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MEDICAL LOSS RATIO REBATES: ERISA PLAN ASSETS?

The Department of Labor has issued new guidance on the medical loss ratio (MLR) rules. This guidance reminds plan sponsors of fully insured group health plans that there are potential fiduciary considerations involved in the receipt of any MLR rebate. *Continued on page 2*

YOU ARE YOUR BROTHER'S KEEPER: CO-FIDUCIARY LIABILITY UNDER ERISA

Plan fiduciaries must not only make sure that their own conduct complies with ERISA's exacting standards; they also have a duty to monitor the conduct of the plan's other fiduciaries. The failure to do so can result in personal liability under ERISA's co-fiduciary duty rules. *Continued on page 3*

IRS REVISES PROCEDURES FOR OBTAINING DETERMINATION LETTERS

The IRS has recently made changes to its determination letter program that are designed to (i) eliminate features that are of limited utility to plan sponsors, and (ii) improve efficiency by reducing the time it takes to process applications. *Continued on page 4*

IRS CAUTIONS AGAINST "SHAM"RETIREMENTS

In a recent ruling, the IRS reiterated its long-standing position that a "pension plan" may not allow active employees to obtain a distribution from the plan – at least, not before their attainment of the plan's normal retirement age (or, if earlier, age 62). *Continued on page 8*

FEDERAL APPEALS COURT UPHOLDS $243,000 DAMAGE AND FEE AWARD FOR EMPLOYER'S FAILURE TO PROVIDE SPD AND ELECTION FORM

A recent ruling from the federal Court of Appeals highlights two critical ERISA basics: fiduciary duties and disclosure requirements. In *Kujanek v. Houston Poly Bag*, the Fifth Circuit upheld an award of damages and fees of more than $243,000 for an employer's failure to provide a participant with a copy of a retirement plan's summary plan description and a distribution election form. *Continued on page 10*

A COMMON PLAN MISTAKE: FAILING TO APPLY THE PROPER "COMPENSATION" DEFINITION

The failure to properly withhold salary deferral contributions from a participant's compensation is one of the most common mistakes that arise in the administration of a Section 401(k) defined contribution retirement plan. This common mistake generally occurs because the plan sponsor fails to apply the proper definition of compensation under the plan. *Continued on page 12*

IRS GUIDANCE FACILITATES LIFETIME INCOME OPTIONS

The IRS has issued a package of proposed regulations and revenue rulings dealing with "lifetime income options." These regulations and rulings apply to both defined contribution and defined benefit plans, and to a variety of life situations. What they share in common is an intent to encourage employers to help their employees more prudently manage their retirement assets during the "drawdown" phase of their retirement. *Continued on page 15*

MEDICAL LOSS RATIO REBATES: ERISA PLAN ASSETS?

The Affordable Care Act requires health insurers to spend a minimum percentage of premium dollars on medical claims and quality improvement. Insurers in the large group market must achieve a medical loss ratio of 85%, while insurers in the individual and small group markets must achieve a medical loss ratio of 80%. Insurers that fail to achieve these percentages must issue rebates to policyholders (MLR rebates).

The Department of Labor (DOL) has issued new guidance on the medical loss ratio rules, reminding plan sponsors of fully insured group health plans that there are potential fiduciary considerations involved in the receipt of any MLR rebate. As a result, plan sponsors who receive such rebates must think carefully about how to allocate them.

For plans subject to ERISA, the first relevant question is whether the rebate will constitute a "plan asset." If so, ERISA's "prohibited transaction" and "exclusive benefit" rules require that the rebate be used solely for the benefit of plan participants and beneficiaries. This would mean that the plan sponsor could not simply deposit an MLR rebate into its general bank account.

This question is reminiscent of the 1990s, when many group policyholders received proceeds from several life insurance companies that were going through a "demutualization" process. At that time, the DOL issued an Advisory Opinion providing guidance on the use of demutualization proceeds. In Technical Release 2011-04, the DOL reiterates some of the same guidelines for determining what plan sponsors should do with an MLR rebate.

If the *plan or trust* is the policyholder, in the absence of specific plan or policy language to the contrary, the MLR rebate will almost certainly be considered a plan asset under ordinary notions of property rights. Thus, MLR rebates issued to multiemployer plans will most likely be considered plan assets, because the insurance policy would typically be issued directly to the multiemployer trust. However, if the *employer* is the policyholder, the determination of whether a rebate is a plan asset is more complicated.

In such instances, the plan sponsor will have to carefully analyze the terms of the insurance policy and other governing plan documents to determine whether the employer may retain the rebate for itself. If the plan documents are silent, the determination will likely hinge on the source of the premium payments and the percentage of premiums paid by the employer versus plan participants. If the premiums were paid entirely out of trust assets, the DOL's view is that the entire amount of the rebate would be considered plan assets. In other circumstances, the portion of the rebate that is attributable to participant contributions will be considered plan assets.

If all or a portion of the rebate *does* constitute plan assets, then plan sponsors will have to determine how and to whom to allocate the rebate. For example, must a portion of the rebate be allocated to *former* plan participants? The selection of an allocation method must be reasonable and must be made solely in the interest of plan participants and beneficiaries. However, the plan fiduciary may weigh the costs to

the plan and the ultimate plan benefit when deciding on an allocation method. Thus, if the cost of calculating and distributing shares of the rebate to former participants approximates (or exceeds) the amount of the proceeds, the fiduciary may limit the allocation to current participants.

Similarly, if it is not cost-effective to distribute payments to plan participants (either because the amounts are de minimis, or because they would give rise to negative tax consequences for plan participants), the fiduciary may apply the rebate for other permissible plan purposes. These might include a credit against future participant premium payments and/or benefit enhancements.

Furthermore, ERISA normally requires that any plan assets must be held in trust. However, under a long-standing "non-enforcement policy," the DOL has exempted from this trust requirement any employee contributions that are made through a cafeteria plan. Technical Release 2011-04 confirms that a similar non-enforcement policy will apply to plan assets attributable to MLR rebates if those rebates are applied to a permissible purpose within three months of receipt.

The first set of rebates will be due in August of 2012, based upon insurers' calculations of their medical loss ratios for 2011. Plan sponsors should therefore review applicable insurance policies and plan documents – and consider the plan asset issues – well before then so that they will know what to do with any MLR rebates they receive.

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YOU ARE YOUR BROTHER'S KEEPER: CO-FIDUCIARY LIABILITY UNDER ERISA

Simply minding your own business and following the rules is sometimes not enough to avoid liability under ERISA. Although Department of Labor enforcement efforts and heightened scrutiny by retiring baby boomers are causing plan fiduciaries to pay more attention to their *own* fiduciary duties, those fiduciaries sometimes forget that they also have an obligation to police the conduct of *other* fiduciaries. ERISA's "co-fiduciary" duty rules can be a trap for the unwary, often placing fiduciaries in extremely difficult positions.

This was certainly the case in a recent lawsuit filed in a New York federal court. In that case (*Smith v. Stockwell Construction Co.*), the ex-wife of a deceased profit sharing plan participant sued the plan sponsor (which served as the plan's administrator), the third-party administrator, and the sponsor's owner (who also served as the trustee of the plan, responsible for choosing investment options). Dawn Smith was the ex-wife of plan participant Kevin Smith. While they were married, Kevin designated Dawn as his beneficiary in the event of his death. Although they later divorced, Kevin did not change that beneficiary designation.

Following Kevin's death, the plan paid his death benefit to his father, rather than to Dawn. After the plan denied her formal claim and appeal, Dawn filed suit in federal court, alleging that the defendants breached their fiduciary duties under ERISA by failing to pay benefits according to the plan's terms. The court dismissed her claim against the TPA, finding that the TPA was not a fiduciary subject to suit under ERISA.

It refused to dismiss the claim against the company in its capacity as plan administrator, however, finding that the administrator was a fiduciary under ERISA, and that Dawn had alleged sufficient facts to support her theory that the administrator breached its fiduciary duty.

The sponsor's owner, Harry Stockwell, Jr., asked the court to dismiss the claims against him, as well. Although he was clearly a plan fiduciary – because he had the authority to select investment funds offered under the plan – Harry had no individual responsibility for deciding how and to whom to pay benefits. Thus, he claimed that he could not be sued under ERISA for violating a duty that he clearly did not have.

Although the court acknowledged that Harry could not be held *directly* liable under ERISA for a failing to pay benefits to the proper beneficiary, it found that he *could* be sued for violating his co-fiduciary duties under ERISA. The lawsuit alleged facts sufficient to show that Harry was aware of the plan's decision not to pay benefits to Dawn, and that he did nothing to correct that error. According to the court, "a fiduciary may be liable for the known breach of a co-fiduciary [in this case, the plan administrator], even when the breach occurs in connection with a function which does not fall within the fiduciary's designated or undertaken responsibilities." So even though Harry did not cause the alleged error in this case, the court found that he could be liable for it because he (i) knew about the error, and (ii) did nothing to correct it.

Stockwell's lessons for those responsible for benefit plans are many, including: (1) know who the plan's fiduciaries are; (2) be vigilant about your own conduct as a fiduciary; (3) be equally vigilant about the conduct of your co-fiduciaries; and (4) do not simply turn a blind eye to fiduciary conduct that you find questionable, even if it is out of your area of responsibility.

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IRS REVISES PROCEDURES FOR OBTAINING DETERMINATION LETTERS

In late 2011, the IRS announced significant changes to its "determination letter" program. For over two decades, this program has allowed sponsors of Section 401(a) qualified plans (including 401(k) plans, profit sharing plans, ESOPs and defined benefit plans) to obtain written assurance from the IRS that both the form of their plan document and certain aspects of the plan's operation satisfy the applicable requirements of the Tax Code.

Although plans with favorable determination letters must still be operated in accordance with the terms of the Code (and the terms of the plan document), a favorable determination letter provides assurance that, if the IRS were ever to audit the plan, it could not "disqualify" the plan solely because the plan document has some minor error or omission. This in turn provides assurance that, so long as the plan is operated properly, (i) the employer will be able to deduct its contributions to the plan, (ii) both employer and employee contributions (other than designated Roth contributions) will not be currently includible

in the employee's gross income, (iii) the earnings on the plan's assets will not be taxed each year, and (iv) distributions from the plan will qualify for tax-free rollover to an IRA or another employer plan.

Current Rules for Obtaining Determination Letters

Under existing procedures, employers that have "individually designed" plan documents may seek a determination letter on those documents during a 12-month period that occurs once every five years, with a given employer's "filing cycle" determined by the last digit of the employer's federal tax identification number (EIN). Cycle A (for sponsors with EINs that end with 1 or 5) just ended on January 31, 2012. Cycle B (for sponsors with EINs that end with 2 or 7) began on February 1, 2012, and will end on January 31, 2013. There are special rules for determining the proper cycle for multiple employer plans, multiemployer (collectively bargained) plans, governmental plans, and plans maintained by members of a controlled group.

Generally, plans must be restated to comply with all recent law changes when they are submitted for a new determination letter. Each fall, the IRS publishes a list (referred to as the "Cumulative List") detailing the law changes that must be reflected in plans to be filed during the next cycle. For example, plans currently filing under Cycle B (which began on February 1, 2012) must comply with the 2011 Cumulative List, while plans that filed under Cycle A (which began on February 1, 2011, and ended on January 31, 2012) had to comply with only the 2010 Cumulative List.

Pre-approved plans (including both "prototype" plans and "volume submitter" plans) are subject to a different procedure. Employers that adopt pre-approved plans may either (i) rely on the IRS opinion letter issued to the sponsor of the pre-approved plan (so long as the employer does not make any significant change to the pre-approved document), or (ii) file for an individual determination letter on their plan (regardless of whether they make any changes to the pre-approved plan). Once every six years, there is a 24-month period during which an employer may adopt the latest version of the sponsor's prototype plan and submit that plan to the IRS for the employer's *own* determination letter.

Although employers that do not make any modifications to a pre-approved plan (other than to check existing boxes or select among pre-approved options) may technically rely on the IRS opinion letter issued to the sponsor of the pre-approved document, many employers (at the advice of counsel and/or recommendations by third-party consultants and service providers) elect to pay the relatively small ($300) user fee and apply for their own individual determination letter (using Form 5307). As a result, even as more employers adopt pre-approved plans, and even though employers may file for determination letters only every five or six years (depending on whether the plan is an individually designed plan or a pre-approved plan), the IRS is still receiving more determination letter applications than it can handle.

New Procedures

As first announced in IRS Announcement 2011-82, the IRS has made several important changes to the determination letter program. According to the IRS, these

changes are designed to (i) eliminate features of the program that are of limited utility to plan sponsors in comparison to the burdens they impose on the IRS, and (ii) improve the efficiency of the program by reducing the time it takes to process applications. Under the modified procedures, however some employers will no longer be able to apply for (or receive) determination letters with respect to their plans.

The most significant change is that, effective May 1, 2012, the only adopters of pre-approved plans that may request a determination letter on a Form 5307 will be adopters of "volume submitter" plans that modify the terms of the pre-approved plan document. (This assumes that the modifications are not so extensive as to cause the plan to be treated as an "individually designed" plan – which must then be filed on the longer, and more expensive, Form 5300.) Thus, employers that adopt a *prototype* plan, and employers that adopt a volume submitter plan *without* modification, will no longer have the option of applying for or receiving a determination letter on their plans.

Those employers may, however, rely on the IRS opinion letter issued to the sponsor of the pre-approved plan. According to the IRS, this "reliance" will provide the same level of protection as an individual determination letter. Whether that turns out to be true (i.e., whether the opinion letter will actually protect the plan sponsor from a subsequent IRS auditor's threat to disqualify the plan) remains to be seen.

Even if a plan is protected from a subsequent *IRS* challenge, however, the lack of an individual determination letter could increase the risk of a court allowing a participant's rollover IRA to be included in – rather than exempt from – the participant's bankruptcy estate. This would be under the theory that the rollover was not from a "qualified" retirement plan, because the plan document was in some way deficient.

The second important change is that, for applications filed after the dates described below, the IRS will no longer provide a determination as to whether a plan satisfies the minimum coverage requirement of Code Section 410(b), the nondiscrimination requirement of Code Section 401(a)(4), or the minimum participation requirement of Code Section 401(a)(26) (which applies solely to defined benefit plans). Currently, employers filing for determination letters have the *option* of completing a Schedule Q (and accompanying demonstrations), thereby obtaining a ruling that the plan satisfies the applicable coverage and/or nondiscrimination requirements of the Code.

In our experience, however, most employers do not complete the Schedule Q (and pay the higher user fee) needed to obtain these rulings, primarily because such a ruling is valid only so long as the employer's demographics do not change. That is, the plan must still be able to demonstrate, *each plan year*, that it covers a sufficient percentage of the employer's non-highly compensated workforce, and that contributions or benefits under the plan do not discriminate in favor of highly compensated employees.

According to the IRS, because this need for subsequent testing reduces the value of these optional rulings, it no longer intends to offer this service. This change is effective for determination letter applications filed on or after February 1, 2012, in the case of individually designed plans that are not

being terminated, and for applications filed on or after May 1, 2012, in the case of pre-approved and terminating plans.

The third change will create two new situations in which an employer that has adopted a pre-approved plan may be required to file a Form 5300 -- the form that is generally filed by sponsors of individually designed plans and that requires a substantial ($2500) user fee. Under current procedures, an adopter of a pre-approved plan must file the longer, more expensive Form 5300 if the plan is a multiple employer plan, or if the application also requests a determination regarding "affiliated service group" or "leased employee" status or a determination as to whether there has been a "partial plan termination." Effective May 1, 2012, an employer seeking a determination letter for a pre-approved plan must *also* file a Form 5300 (rather than a Form 5307) if either:

1. The employer has added language to a pre-approved plan in order to satisfy the requirements of either Code Section 415 (the limit on annual additions) or Code Section 416 (the "top-heavy" rules) due to the required aggregation of plans (i.e., by specifying which plan will deal with excess annual additions or provide the top-heavy minimum); or

2. The plan provides for a "normal retirement age" that is earlier than age 62.

Impact of the Changes

As indicated above, the IRS hopes that these changes will both reduce the number of determination letter applications it receives *and* simplify its review of the applications it does receive. It remains to be seen, however, whether employers that have historically sought and obtained individual determination letters will be content to rely on the opinion letter issued to the sponsor of the pre-approved plan. If not, they may opt for a volume submitter plan (in lieu of a prototype) and then modify the document just enough that it will qualify for filing on a Form 5307.

Care would need to be taken in this situation, however, to make sure that the changes are not so significant as to cause the plan to be treated as an individually designed plan. Should that be the case, (i) the plan would be required to file the more expensive Form 5300, and (ii) this could only be done during the appropriate 12-month period to be considered an "on-cycle" filing.

In addition, we are still early in the current six-year cycle for pre-approved defined contribution plans. The period for sponsors to submit those plans to the IRS for new opinion letters does not close until April 2, 2012, and it will then take the IRS another year or more to review those applications and issue new opinion letters. That means it will still be two to three years before the next "window" of time for employers to adopt and file applications for pre-approved plans. There could be further changes to the determination letter program by that date.

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IRS CAUTIONS AGAINST "SHAM" RETIREMENTS

A recent private letter ruling gave the IRS an opportunity to reemphasize its position that "pension plans" (whether defined benefit or money purchase) must not allow in-service distributions before age 62. A participant's "early retirement" will not support a distribution unless the participant actually terminates employment, and a pension plan that makes distributions in connection with a sham retirement may be disqualified.

Although the result announced in PLR 201147038 was not surprising, the ruling is interesting for a couple of reasons. First, it arose in a somewhat unusual context. Second, the IRS cited an unusual variety of sources in reaching its conclusion.

This ruling arose when a multiemployer pension plan entered into "critical" funding status. Under the law, this forced the plan's trustees to consider eliminating certain otherwise-protected benefits – including a heavily subsidized early retirement benefit. The plan provided unreduced early retirement benefits to participants retiring with 20 or more years of service, regardless of their age.

The plan's trustees proposed to eliminate this heavily subsidized benefit, but only after giving eligible participants 60 days advance notice of its elimination. Participants could then exercise their right to "retire" – thereby locking in the subsidy – but then immediately return to covered employment. Although their pensions would be suspended during this period of "reemployment," they would thereby retain the right to terminate employment at a *later* date (but still before their normal retirement date) and receive the unreduced pension. The trustees asked the IRS to rule that this approach would not disqualify the plan.

In ruling to the contrary, the IRS relied on a pre-ERISA regulation issued under Code Section 401(a). This requires that any pension plan provide for the payment of benefits "after retirement." Later regulations allowed for in-service distributions after a plan's normal retirement date, and the 2006 Pension Protection Act added yet another exception for in-service distributions commencing at or after age 62.

The task the IRS faced in issuing this ruling was to put some meat on the bones of the regulatory phrase "after retirement." In doing so, the IRS cited a veritable menagerie of sources, including the following:

- Regulations issued under Code Section 409A (dealing with *nonqualified* deferred compensation),
- Regulations describing the "elapsed time" method of crediting service,
- A 1979 revenue ruling defining the phrase "separation from service" for purposes of the special tax treatment afforded certain "lump-sum distributions,"
- The preamble to 2004 regulations concerning "phased retirement," and
- A 1993 decision by the Seventh U.S. Court of Appeals, which itself relied on *Webster's Ninth New Collegiate Dictionary* for the definition of "retire."

After considering these various authorities, the IRS ruled as follows:

> We have concluded that employees who "retire" on one day in order to qualify for a benefit under the Plan, with the explicit understanding between the employee and employer that they are not separating from service with the employer, are not legitimately retired. Accordingly because these employees would not actually separate from service and cease performing services for the employer when they "retire" these "retirements" would not constitute a legitimate basis to allow participants to qualify for early retirement benefits (which are then immediately suspended). Such "retirements" will violate section 401(a) of the Code and result in disqualification of the Plan under section 401(a) of the Code.

Noting the Pension Protection Act change referenced above, the IRS did make clear that this conclusion does *not* apply after a participant's attainment of age 62.

So what are the practical implications of this ruling? Although a PLR is binding only with respect to the taxpayer to whom it is issued, other multiemployer plans should certainly heed its warning. Participants in these plans should not be allowed to avoid the type of benefit cutbacks the Tax Code requires as a way of exiting critical funding status simply by engaging in sham retirements.

But sponsors of *single*-employer pension plans should heed this warning, as well. Increasingly, older employees seek to be placed on a reduced work schedule but then allowed to supplement their lower salary or wages by beginning to receive their pension benefit. Unless such an employee is at least age 62, however, an employer will want to *deny* this request. The risk is that the IRS will audit the plan and then revoke its qualified status on the ground that it allows impermissible in-service distributions to active employees.

To ensure that an "early retirement" is not simply a sham – designed to gain access to a pension benefit while continuing to work for the same employer – any pension plan sponsor should take steps to ensure that benefits are paid only after a bona fide retirement. For instance, each potential early retiree might be asked to represent that he or she has no present intention of returning to work for the plan sponsor. And even though the IRS has never endorsed a "safe harbor" period of *non*-employment that will support an early retiree's reemployment, pension plan sponsors might consider adopting a policy that forecloses the reemployment of retirees within 90 or 180 days of their retirement.

Now that the IRS has gone to the trouble of documenting its position in this area, IRS auditors may begin focusing more closely on this sham-retirement issue. Pension plan sponsors who choose to ignore this issue may therefore find themselves caught up in an unpleasant dispute with the IRS.

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FEDERAL APPEALS COURT UPHOLDS $243,000 DAMAGE AND FEE AWARD FOR EMPLOYER'S FAILURE TO PROVIDE SPD AND ELECTION FORMS

A recent ruling by a federal appellate court highlights two critical ERISA basics: fiduciary duties and disclosure requirements. In *Kujanek v. Houston Poly Bag*, the Fifth Circuit Court of Appeals upheld an award of damages and attorneys' fees of more than $243,000 for an employer's failure to provide a participant with a copy of a retirement plan's summary plan description (SPD) and a distribution election form. And as explained below, that amount could increase significantly when the lower court reconsiders the question of statutory penalties.

This case arose from a dispute between Houston Poly Bag I, Ltd. (Poly Bag), the sponsor of a profit sharing plan (the Plan), and long-time Poly Bag employee Kenneth Kujanek, a participant in the Plan. Kujanek resigned from Poly Bag in September of 2007 and, by the end of that year, had a vested account balance of about $490,000.

Poly Bag's policy was to provide SPDs to employees only on request. Upon Kujanek's termination, it did not provide Kujanek with a copy of the SPD, a distribution form, or any other information concerning his Plan account.

Several years of litigation between Poly Bag and Kujanek ensued, during which the value of Kujanek's Plan accounts steadily decreased due to investment losses. During the first year of that dispute, Kujanek contacted the Plan's financial advisor and requested the information necessary to obtain a distribution of his Plan account.

The advisor passed this request on to Poly Bag. Relying on language in its SPD that required all requests for Plan information to be in writing, Poly Bag neither provided the required forms nor contacted Kujanek.

In 2009, during a second round of litigation, Kujanek finally received a distribution, but by that time his account had decreased in value to $306,000. He sued Poly Bag for the difference (over $183,000) in his Plan accounts between the end of 2007 and the date he received the distribution.

Two separate aspects of Poly Bag's obligations as plan administrator were at issue in the case: its obligation to act solely in Kujanek's interest, which arises under ERISA's *fiduciary* rules, and its statutory obligation to provide participants with information about the Plan, which arises under ERISA's *disclosure* rules.

While ERISA does not explain how these obligations relate to one another, the *Poly Bag* decision demonstrates that the letter of the disclosure rules is not a shield against the spirit of the fiduciary rules. In this case, the employer ran afoul of *both* sets of rules.

Fiduciary Duties

It should not be news to most plan sponsors that—when they act in a fiduciary capacity—ERISA requires them to act solely in the interest of the plan's participants and beneficiaries. Fiduciaries must also refrain from any actions that would result in a conflict between their own interests and those fiduciary obligations. Under the common-law trust principles that courts apply when interpreting ERISA's fiduciary rules, this duty includes the obligation to inform participants of facts known to the fiduciary but not the participant, and that the

participant needs to know for his or her own protection.

To defend itself against Kujanek's charge that it breached this fiduciary duty by failing to provide the SPD and a distribution form, Poly Bag relied on language in the Plan's SPD requiring all requests for Plan documents (including distribution forms) to be in writing. The Court rejected this argument because Poly Bag knew in 2008 (if not earlier) that Kujanek wanted a distribution of his account balance. The Court held that, as soon as Poly Bag knew of Kujanek's inquiry, it had a fiduciary obligation to provide him with the forms. The SPD language (requiring a written request) could not shield Poly Bag from that obligation.

The court noted that "ERISA's fiduciary duty is the highest known to the law." According to the court, Poly Bag violated that duty by withholding Plan documents and rollover information. It therefore awarded Kujanek the damages he sought – i.e., the amount by which his account balance had decreased from its $490,000 height at the end of 2007. It also upheld the district court's award of more than $60,000 in attorneys' fees.

Disclosure Obligations

In addition to the damages for breach of fiduciary duty, the lower court had awarded Kujanek $25,000 in statutory penalties for Poly Bag's violation of ERISA's disclosure rules. Those rules require plan administrators to furnish participants with certain plan documents within 30 days of a written request. Violations are punishable by penalties of up to $110 per day. The district court based its award on a document production request made during the litigation that followed Kujanek's termination.

The appellate court reversed the lower court's ruling on this point, noting that discovery requests during litigation are "lawyer-to-lawyer" communications, rather than "participant-to-administrator" communications. Thus, while the discovery request was in writing, it was not a request from the participant to the Plan administrator.

That is not the end of the penalties question, however. In fact, the Court's remand of this question to the district court may well reflect its opinion that the penalty was too *small*.

The Court was "troubled" by Poly Bag's failure to comply with another part of the same disclosure rules: the plan administrator's obligation to regularly distribute SPDs (including updates) and other plan documents to all participants. Rather than providing these documents as a matter of course, Poly Bag provided them only on request.

The Court remanded the question of statutory penalties to the district court, instructing it to determine whether Poly Bag's failure to regularly distribute SPDs and other materials, in general, and distribution information, in particular, to participants is a basis for further penalties. If the district court decides that it is, the penalty clock would start *much* sooner than the discovery request. Indeed, it could start ticking as far back as Kujanek's first year as a Poly Bag employee—about 20 years before he received his distribution from the Plan. At up to $110 per day, the penalty for a violation over that period could be

substantially larger than the $25,000 penalty the appellate court overturned.

We believe that such an award is unlikely, however – at least on the basis of ERISA's penalty provisions. This is because there is *no* monetary penalty for an administrator's failure to distribute SPDs in the ordinary course. (A "willful" failure to comply with ERISA's disclosure requirements is a criminal offense, but this was not a criminal proceeding.) It is not clear why Congress required administrators to distribute such documents but then failed to specify a monetary penalty for violating that requirement. However, despite the appellate court's instructions to the trial court, there is no statutory basis for a penalty award.

Of course, the district court might determine that the systematic failure to provide employees with information about the Plan is another *fiduciary* violation and award damages on that basis. As we reported in our November article, courts have been known to do precisely that when plan sponsors fail to live up to their disclosure obligations. We will watch with interest the further proceedings in the district court.

What Does This Case Mean for Plan Sponsors?

In this case, an employer's failure to provide two routine documents—an SPD and a distribution form—has already cost it more than $180,000 in damages and more than $60,000 in attorneys' fees. In the months to come, that failure could cost it even more in statutory penalties. *Poly Bag* should therefore remind employers of some ERISA fundamentals:

- *Never* take ERISA's reporting and disclosure obligations lightly. Prepare, update, and distribute SPDs and other plan materials on time.

- *Never* take ERISA's fiduciary obligations lightly. Placing even the slightest obstacle between a participant and a distribution form (or other plan document) can have disastrous results. Even *failing* to act when participants do not know that their benefits are at risk can violate ERISA's fiduciary rules. This obligation is not relaxed for troublesome or disgruntled employees. Indeed, these are the *last* employees who should be handed an axe to grind in federal court.

- *Never* disregard a participant's request for plan information. Although ERISA's disclosure rules refer only to *written* requests from participants, a failure to provide materials requested in other ways (e.g., orally or through a third party) could be a violation of a fiduciary duty.

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A COMMON PLAN MISTAKE: FAILING TO APPLY THE PROPER "COMPENSATION" DEFINITION

Defined contribution retirement plans (such as 401(k) plans) often use different definitions of compensation for different purposes. It is important for plan sponsors to apply the proper definition when dealing with employee deferrals and allocations. A plan's definition of compensation must

satisfy applicable rules for determining the amount of contributions, and plan sponsors must follow the plan document's definition when operating the plan.

The first step for plan sponsors in determining whether they are using the proper compensation for allocation and deferral purposes is to review the plan document. Many plan sponsors operate their plans on the basis of a short summary containing many of the definitions and operational requirements. As the plan is amended, however, the compensation definition may change while the plan continues to be operated as before.

Plan sponsors should review the section of the plan that deals with allocations and deferrals. Each plan document contains a section, either in the plan document or in a related adoption agreement, which discusses how the plan is to make allocations and/or deferrals. This section will say, for example, "Employees may defer up to 75% of their Compensation." Plan sponsors should then go to the plan section containing definitions and find the "Compensation" definition. Next, they should spot-check deferrals and allocations to see if, in operation, they are using the correct definition of compensation. Some of these definitions can get very complicated, with specific inclusion or exclusion of items such as expense reimbursements, car allowances, bonuses, commissions, and overtime pay. For plans with a complicated definition of compensation, a worksheet to calculate the correct amounts can be helpful.

If a plan sponsor discovers a mistake in applying these plan provisions, there are a couple of ways to make corrections. If elective deferrals have been taken from amounts that are not included in the plan's definition of "compensation," the plan sponsor should direct the trustee or custodian of the plan to distribute those excess deferrals, plus earnings, to the participant.

If there are improper profit-sharing allocations, the plan administrator should either forfeit and reallocate the allocations, plus earnings, to other plan participants or place those allocations and earnings in an unallocated suspense account for later use.

Of course, an improper allocation may also result in an *under*-contribution. If that occurs, the plan sponsor must make a corrective contribution, including earnings, on behalf of the affected participants.

Here is an example: Employer XYZ sponsors a 401(k) plan for its employees. There are 20 participants in the plan. The plan's definition of compensation for deferral and allocation purposes was amended, effective in 2008, to exclude bonuses. For the 2010 plan year, however, Employer XYZ did not exclude bonuses from the compensation used to determine allocations and deferrals. There were three highly compensated employees (HCEs), each of whom had base compensation of $120,000 and a $30,000 bonus. Each of these HCEs had elected to defer 6% of compensation, and the plan provides for a fixed profit-sharing allocation of 5% of compensation to each participant's account.

Each of the three HCEs *properly* received a profit-sharing allocation equal to 5% of his or her $120,000 compensation ($6,000), but also *improperly* received an allocation equal to 5% of the $30,000 bonus ($1,500). Also, each of the three HCEs *properly* deferred 6% of his or her $120,000 base

compensation ($7,200), but *improperly* deferred 6% of the $30,000 bonus ($1,800).

Here is the proper correction for this situation: For each HCE, forfeit the profit-sharing allocation of $1,500 (plus earnings) and place that amount in an unallocated account to be used for profit-sharing allocations in future plan years. Distribute the improperly allocated elective deferrals of $1,800 (plus earnings) to each of the three HCEs.

If a mistake is made with respect to the operation or administration of a plan, the IRS's Employee Plans Compliance Resolution System (EPCRS) allows the plan's sponsor to remedy that mistake and thereby avoid the consequences of plan disqualification. There are three components to EPCRS: (1) the Self-Correction Program (SCP) permits a plan sponsor to correct certain plan failures without contacting the IRS; (2) the Voluntary Correction Program (VCP) permits a plan sponsor, any time before audit, to pay a limited "compliance fee" and receive the IRS's approval for correction of plan failures; and (3) the Audit Closing Agreement Program (Audit CAP) permits a plan sponsor to pay a "sanction amount" and correct a plan failure even while the plan is under audit.

The prior example illustrates an "operational failure," because the employer failed to operate the plan in accordance with its terms (by not excluding bonuses from the compensation used to determine allocations and deferrals under the plan). Employer XYZ may therefore use SCP to correct this failure if the failure was either (1) insignificant, or (2) corrected by the end of the second plan year after the year of the failure. Otherwise, it would be necessary to rely on either VCP or Audit CAP.

Here are some ways that plan sponsors might avoid this common mistake of using the wrong compensation definition:

- Perform annual reviews of the plan's operations.
- If the plan document is amended, check the definitions against the old plan document, noting any differences.
- If the plan document is amended, communicate those changes to everyone involved in the plan's operations.
- Make sure to properly train the person in charge of payroll to understand the plan document.
- Know what the plan's third-party administrators have agreed to provide. They may be relying on the plan sponsor for all information, such as compensation and deferral amounts, used in their own work.
- If possible, simplify the plan's definition of compensation and use the same definition for multiple purposes.

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IRS GUIDANCE FACILITATES LIFETIME INCOME OPTIONS

Recent years have seen a growing consensus that employees need better tools for planning their retirement. This applies not only to the saving and investing phase, but also the drawdown phase. Retirees who receive their entire retirement benefit in a single lump-sum payment run a significant risk of "outliving their retirement assets."

In the past, the solution to this problem was a defined benefit plan, which typically pays benefits in the form of a life or joint life annuity. As employers have sought greater predictability in their annual retirement plan expenses, however, there has been a pronounced shift away from defined benefit plans and toward defined contribution plans.

Although defined contribution plans *can* offer annuity options, they seldom do. In part, this is to avoid the administrative complexities posed by the qualified joint and survivor annuity (QJSA) and qualified preretirement survivor annuity (QPSA) rules, which impose intricate election and spousal consent procedures. Moreover, even plans that do offer annuity options rarely see retirees take advantage of them.

In February of 2010, the IRS and Department of Labor jointly issued a "request for information" on the subject of "lifetime income options." In response to the numerous comments the agencies received, the IRS has now issued a package of guidance designed to encourage employers to offer more lifetime income options to their retirees. This package includes two separate sets of proposed regulations, along with two revenue rulings.

Qualified Longevity Annuity Contracts

One set of proposed regulations would create a partial exemption from the "minimum required distribution" (MRD) rules. The MRD rules require that payment of benefits under an employer-sponsored retirement plan or traditional (non-Roth) IRA generally begin by age 70½, and then be paid over a specified period of time. This new partial exemption from the MRD rules would apply to "qualified longevity annuity contracts" (QLACs).

The QLAC regulations would allow a participant in a defined contribution plan to use a *portion* of his or her account balance (generally, the lesser of 25% of the account or $100,000) to purchase a QLAC. Under a QLAC, annuity benefits would commence at a fairly late date (though no later than age 85) and be paid in the form of a single or joint life annuity. The key is that the amount used to purchase the QLAC would be *disregarded* when applying the MRD rules to the retiree's account balance. This, in turn, would ensure that no portion of this amount must be paid to the retiree before the QLAC's benefit commencement date in order to satisfy the MRD rules.

In the preamble to these proposed regulations, the IRS notes the following dual advantages of a QLAC:

> Purchasing longevity annuity contracts could help participants hedge the risk of drawing down their benefits too quickly and thereby outliving their retirement savings. … Purchasing a longevity annuity contract would also help avoid the opposite concern that participants may live beneath their means in order to avoid outliving their retirement savings.

Under these regulations, QLACs could be offered under any defined contribution plan to which the MRD rules apply, including qualified 401(a) plans, 403(b) tax-sheltered annuities, governmental 457 plans, and traditional IRAs. At present, however, these QLAC regulations are only proposed. Moreover, the IRS has made clear that the existing MRD rules will continue to apply until these regulations are issued in final form.

Application of QJSA and QPSA Spousal Protections in Deferred Annuity Context

Many of the questions raised by deferred annuity contracts (such as the proposed QLACs) involve the application of the QJSA and QPSA notice, election, and spousal consent rules. Typically, any defined contribution plan that allows a participant to elect a life annuity form of payment must then comply with the full set of QJSA and QPSA rules. In Revenue Ruling 2012-3, however, the IRS explains how to limit the application of these rules to deferred annuity contracts.

The ruling considers three different factual scenarios. Under all three scenarios, a participant in a defined contribution plan may invest part or all of his or her account balance in a deferred annuity contract. Under that contract, payments are to commence at the later of the participant's retirement or attainment of age 65, with the participant then allowed to elect among various annuity forms of payment.

Under Scenario One, a participant could also elect to receive the value of the contract in the form of a single lump-sum payment. This lump-sum option would not be available to a participant under Scenario Two. Under both of Scenarios One and Two, the participant's surviving spouse (if any) would receive the entire value of the contract if the participant were to die before payments commence. Scenario Three then differs from Scenario Two only in that the participant could *waive* that spousal benefit (with the spouse's written consent) at the time the contract is purchased.

In addressing each of these scenarios, the IRS concludes as follows:

- Under Scenario One, the participant's ability to elect a lump-sum payment under the deferred annuity contract means that no annuity form of payment is actually elected at the time the contract is purchased. Accordingly, neither the QJSA nor the QPSA rules would apply at that time. The QJSA rules would apply during an election period immediately preceding the eventual annuity starting date. However, because neither the participant nor the spouse may waive the QPSA benefit, the plan need not comply with the QPSA rules.

- Under Scenario Two, the participant may not elect a lump-sum (or other non-annuity) form of payment. The purchase of the deferred annuity contract therefore constitutes the election of an annuity form of payment. For that reason, the QJSA rules would apply at the time the contract is purchased. As under Scenario One, however, the inability to waive the QPSA benefit means that the plan need not comply with the QPSA rules.

- Finally, the plan in Scenario Three would be required to comply with both the QJSA *and* QPSA rules at the time the participant invests in the deferred annuity contract. The QPSA rules would apply for the simple reason that – unlike under the

other two scenarios – this contract does not otherwise guarantee a surviving spouse a benefit as valuable as the QPSA benefit.

By highlighting the salient factors in any QJSA or QPSA analysis of an investment in a deferred annuity contract, this ruling should eliminate some of the uncertainty otherwise associated with those contracts. Once the IRS finalizes its proposed QLAC regulations, those annuity contracts should therefore benefit from this ruling.

Split Distribution Options Under Defined Benefit Plans

Some defined benefit plans already permit retirees to receive all or a portion of their benefit in the form of a lump-sum payment. In converting the plan's annuity form of payment into such a lump sum, the Tax Code requires the use of certain actuarial assumptions (known as the "417(e) assumptions"). Moreover, if only a *portion* of a benefit is payable as a lump sum, the remaining benefit – even if paid as an *annuity* – must also satisfy these 417(e) assumptions. In proposing the second set of regulations, the IRS has acknowledged that this administrative complexity may discourage employers from even *offering* such split distribution options.

Consistent with the goal of allowing participants to receive a portion of their benefit in a lump sum and a portion as an annuity, the IRS has proposed to simplify the rules to be followed by defined benefit plans that choose to offer split distribution options. The 417(e) assumptions would apply only to *non*-annuity payment forms (such as partial lump sums), while any *annuity* form of payment could be determined on the basis of the plan's own actuarial assumptions. If these regulations are finalized as proposed, sponsors of defined benefit plans may want to consider offering a split distribution option.

Unfortunately, the preamble to these regulations cautions that any plan *currently* offering a split distribution option could not simply adopt this simplified approach to calculating annuities. Instead, such a plan would have to comply with the "anti-cutback" rules of Code Section 411(d)(6). These might require a "wear-away" approach, thereby *further* complicating the calculation of split distribution options.

Rolling Assets from a Defined Contribution Plan into a Defined Benefit Plan

The other recent ruling (Revenue Ruling 2012-4) addresses an option that is already available to plan sponsors. Under this option, participants in a defined *contribution* plan may be allowed to roll some or all of their account balance into a defined *benefit* plan sponsored by the same employer. That rollover amount would then be converted into an additional annuity benefit under the defined benefit plan. By rolling over only a *portion* of his or her account balance, such a participant could effectively receive a portion of that balance in the form of a lump sum and the remainder as an annuity.

This ruling points out, however, that two different sets of Tax Code constraints apply to a defined benefit plan when it converts a rollover amount into an annuity form of payment. On the one hand, the additional annuity benefit must be *large* enough to ensure that the conversion does not result in an impermissible "forfeiture" of the employee contributions attributable to the

rollover. On the other hand, this annuity benefit must not be *too* large. If it is, then some portion of that benefit must be counted against the Tax Code Section 415 limitation on benefits payable under a defined benefit plan.

Fortunately, a plan may comply with both these nonforfeiture and Section 415 constraints by applying the same set of actuarial assumptions when converting a rollover amount into an annuity benefit. These are the 417(e) assumptions referenced above. Thus, any defined benefit plan that allows – or that might be *amended* to allow – participants to obtain an additional annuity benefit by transferring a rollover amount from a defined contribution plan should specify the use of these assumptions.

Although this revenue ruling applies only to rollovers made on or after January 1, 2013, the ruling notes that sponsors may also rely on its *holdings* with respect to rollovers made *before* that date.

Implications for Employers

Nothing in this recent package of guidance would *require* employers to offer additional distribution options under their plans. However, employers that wish to facilitate their retirees' orderly drawdown of retirement assets might consider adding one or more of these options.

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