subtransfer agency fees, commissions, and other things of value, such as trips, vacations, gifts, and so on. It would include all payments of those types, both direct and indirect. We understand that it will also include payments to affiliates of advisers and providers.

Because of the growing awareness of this project, and because of the belief that the regulatory requirements will be meaningful, many providers are already gearing up to report that information at point of sale. Advisers will also need to report all of their revenues for themselves and revenues received by their affiliates.

As a starting point, we recommend that plans sponsors work with their advisers and providers to gain an understanding of the different types of money flows, who that money is paid to, and how the money benefits their plan. ❖

IRS and DOL

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indicated that the final regulations may include those options as QDIAs for short periods of time.

Practitioners had also questioned whether fiduciaries who selected a balanced fund as the QDIA would need to periodically evaluate whether it continued to be appropriate for the participants in the plan as a whole. The DOL official indicated that the final regulations may indicate that fiduciaries that select a balanced fund as the plan's QDIA will need to determine which balanced fund is appropriate for their plan on an annual basis.

Overall, the information provided by the IRS and DOL was positive. Employers will likely be pleased with the shorter IRS audits, faster VCP application time and forthcoming guidance on default investments. ❖

Firm Message

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and explains why a delay in issuing the final regulations may not matter.

Both Marty and I are ending our tenures as co-chairs of the Conference. Speaking for myself, I have enjoyed my decade and a half role in helping to plan and present the LABC, which has become the premier benefits conference on the West Coast. I know we will continue to be involved in the future, though in less demanding ways.

As with any of our newsletters and bulletins, if you have questions about any of the topics addressed in these articles, please call the author or your regular benefits attorney at

- Bruce Ashton
BruceAshton@Reish.com

Short and Long-Term Goals of Congress



By Heather Bader-Abrigo, Esq. (HeatherAbrigo@Reish.com)

At the 2007 Los Angeles Benefit Conference (“LABC”), there were discussions of the short and long-term goals of Congress regarding employee benefit plans. Furthermore, Amy Turner, Senior Health Law Specialist, Office of Health Plan Standards and Compliance Assistance of the Employee Benefits Security Administration, Department of Labor discussed how Plan Sponsor’s may reward employees for healthier lifestyles without violating the nondiscrimination requirements of the Health Insurance Portability and Accountability Act (HIPAA).

Washington Updates

Currently, Congress has four items on the short-term agenda for employee benefit plans. When Congress passed the Pension Protection Act (“PPA”), it left open some technical issues that needed to be addressed. For example, whether defined benefit plans are required to continue to issue summary annual reports and whether collective investment funds which hold pension plan assets are exempt from the stock diversification notice requirements of the PPA. Congress is now working on those and other corrections and we hope to receive guidance later in the congressional session. Second, Congress is focusing on executive compensation. The Senate Finance Committee is discussing setting a one million dollar limit on tax-deferred compensation. Third, Congress is focusing on expanding the remedies that plan participants have under ERISA. Lastly, Congress will focus on what fees are paid from 401(k) plans. An oversight committee has been assigned to focus on 401(k) fees.

Long term goals of Congress include requiring employers, with more than 50 employees, that do not sponsor a retirement

plan, to offer automatic individual retirement accounts for their employees. Congress is also looking to expand the availability of the Saver’s Tax Credit to individuals whose income is equal to or less than \$60,000. The Saver’s Tax Credit is a non-refundable tax credit for individuals who participate in certain retirement plans.

Wellness Programs

In December 13, 2006, the Department of Labor, Department of Treasury and the Department of Health and Human Services issued HIPAA nondiscrimination regulations. HIPAA provides that individuals cannot be denied eligibility for benefits or charged more for coverage because of any health factor.

At LABC, Amy Turner of the Department of Labor discussed the new regulations. Specifically, under the new regulations an employer can encourage healthy practices of their employees by offering rewards for meeting standards related to a health factor. For example, employers may reward non-smoking employees by paying a greater portion of non-smoking employees health insurance premiums than smoking employees.

Specifically, the wellness program rules require that: (i) the total reward for the wellness program must be limited to 20% of the cost of employee-coverage under the plan; (ii) the program must be reasonably designed to promote health and prevent disease; (iii) individuals must be eligible to participate in the plan annually; (iv) the rewards must be available to all similarly situated individuals; and (v) there must be a reasonable alternative standard that is disclosed in all materials regarding the program. If the wellness program rules are met, employers have an affirmative defense to an allegation of discrimination under HIPAA. ❖

Saving More Tomorrow

We maintain a library of articles by leading academics in the field of behavioral finance. The articles focus on issues related to the behavior of participants in self-funded and self-directed retirement plans, such as 401(k)’s, 403(b)’s and 457(b)’s.

Our library includes the seminal study, “Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving,” by Richard H. Thaler of the University of Chicago and Sholo Benetzi of UCLA.

The abstract of the study is as follows: “As firms switch from defined benefit plans to defined contribution plans, employees bear more responsibility for making decisions about how much to save. The employees who fail to join the plan, or who participate at a very low level, appear to be saving at less than the predicted lifecycle savings rates. Behavioral explanations for this behavior stress bounded rationality and self-control and suggest that at least some of the low-saving households are making a mistake, and would welcome aid in making decisions about their saving. In this paper, we propose such a prescriptive savings program, called Save More Tomorrow™ (hereafter, the SMarT program). The essence of the program is straightforward: people commit in advance to allocate a portion of their future salary increases toward retirement savings. We report evidence on the first three implementations of the SMarT program. Our key findings, from the first implementation, which has been in place for four annual raises, are the following: (1) a high proportion (78 percent) of those offered the plan joined; (2) the vast majority of those enrolled in the SMarT plan (80 percent) remained in it through the fourth pay raise; and (3) the average saving rates for SMarT program participants increased from 3.5 percent to 13.6 percent over the course of 40 months. The results suggest that behavioral economics can be used to design effective prescriptive programs for important economic decisions.”

This study is particularly relevant to today’s issues—because it marked the beginning of the movement to automatic plans, including automatic enrollment, deferral increases and investing.

QDIA Guidance is “Slipping”



By Fred Reish, Esq. (FredReish@Reish.com)

The Pension Protection Act added ERISA section 404(c)(5) to offer protection to fiduciaries who select default investments for participants. While that seems like a good idea, in and of itself, it is particularly important because of automatic enrollment... automatically enrolled plans may experience defaults of 60%, 70% or even 80% of the participants.

As the PPA was being considered, Plan sponsors expressed their concern that automatic enrollment might be problematic if fiduciaries were not given a “safe harbor” for investing participant money where the participant failed to give directions (i.e., a participant “default”). To remove that barrier to the adoption of automatic enrollment—which Congress strongly supports—the PPA directed the Department of Labor to issue a regulation under the new section 404(c)(5) to specify the types of investments that would have, in effect, a fiduciary safe harbor. The DOL promptly issued proposed regulations which identified three types of investments:

- Age-based lifecycle funds (sometimes called target maturity funds);
- Risk-based lifestyle funds and balanced funds; and
- Managed accounts (if the fiduciary manager signs on as an ERISA 3(38) investment manager).

The proposed regulation has proven to be highly controversial. In particular,

the stable value industry is aggressively challenging the fact that their product was left out. As a result, the issue has now become highly politicized—on top of the difficult investment and policy considerations.

The PPA mandated that the final regulation be issued by the Department of Labor by mid-February. However, that day has come and gone. At the LABC, a representative of the DOL would only say that the timing of the issuance of the final regulation is slipping. As a result, it is difficult to estimate—or, more accurately, to “guesstimate”—when the final regulation will be issued.

My logical mind tells me that the DOL is under considerable pressure to issue the final regulation because of the statutorily mandated time limit. On the other hand, my intuition tells me that this “hot potato” could take a while to resolve.

However, the timing should not matter to most employers. I say that for two reasons.

The first is that it seems virtually certain that the three alternatives in the proposed regulation will also be in the final regulation. As I see it, the issue is whether there will be additional categories. Based on my experience in working with employers and plan committees over the last few years—and, more recently, after the enactment of the PPA—is that plan sponsors and fiduciaries are moving away from money market accounts and stable value vehicles in any event. The concern that most employers have is that, unless there is some equity component for the default investment (that is, unless some of the money is

allocated to stocks), participants have little chance of accumulating benefits at a rate that exceeds both inflation and the impact of taxes on the earnings. Between taxes and inflation, an investment would probably have to compound at 6% or more in order for the principle to grow significantly in terms of purchasing power. As a result, there is a trend among employers in favor of the three categories specified in the proposed regulation.

Secondly, ERISA’s investment principles are based on generally accepted investment theories, including modern portfolio theory. In order to comply with those theories, fiduciaries need to invest participant default money across a broad range of investment options of types that are not highly correlated with one or another. That is, fiduciaries need to invest that money in a way that balances risk and reward in a manner appropriate for long-term investing and that utilizes multiple asset classes. Based on my experience, almost all lifecycle funds, lifestyle funds and managed accounts are built on a foundation of generally accepted investment theories, such as modern portfolio theory and strategic asset allocation. By investing default money in that way, fiduciaries can be comfortable that they are satisfying ERISA’s investment rules under section 404(a) (which contains ERISA’s general fiduciary rules, including the prudent man rule). As a result, the fiduciaries should not be worried about the timing of the issuance of the final 404(c)(5) regulation—because 404(c)(5) provides a defense . . . which is not needed by fiduciaries that comply with 404(a). So, while the 404(c)(5) regulation is slipping, there is no reason for plan sponsors and fiduciaries to allow their plans to slip away from prudent participant investing—even in a default situation. ♦

Tax-Exempt and Government Plans



By Stephanie Bennett, Esq. (StephanieBennett@Reish.com)

At the 2007 Los Angeles Benefits Conference, W. Thomas Reeder, the Deputy Benefits Tax Counsel for the Office of Tax Policy at the Department of Treasury, discussed important issues for tax-exempt and governmental entities that sponsor retirement plans.

Final 403(b) Regulations

Mr. Reeder stated that the final 403(b) regulations are a top priority for Treasury and will probably be published within the next six months. Government school districts and tax-exempt organizations that sponsor 403(b) plans are reluctantly anticipating the final 403(b) regulations, because of the added burden of compliance. The reluctance of many plan sponsors can

be explained by the additional requirements placed upon sponsors, for example, the plan document requirement.

The proposed regulations were projected to be effective on January 1, 2007. On August 29, 2006, the Service announced that the general effective date for the final 403(b) regulations would be extended to at least January 1, 2008.

If you are hoping for substantial changes, do not hold your breath, because the final regulations will probably be very similar to the proposed regulations. Mr. Reeder did mention that a small change will be made to the plan-to-plan transfer rules in the proposed regulations.

Finally, Mr. Reeder mentioned that the Treasury is also working on issuing sample 403(b) plan document language.

New Regulation on What Constitutes a Governmental Plan

Mr. Reeder also announced that Treasury is working on a large project with the Department of Labor and the Pension Benefit Guaranty Corporation (PBGC) that will provide guidance on what constitutes a governmental plan under section 414(d) of the Internal Revenue Code. A governmental plan is a plan established and maintained by the U.S. government, by any state or political subdivision of a state, or by any federal or state agency or instrumentality. Understanding whether or not a plan is a governmental plan is important. Governmental plans are exempt from a number of the plan qualification

requirements under the Code (e.g., the minimum vesting rules, the minimum age and service requirements, etc.) and from Titles I and IV of ERISA. Title I contains rules for reporting and disclosure, vesting, participation, funding, fiduciary conduct, and civil enforcement and Title IV covers the insurance of defined benefit pension plans.

In particular, the regulation will focus on what entities can be considered a federal or state “agency” or “instrumentality.” ♦

IRS Report

The IRS has issued a report of its findings regarding compliance by tax exempt entities with respect to executive compensation. Through informal compliance checks of over 1200 organizations and audits of about 780 organizations, the IRS has reached the following conclusions:

- Significant reporting issues exist – Over 30% of compliance check recipients were required to amend their filing with the IRS and the IRS elected to audit another 15%. In part, this has lead the IRS to conclude that change to the reporting forms are required.
- Other than reporting issues, the IRS has not found widespread non-compliance in other areas, though they indicated that further examination “is warranted.”
- Though only 25 organizations are involved, the amount of proposed excise tax assessments for “excess benefit” transactions exceed \$21 million, against 40 disqualified persons or organization managers.
- The IRS found high compensation amounts for executives, but also found that they were generally substantiated based on appropriate comparability data.

403(b) Announcement

Robert Architect, Employee Plan Division, announced that the final 403(b) regulations should be out by the end of June with a general effective date of January 1, 2008. He made the announcement at the Washington Non-Profit Legal & Tax Conference.

He also said the IRS expects to publish a revenue procedure that will contain sample plan language to help employers create plan documents.

More information will be reported as it becomes available.

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