PENSION PLANS: EVERYTHING YOU NEED TO KNOW, BUT WERE AFRAID TO ASK

October, 2010

by: Marcia S. Wagner, Esq.
The Wagner Law Group
A Professional Corporation
99 Summer Street, 13th Floor
Boston, MA 02110
Tel: (617) 357-5200
Fax: (617) 357-5250
www.erisa-lawyers.com

TABLE OF CONTENTS

Page

I. DIFFERENT TYPES OF RETIREMENT PLANS

Retirement plans are tightly regulated under federal law. Because of the different ways in which federal law impacts different types of retirement plans, it is helpful to categorize these plans into these three main categories:

A. Tax-Qualified Retirement Plans.

B. IRA Plans and IRAs.

C. Nonqualified Retirement Plans.

Selecting an appropriate type of plan for your business, as well as complying with the particular requirements for the type of plan selected, are both critical. Although the establishment of a retirement plan is completely voluntary, once the plan has been established, you must comply with all legal and regulatory requirements. Violations of the law -- even if unintentional, innocent or noninjurious -- can result in severe sanctions and, in certain cases, personal liability for plan fiduciaries.

II. OVERVIEW OF ERISA

The Employee Retirement Income Security Act of 1974 ("ERISA") is the federal law governing U.S. private retirement plans generally. It was the first comprehensive enforcement scheme for employee benefits, including qualified retirement plans. The goal was to protect the interests of plan participants by replacing largely inadequate law with standard reporting and disclosure rules, vesting and benefit accrual standards, anti-alienation provisions and fiduciary standards with specified prohibited transactions.

The law is divided into four Titles. Title I is enforced by the Department of Labor (“DOL”). Title II is within the jurisdiction of the Internal Revenue Service. Title III provided basic ground rules for coordination between the government agencies and for the enrollment and regulation of actuaries. Title IV creates an insurance program for defined benefit plans through the government-owned corporation called the Pension Benefit Guaranty Corporation (“PBGC”), which is housed within the jurisdiction of the DOL.

Title I, under the jurisdiction of DOL, includes:

- reporting and disclosure requirements;
- fiduciary standards;
- retirement benefit standards (*e.g.*, participation, vesting, benefit accrual);
- enforcement and preemption rules;
- access to federal courts for participants and beneficiaries, fiduciaries, and the DOL.

Title II amends the Internal Revenue Code’s rules for qualified plans by amending the minimum requirements. It also mirrors many provisions in Title I. The most significant provisions address:

- minimum participation
- vesting
- benefit accrual
- funding standards
- nondiscrimination rules
- limitations on benefits and contributions.

Title III is an administrative section that provides basic ground rules for coordination between the agencies and for the enrollment and regulation of actuaries.

Title IV establishes a pension plan termination insurance program and creates the PBGC for administration and enforcement of the program. The PBGC's main responsibilities include administering termination insurance for defined benefit plans and monitoring the financial health of these plans. The PBGC is empowered to require plan administrators to report various reportable events considered to be warning signs that a defined benefit plan might be in financial difficulty.

III. TAX-QUALIFIED RETIREMENT PLANS

A. Definition.

A tax-qualified plan is a "pension plan" or "employee pension plan" within the meaning of ERISA Section 3(2)(A) which also meets the vast array of qualification requirements contained in Code Section 401(a), et seq. There are two broad categories of qualified plans, "defined benefit plans" and "defined contribution plans."

An employer may adopt and maintain one or more qualified plans. Any type of legal entity (proprietorship, partnership, corporation) can adopt a qualified plan covering its employees and, if applicable, the self-employed persons (proprietor or partner) working in the business.

Plans referred to as "Keogh" or "H.R. 10" plans are qualified defined benefit or defined contribution plans adopted by a proprietorship or partnership without any employees. The special rules and limitations formerly applicable to these types of plans were largely abolished by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), which imposed, instead, the so-called "top-heavy" rules.

B. Advantages of Maintaining a Tax-Qualified Plan.

1. Immediate tax deduction for employer contributions (Code Section 404(a)).

2. Employees are not currently taxed on employer contributions (Code Section 402(a)(1)).

3. Earnings on assets held in the plan's trust accumulate tax-free (Code Sections 402(a)(1) and 501(a)).

4. On receipt of distributions, employees can often defer recognition of income by "rolling over" the distribution to an individual retirement account ("IRA") or another qualified plan.

5. Assets in the qualified trust are protected from the employer and from creditors of both the employer and the employee. (Code Sections 401(a)(2); 401(a)(13)).

6. Participants in certain plans (defined benefit pension plans) qualify for PBGC guarantees of certain levels of benefits if the plan terminates without sufficient funds to pay all promised benefits. (ERISA §4022)

C. Defined Benefit Plans ("DB Plans").

1. Definition.

A "defined benefit plan" provides the employee with a certain amount of pension benefits beginning at retirement. The amount of the pension may be determined with reference to several factors; ordinarily a formula is based on the employee's compensation, years of employment, and, perhaps, Social Security benefits. Benefits are normally stated in terms of, and actually paid as, an annuity for life after retirement. The employer's regular annual contributions toward the cost of the plan are determined actuarially. The trust or other investment fund supporting a defined benefit plan is not segregated into "accounts" for individual employees, but instead is invested as a single fund and available for payment of all pensions and death benefits arising under the plan.

2. Types of Defined Benefit Plans.

a. Fixed Benefit Plan. The benefit payable at normal retirement is a stated dollar amount (e.g., $100 per month commencing upon retirement on or after age 65).

(1) This approach provides inflation protection for the employer, but not for the employee.

(2) Changes in compensation to reflect inflation, deflation, promotion or demotion will not affect the amount of the pension.

(3) This approach favors the lower paid employees by providing a higher benefit as a percentage of compensation.

b. Flat Benefit Plan. The benefit payable at normal retirement is a stated percentage of pay, (e.g., 30% of pay commencing upon retirement on or after age 65). This approach automatically adjusts the pension for changes in compensation due to inflation, deflation, promotion or demotion. The definition of "pay" is very important and must be nondiscriminatory both on its face and in operation *(i.e.*, must not discriminate in favor of highly compensated employees).

c. Unit Benefit Plan. The benefit payable at normal retirement depends upon the period of service with the employer (or under the plan) prior to retirement, (e.g., 1% of pay for each year of service; or, $10 per month for each year of service). This approach rewards longer service employees but may not provide a large enough pension for a key employee recruited later in his career.

d. Cash Balance Plans. This is a defined benefit plan which looks, from the employee's point of view, like a defined contribution plan. Each employee's benefit is converted into a lump sum equivalent to which "interest" is credited at a specified, guaranteed rate. The result is that each participant appears to have an individual account which is earning interest. However, the plan does not really maintain individual accounts; the "balance" an employee sees is simply the lump sum actuarial equivalent of his accrued benefit, which may or may not be fully funded by assets actually in trust.

3. Methods For Calculating Pay.

A compensation based pension formula (such as either the flat benefit or unit benefit formulas described above) requires a definition of the compensation to be used to calculate the pension to be paid. Two methods are used to determine compensation for the purpose of establishing the pension benefit:

a. Final Average Pay. The benefit paid at normal retirement is based upon the participant's average compensation over a defined period of time (e.g., final five years preceding retirement; or highest five consecutive years of the ten consecutive years preceding retirement).

(1) This approach has a leveling effect on changes in compensation occurring during a short period preceding retirement.

(2) Increases in compensation later in an employee's career significantly increase the pension paid with respect to his entire career with the employer.

(3) Inflation tends to take the decision to increase pension costs out of the hands of the employer.

b. Career Average Pay. The benefit paid at normal retirement is based upon the participant's average compensation during the entire period he is either employed by the plan sponsor or is a participant in the plan.

(1) This approach will produce a lower benefit in an inflationary economy than the final average pay approach. However, rather than experiencing increasing costs due to inflation, the decision to increase pensions to match inflation is retained by the employer.

(2) This approach tends to penalize a "fast track" employee whose pay rises significantly during his career when comparing his pension as a percentage of final average pay to the pension of an employee whose earnings stay relatively the same throughout his career.

c. IRS Limits on Pay. A plan may consider no more than $245,000 (for 2010, as indexed) of pay per year (Code Section 401(a)(17)).

4. Integration with Social Security.

Social Security generally produces a higher benefit as a percentage of pay for lower paid employees than it does for employees whose pay exceeds the Social Security taxable wage base. For that reason, employers often prefer to adjust the benefit provided under their qualified plans to provide a relatively higher benefit for higher paid employees. The Tax Reform Act of 1986 ("TRA '86) amended Code Section 401(l), to strictly limit the differentiation permitted in integrated plans between higher and lower paid employees. For example, the benefit payable under the pension plan could be reduced by a portion of the social security benefit payable (e.g., 50% of final average pay reduced by 50% of the social security benefit payable at age 65).

5. Summary of Characteristics of Defined Benefit Plans.

a. The employer has a fixed commitment to contribute to the plan which must be expressed as definitely determinable benefits.

b. Defined benefit plans are generally and customarily fully financed by the employer (and not with employee contributions).

c. The investment risk is on the employer.

d. A defined benefit plan can better recognize past service, than can a defined contribution plan. For that reason, defined benefit plans generally favor older employees with longer tenure rates because of their ability to provide benefits based on past service.

e. Under a defined benefit plan it is generally easier to provide cost of living adjustments (“COLAs”) on retirement benefits.

f. Defined benefit plans may pay disability and incidental death benefits as well as retirement benefits.

g. Generally, a defined benefit plan may not pay layoff, sickness, accident, hospitalization or medical benefits. (But note that payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and dependents is authorized under certain circumstances under Code Section 401(h); see also Code Section 420 permitting excess pension assets to be used to fund retiree medical benefits).

h. Generally, in-service distributions are not permitted under defined benefit plans.

i. The PBGC guarantees benefits and the employer must pay PBGC premiums.

D. Defined Contribution Plans ("DC Plans").

1. Definition.

A "defined contribution plan" is sometimes also referred to as an "individual account plan." These plans maintain separate bookkeeping accounts in the trust fund or other funding medium for each covered employee; the employee's share of his employer's contributions are allocated to his account; investment gains and losses are allocated to his account. The benefits available to the employee from the plan are limited to his vested interest in the value of his account in the trust fund. The account could be paid out in the form of a life annuity (for example, by using the account to purchase an insurance company annuity contract), but more commonly benefits from defined contribution plans are paid in a lump sum or in a fixed number of annual installments.

Code Section 414(i) defines a defined contribution plan as "a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gain and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account."

2. Types of Defined Contribution Plans.

a. Money Purchase Pension Plan.

(1) General. A money purchase pension plan provides for a fixed rate of annual employer contributions for allocation to the accounts of employees. Normally, the contribution rate is stated as a percentage of each employee's compensation. The employer's annual contribution is a legal funding obligation for as long as the plan remains in effect, and must be paid to the plan's trust fund regardless of whether the employer is currently profitable (Code Section 412).

(2) Target Benefit Plan. A target benefit plan is a money purchase pension plan which determines the employer's annual contribution with reference to a projected or "target" pension benefit that the plan expects to provide to each covered employee. The target plan is like a defined benefit plan in that the employer's annual contribution for each employee is determined pursuant to actuarial computations working backward from the targeted benefit for that employee. The target plan is a defined contribution plan, however, in that individual accounts are maintained and the amount of pension actually payable will be determined solely on the basis of the value of the employee's account when benefits commence.

b. Profit Sharing Plan. A profit sharing plan typically provides for employer contributions on a discretionary basis. Despite its label, contributions to a profit sharing plan do not have to be limited to, or made from, the employer's profits. The employer's contributions from year to year can be a fixed amount or rate or determined in accordance with a formula, or contributions may be subject to the discretion of the employer, or some combination of the foregoing. However, there is no legal requirement that contributions continue on an ongoing basis, and profit sharing contributions may be suspended by the employer.

Some profit sharing plans are established as "age weighted" or "new comparability" plans whereby different categories of employees receive different benefits, with the older, more highly compensated employees receiving greater annual allocations than younger, less well-paid employees. As a result of the time value of money, a dollar contributed on behalf of a young person with forty years to retirement is worth significantly more at retirement age, than a dollar contributed on behalf of an older person who will retire in only a few years. Thus, even though the plan is actually providing actuarially equivalent benefits to all participants, an older person receives a greater dollar allocation than a younger person.

c. Code Section 40l(k) Plan. A Code Section 40l(k) plan is a profit sharing plan (or a stock bonus plan) which meets the additional requirements in Code Section 40l(k) for a "cash or deferred arrangement" (thus sometimes being referred to as a "CODA"). Under a Code Section 40l(k) plan, within certain limits, covered employees may elect to have a portion of the compensation they would otherwise have received from the employer in cash contributed to the Code Section 40l(k) plan. Contributions made in this manner are excludable from the employee's current income for federal income tax purposes. Employer contributions, such a "matching contributions," may be added to the employee's account. For 2010, the maximum amount a participant may electively defer is $16,500 (as indexed), and, if he or she is over 50, a "catch up" contribution of $5,500 (as indexed).

Effective in 2006, 401(k) plans may be so-called Roth 401(k) plans, where by employees make after-tax contributions to the plan and a distribution from the principal and earnings are tax-free.

d. Stock Bonus Plan. A stock bonus plan is similar in most respects to a profit sharing plan adopted by a corporation, with one important difference: benefits from the plan are paid in the form of stock of the employer corporation. Stock bonus plans normally invest substantially all of the plan's trust fund in stock of the employer corporation. An employee stock ownership plan ("ESOP") is a stock bonus plan which meets certain additional tax law requirements. The ESOP can borrow funds to acquire stock of the employer corporation. Benefit distributions from an ESOP are normally made in the form of stock of the employer corporation, but cash may be distributed in lieu of stock if the employee consents.

3. Summary of Characteristics of Defined Contribution Plans.

a. There is greater flexibility in the employer's contribution commitment.

b. There are lower administrative costs and no actuary is required for minimum funding standards.

c. Defined contribution plans permit employer/employee cost sharing.

d. No PBGC premiums for most defined contribution plans (but, as a result, no PBGC insurance coverage for benefits).

e. The terms and structure of defined contribution plans are easier to communicate and understand.

f. Defined contribution plans generally favor younger employees as there is little flexibility to provide for past service.

g. The investment risk is on the employee.

h. Defined contribution plans often permit in-service (e.g., hardship) distributions.

i. Possibility of allowing employee to direct the investment of assets in his or her amount, e.g., ERISA §404(c) plans;

E. Basic Rules for Qualified Plans.

While it might appear, from the foregoing sections, that an employer has a great deal of flexibility with respect to structuring its retirement system, in fact ERISA and the Code impose a comprehensive set of rules with which qualified plans must comply. The philosophy behind all of these regulations is that, in order to be deserving of special tax treatment, a company's retirement system must help advance certain of the government's social policies.

The best example of this can be seen in the minimum coverage and nondiscrimination rules and regulations which are, in general, designed to ensure that an employer’s tax-qualified plan benefits both the “rank and file” as well as the firm’s management employees.

The following is a discussion of some of the more important rules with which an employer should be familiar when deciding how to design its retirement system:

1. Eligibility and Participation Rules.

a. Minimum Age and Service Conditions (Code Section 410(a)(1)).

(1) A plan may not exclude an employee from participation on account of age beyond the date the employee attains age 21.

(2) Generally, a plan may not exclude an employee from participation on account of a minimum service requirement greater than one year of service. However, a two-year service requirement may be imposed if the plan provides for all benefits to be 100 percent vested and nonforfeitable at all times.

b. No Maximum Age Conditions (Code Section 410(a)(2)). A plan may not exclude an employee from participation on the basis of the attainment of a specified age.

c. Years of Service (Code Section 410(a)(3)). For purposes of the minimum service condition, a year of service is a 12-consecutive month period during which the employee completes at least 1,000 hours of service. Such period initially is required to be based on the 12-month period beginning with the employee's employment commencement date.

d. Time of Entry (Code Section 410(a)(4)). A plan must permit an employee who has satisfied its age and service requirements to commence participation in the plan within 6 months.

e. Minimum Participation Standard for DB Plans (Code Section 401(a)(26)). A defined benefit pension plan must benefit the lesser of 50 employees or 40% of the employer's employees.

2. Minimum Coverage Requirements (Code Section 410(b)).

a. Purpose. The minimum coverage rules are designed to ensure that the employer's nonhighly compensated employees ("NHCs") have opportunities to participate in the retirement plan that are comparable to the opportunities enjoyed by the highly compensated employees ("HCEs").

b. Minimum Coverage Testing. A plan must satisfy one of three tests (excluding from consideration employees who have not met the statutory minimum age and service requirements referred to above).

(1) Percentage Test. The plan must benefit at least 70% of all nonhighly compensated employees.

(2) Ratio Test. The percentage of nonhighly compensated employees benefited under the plan must be at least 70% of the percentage of highly compensated employees benefited under the plan.

(3) Average Benefit Percentage Test. The plan must (i) benefit a classification of employees that does not discriminate in favor of highly compensated employees, and (ii) the average benefit percentage (i.e., employer-provided contributions or benefits expressed as a percentage of compensation) for nonhighly compensated employees must be at least 70% of the average benefit percentage of highly compensated employees.

c. Testing on Controlled Group Basis. Tests are applied on a controlled group basis or, at the election of the employer, on a separate line of business basis (Code Section 414(r)).

3. Nondiscrimination Rules (Code Section 401(a)(4)).

a. General. A plan is qualified only if the contributions to or benefits provided under the plan do not, in either form or effect, discriminate in favor of highly compensated employees. Additionally, the benefits, rights and features provided under the plan must be available to participants on a nondiscriminatory basis, and the effect of the plan in certain special circumstances (amendment, termination and grant of past service credit) must be nondiscriminatory.

b. Nondiscrimination Testing. All tax-qualified plans are subject to a general quantitative nondiscrimination test, sometimes referred to as the "general test" (other than 401(k) plans). The annul contributions or benefit accruals for NHCs are compared against those of HCEs under this numerical test. However, plans with "safe harbor" benefit formulas are deemed to pass the general test automatically. For example, a profit-sharing plan that provides a uniform contribution equal to 5% of pay to each eligible employee under the plan would generally satisfy the safe harbor.

c. ADP/ACP Testing for 401(k) Plans. 401(k) plans are not subject to the general test. Instead, a 401(k) plan must satisfy the Actual Deferral Percentage (ADP) test, which measures whether the average deferral rate of all NHCs eligible to contribute to the plan is sufficient in comparison to the average deferral rate of all eligible HCEs. A plan fails the ADP test if the eligible NHCs fail to contribute at a high enough rate. If a 401(k) plan has a match, it must pass the Actual Contribution Percentage (ACP) test, which compares the average match rate of eligible NHCs against the average match rate of eligible HCEs. If a 401(k) plan fails the ADP/ACP tests, generally the excess contributions for HCEs must be reversed or the NHCs must receive supplemental employer contributions. However, the plan is deemed to pass the ADP/ACP tests automatically if the sponsor makes a "safe harbor" match or profit-sharing contribution in accordance with IRS rules.[1]

4. Minimum Vesting Standards.

a. Defined Benefit Plan (Code Section 411(a)(2)). A defined benefit plan must satisfy one of the following statutory requirements:

(1). 5-Year Full Vesting. An employee must be 100% vested upon completion of five years of service. A plan that provides for "all or none" or "cliff" vesting must satisfy this minimum vesting requirement.

[1] IRC Section 401(k)(12) establishes the safe harbor requirement for a matching contribution or a profit-sharing contribution. IRC Section 401(k)(13) establishes an alternative safe harbor for a matching contribution or profit-sharing contribution if the plan has an automatic enrollment feature.

(2) 3-to-7-Year Graded Vesting. If the plan provides for graded vesting, employees must vest at least as quickly as required by the following table:

Years of Service	Nonforfeitable Percentage
Less than 3	0%
at least 3	20%
at least 4	40%
at least 5	60%
at least 6	80%
7 or more	100%

(3) Special Vesting Rule for Cash Balance Plans. A cash balance plan must provide for 100% vesting for employees upon completion of 3 years of service.

b. Defined Contribution Plan (Code Section 411(a)(2)). A defined contribution plan must satisfy one of the following statutory requirements:

(1) 3-Year Full Vesting. An employee must be 100% vested upon completion of three years of service. A plan that provides for "all or none" or "cliff" vesting must satisfy this minimum vesting requirement.

(2) 2-to-6-Year Graded Vesting. If the plan provides for graded vesting, employees must vest at least as quickly as required by the following table:

Years of Service	Nonforfeitable Percentage
Less than 2	0%
at least 2	20%
at least 3	40%
at least 4	60%
at least 5	80%
6 or more	100%

NOTE: An employee's rights in his or her accrued benefit derived from employee contributions must be 100% vested and nonforfeitable at all times.

c. Vesting Upon Attainment of Normal Retirement Age (Code Section 411(a)(8)). Both DB and DC plans must provide that an employee's right to plan benefits is nonforfeitable upon attainment of normal retirement age. Normal retirement age is the age set forth in the plan, but not after the later of (i) age 65, or (ii) if the employee commenced plan participation within five years of the plan's normal retirement age, the fifth anniversary of commencement of participation.

d. Years of Service for Vesting Purposes (Code Section 411(a)(5)).

A year of service is a 12 consecutive month period during which the employee completes at least 1,000 hours of service. Such period can be designated by the plan.

5. Top-Heavy Rules.

a. Purpose. The top-heavy rules are designed to ensure NHCs receive at least a minimum benefit if the plan becomes "top heavy," which occurs when a disproportionate amount of the plan's assets are held for the benefit of "key employees." Key employees generally include officers earning more than $160,000 (for 2010) and certain employees who own at least 1% of the employer.

b. Top-Heavy Test. A plan is top-heavy for any year in which more than 60% of the benefits accrued under the plan belong to key employees.

c. Requirements for Top-Heavy Plan. If a plan is top-heavy for any year, the NHCs must receive certain minimum benefits (*e.g.*, minimum contribution equal to 3% of compensation in the case of a top-heavy defined contribution plan). In addition, the plan is subject to minimum vesting requirements for any top-heavy year which provide for more rapid vesting than would normally apply.

6. Benefit Accrual Rule for DB Plans. (Code Section 411(b)(1)). A defined benefit plan must not provide for "backloaded" benefit accruals. For example, a plan can not provide that a participant will accrue a $0 benefit for the first 29 years of employment, and then will accrue a full retirement benefit upon completion of 30 years of service. From a policy perspective, this anti-backloading rule supplements the minimum vesting rules, and both rules are designed to ensure that retirement benefits are not illusory. Under the benefit accrual rule, DB plan benefits must accrue ratably over the employee's career, and, under the minimum vesting rule, they must vest after a reasonable period of service.

7. Minimum Funding Standards for DB Plans and Money Purchase Plans.

a. Purpose of Minimum Funding Rules. The minimum funding rules are intended to ensure that inadequate financing does not result in benefit plans being unable to satisfy their obligations to pay benefits to participants when such obligations become due. Thus, ERISA and the Code require plans (other than those specifically exempted) to be funded in a manner which Congress has determined would help ensure solvency. The funding rules require that employers make contributions with respect to benefits accrued both for current and past service and require that contributions be made to fund accrued benefits even if they are not vested. The requirements are backed by a ten percent (10%) excise tax in the event the funding rules are not satisfied. An 100% excise tax is imposed if the deficiency is not corrected. The excise tax liability is applied on a controlled group basis.

b. Plans Exempt from Minimum Funding Rules (Code Section 412(h)). The minimum funding rules apply to all plans qualified under Code Section 401(a), except that the rules do not apply to profit sharing or stock bonus plans.

8. Limitations on Contributions and Benefits.

a. Defined Contribution Plans (Code Section 415(c)).

The Code imposes limits on the contributions or "annual additions" which may be made to a plan on behalf of an employee. Annual additions are limited to the lesser of (1) 100% of compensation, or (2) $49,000 (in 2010, as indexed).

b. Defined Benefit Plans (Code Section 415(b)).

The Code imposes a maximum limit on the benefit which may be paid from a defined benefit plan. The plan's maximum benefit, when expressed in the form of a straight-life annuity, generally may not exceed the lesser of (a) $195,000 (in 2010, as indexed), or (b) 100% of an employee's average compensation for his high three consecutive years. The limits are actuarially adjusted if benefits are paid in a form other than as a straight-life annuity, and for other various circumstances.

9. Maximum Deduction for Plan Contributions.

a. Defined contribution plans – The maximum deduction permitted annually for a profit-sharing or stock bonus plan is equal to 25% of all participants' compensation for the year (Code Section 404(a)(3)(A)).

b. Defined benefit plans – The maximum deduction for defined benefit plans is linked to the minimum funding standards. Generally, the employer can contribute and deduct a maximum amount equal to sum of (1) the year's "normal cost" for benefits, (2) the amount necessary to fully fund the plan's funding target, and (3) a "cushion" amount based on the funding target (Code Section 404(o)(2)). Minimum required contributions to a pension plan are always deductible (Code Section 404(o)(1)).

F. IRS and Plan Document Rules

1. Written Plan Requirement.

Retirement plans that satisfy the requirements of IRC § 401(a) are qualified and therefore extended favorable tax treatment. Treasury regulations require that a qualified retirement plan must be a definite written program established and maintained by an employer and that it satisfy the requirements of IRC § 401(a) in form (i.e., the terms of the plan document must comply with the law), in operation.[2] Benefits must be definitely determinable under the provisions of the plan

[2] Treas. Reg. § 1.401-1(a)(2).

document. In addition, the plan document must be timely updated to reflect minimum standards and other requirements by law.

2. IRS Determination Letter Program.

The IRS's determination letter program permits a plan sponsor to have the IRS review the form of the plan for compliance. The Service refers to this as "up-front compliance."[3] Such compliance does not protect the plan sponsor from plan operational or testing failures. Any failure to comply with the plan form requirements (referred to as a "disqualifying provision") of the Code subjects the plan to potential disqualification. The IRS has the power to disqualify a plan should it contain a "disqualifying provision," and the courts have affirmed this authority, irrespective of the significance of the defect, the innocence of the wrongdoer, or the unreasonableness of disqualification compared to the violation committed.[4] The Service also contends that once a disqualifying provision occurs, the plan remains disqualified until the defect is rectified, regardless of the statute of limitations.[5]

The Service has established a five-year staggered determination letter program for individually designed plans. Thus, plan sponsors must submit their plan documents for IRS review every 5 years. In addition to timely submissions for IRS review, the plan sponsor must adopt good faith interim amendments. A "good faith interim amendment" represents the sponsor's good faith effort to amend the plan to satisfy a particular qualification requirement as required by a change in the law.

3. Prototype and IRS Pre-Approved Plans.

An individually-designed plan is usually prepared by an attorney and can be expensive to implement (of course, in the long run, it may save the employer money since it will be designed to specifically meet the employer's needs). A less expensive approach may be the "prototype plan" -- a template plan document available through many large financial institutions (e.g., life insurance companies, investment companies) which has been pre-approved for use by the IRS. Prototype plan providers customarily require the plan to invest in the provider's own proprietary investment vehicles. A company which is considering adopting a prototype plan should always have the prototype documents first reviewed by its attorney.

[3] *The Future of the Employee Plans Determination Letter Program: Some Possible Options, available at* www.irs.gov/irs-tege/paper1.pdf. The Service used the expression "up-front compliance" as the determination letter program, as it then existed, ensured that the form of the plan document or plan amendments is qualified from its inception. Such approach was traditionally viewed as the preferred method to ensure future compliance.
[4] See e.g., Buzetta Construction Corp., v. Comm'r., 92 T.C. 641 (1989); Martin Fireproofing Profit Sharing Plan and Trust v. Comm'r., 92 T.C. 1173 (1989); Basch Engineering Inc., v. Comm'r., 59 T.C.M. 482 (1990).
[5] Under the tainted asset theory, if a plan becomes disqualified for more than five years with money remaining in the plan, the IRS can disqualify the plan even for years barred by the statute of limitations. See Rev. Rul. 73-79, 1973-1 C.B. 194 and Martin Fireproofing Profit Sharing Plan and Trust v. Comm'r., *supra* note 9.

IV. IRA PLANS AND IRAs

If the employer does not wish to maintain a "full blown" qualified plan, it may encourage its employees to contribute to their own individual retirement accounts (“IRAs”) under an employer-sponsored IRA plan.

A. General Rules for Individual Retirement Accounts ("IRAs").

1. An IRA must be a trust or a custodial account, the trustee or custodian of which is a bank or similar "qualified person."

2. Contributions may only be made in cash and different types of IRAs are subject to different annual limits (which are typically significantly lower than the limit applicable to tax-qualified DC plans).

3. Assets cannot be invested in life insurance contracts.

4. The individual's account balance must be fully vested and nonforfeitable at all times.

5. The IRA must be maintained pursuant to a written document. In this regard, the IRS has published IRA form agreements, which many IRA providers utilize to establish an IRA.

6. An “individual retirement annuity” (an “IRA annuity”) is subject to the same rules as an IRA. However, instead of contributing to an IRA trust or custodial account, contributions are made under an annuity contract from an insurance company.

B. Simplified Employee Pension Plan ("SEP") and SEP IRAs.

1. General. A SEP provides an employer with a simplified way to establish a retirement plan for its employees without the administrative costs associated with a tax-qualified retirement plan. Unlike a 401(k) plan where a plan trustee has custody of each participant’s account under the plan, under a SEP, each participating employee owns and controls his or her own SEP IRA. Additionally, the employer must fund the contributions made to each participant’s SEP IRA.

2. Employer and Employee Eligibility Requirements for a SEP.

As a tax-qualified investment vehicle, a SEP is subject to various eligibility rules under Code Section 408(k).

a. Generally, any private employer can set up a SEP, including a sole proprietorship or partnership.

b. All eligible employees <u>must</u> be eligible to participate in the SEP. An individual is an eligible employees for the current year if the employee (1) has attained age 21, (2) has performed service for the employer in at least 3 of the 5 years preceding the current year, and (3) has received from the employer at least $550 (in 2010, as indexed) during the current year.

3. <u>Contribution Requirements for a SEP</u>.

a. An employer may adopt a mandatory or discretionary contribution formula. However, if a contribution is made for any year, all eligible employees must receive a contribution.

b. Contributions must be made pursuant to a "definite written allocation formula" which specifies the requirements an employee must satisfy to share in the allocation and how the amount allocated is computed. The rate of contribution must not discriminate in favor of highly compensated employees. Code Section 408(k)(3)(C) establishes that contributions by an employer to a SEP are considered discriminatory unless the contributions bear a uniform relationship to compensation of each eligible employee. However, certain limited exceptions apply, including a Social Security integration rule which allows non-uniform contributions (*i.e.*, different contribution percentages apply to compensation above and below the Social Security wage base).

c. The annual contribution to any eligible employee under a SEP is subject to a limit equal to the lesser of (1) 25% of compensation up to $245,000 (for 2010, as indexed), or (2) $49,000 (for 2010, as indexed) (Code Section 408(j)).

d. An eligible employee may contribute to his or her own SEP IRA. However, the contribution limits that apply to a "regular" Traditional IRA apply (*i.e.*, $5,000 for 2010 as indexed), and all or a portion of the employee contribution may be nondeductible based on the employee's level of Adjusted Gross Income ("AGI").

e. All eligible employees must be 100% vested in all contributions at all times.

4. <u>Other Requirements for a SEP</u>.

a. A SEP is subject to the same top-heavy plan rules that apply to tax-qualified retirement plans. If the SEP is top-heavy in any year, all non-key employees who are eligible employees must receive a 3% minimum contribution.

b. Eligible employees must have the right to withdraw or rollover amounts held in their SEP IRAs at any time.

c. SEP and SEP IRAs must be established by adopting or executing written agreements. These written agreements can be based on IRS model forms.

d. The employer must provide annual notices to participants showing the amount of employer contributions made to the employee's SEP IRA. The IRS has a model notice which can be used to satisfy this annual notice requirement.

C. Savings Incentive Match Plan for Employees of Small Employers ("SIMPLE") and SIMPLE IRAs.

1. General. Similar to a SEP, a SIMPLE provides an employer with a simplified way to establish a retirement plan for its employees. However, a SIMPLE is limited to small employers only. A SIMPLE contemplates both salary deferrals and employer contributions and, in this regard, a SIMPLE has many similarities to a traditional 401(k) plan.

2. Employer and Employee Eligibility Requirements for a SIMPLE.

A SIMPLE is subject to a number of strict eligibility requirements under Code Section 408(k).

a. An employer may maintain a SIMPLE during the current year only if (1) it employed no more than 100 employees who earned $5,000 or more during the prior year, and (2) the employer does not maintain another tax-qualified retirement plan, SEP or SIMPLE.

b. All eligible employees must be eligible to participate in a SIMPLE. An individual is an eligible employees for the current year if the employee received at least $5,000 from the employer during any 2 prior calendar years (whether or not consecutive) and is reasonably expected to receive at least $5,000 during the current year. The employer has the flexibility to waive these eligibility conditions for employees and include all employees in the SIMPLE.

3. Contribution Requirements for a SIMPLE.

a. Eligible employees may make salary reduction contributions annually up to $11,500 (for 2010, as indexed). For employees who are age 50 or older, the contribution limit is increased to $14,000.

b. The employer must either:
(1) contribute two percent of compensation for all eligible employees, or
(2) match 100 percent of employees' contributions, up to three percent of compensation (with a limited ability to reduce the level of matching contributions).

c. All eligible employees must be 100% vested in all contributions at all times.

4. Other Requirements for a SIMPLE.

a. Unlike a 401(k) plan or a SEP, a SIMPLE is not subject to the top-heavy plan rules that apply to tax-qualified retirement plans.

b. Unlike a 401(k) plan, a SIMPLE is not subject to annual ADP/ACP testing.

c. Eligible employees must have the right to withdraw amounts held in their SEP IRAs at any time. However, with respect to rollovers, (1) during the first 2 years of participation, an eligible employee can only roll over amounts held in a SIMPLE IRA to another SIMPLE IRA, and (2) thereafter, amounts can be rolled over to other types of IRAs and tax-qualified plans in accordance with the normal rollover rules.

d. A SIMPLE and SIMPLE IRAs must be established by adopting or executing written agreements. These written agreements can be based on IRS model forms.

e. The employer must provide annual notices to participants explaining their ability to contribute to the plan and to receive employer contributions. The IRS has a model notice which can be used to satisfy this annual notice requirement.

D. Traditional IRAs – If an employer does not maintain a tax-qualified retirement plan or IRA plan, the employees should consider contributing to a Traditional IRA. If the employee's spouse is also unable to participate in a plan, both the employee and the spouse can make fully deductible contributions to their own respective Traditional IRAs. The contribution limit for a Traditional IRA is $5,000 (for 2010, as indexed). For individuals who are age 50 or older, the contribution limit is increased to $6,000.

However, if the employee or the employee's spouse is an active participant in a plan, their contributions to the Traditional IRA may not be fully deductible. Deductions are phased out based on Adjusted Gross Income ("AGI"). However, even if all or a portion of a contribution is nondeductible, contributions to a Traditional IRA can always be made on an after-tax basis up to the applicable $5,000 or $6,000 annual limit.

Earnings in a Traditional IRA accumulate on a tax-deferred basis until distributed to the IRA owner.

E. Roth IRAs – An employee can contribute to a Roth IRA, even if the employee or the employee's spouse are active participants in a plan, SEP or SIMPLE. However, the contribution limit for Roth IRAs is phased out based on AGI, and employees may be unable to contribute to Roth IRAs due to high income levels.

The annual limit on contributions made to a Roth IRA of $5,000 (for 2010, as indexed), but this limit is subject to reduction and is phased out for individual and joint tax filers with higher AGIs. For individuals who are age 50 or older, the annual limit is increased to $6,000.

Qualified distributions (including earnings) from these IRAs are tax-free. A qualified distribution generally is a distribution made at least five years after the initial Roth IRA contribution was made, and that is made due to one of the following: (i) the individual's attainment of age 59-1/2; (ii) the death of the individual; (ii) the disability of the individual; or (iv) first-time homebuyer expenses for the individual.

V. NONQUALIFIED RETIREMENT PLANS

A. Overview

Non-qualified plans are generally individually tailored arrangements that benefit highly compensated employees only.

One of the most common functions for non-qualified retirement plans is to supplement benefits payable under the qualified plans of an employer. For example, most sizable employers maintain one or more SERPs, or supplemental executive retirement plans, for executive employees. Nonqualified plans can also be established to give eligible employees the opportunity to defer their compensation.

B. Types of Nonqualified Plans Under ERISA

1. Under ERISA, there are 2 basic types of nonqualified plans. These include:

a. "Excess benefits plans" – ERISA §3(36) defines an excess benefit plan as one maintained "solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by §415 of the Internal Revenue Code of 1986 …"; ERISA §4(b)(5) completely exempts such plans from ERISA coverage if they are unfunded.

b. "Top hat" plans – these are plans which are unfunded and are maintained by an employer "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees;" See, e.g. ERISA §§201(2); 301(a)(3); and 401(a)(1), which exempt such plans from the participation, funding and vesting requirements, respectively, of ERISA; such plans are still subject to abbreviated reporting and disclosure requirements, and also to the fiduciary provisions of ERISA.

2. Because excess benefit plans and top hat plans are unfunded, they do not need tax qualified status under Internal Revenue Code Section 401(a), and therefore do not need to be nondiscriminatory. By design, they do discriminate in favor of highly compensated employees.

3. The informal funding of such plans through a nonqualified "rabbi trust" will not result in their being treated as "funded" for ERISA or tax purposes. Unlike a tax-qualified plan trust, the assets of a rabbi trust are subject to the claims of creditors in the event of the company's bankruptcy.

C. Qualified Plans v. Nonqualified Plans

There are 4 key differences between tax-qualified retirement plans and nonqualified plans.

Tax-Qualified Plans	Nonqualified Plans
- Qualification rules prohibit discrimination in favor of the highly compensated and impose contribution and benefit limits.	- Nondiscrimination rules and most other limits do not apply.
- ERISA minimum standards apply to eligibility, participation, vesting, funding, etc.	- ERISA minimum standards do not apply.
- Plans must be funded.	- Plan must be unfunded.
- Employee's deferred compensation is not taxed until payment.	- Employee's deferred compensation is not taxed until payment or "constructive receipt."[6]

D. Section 409A and Voluntary Deferred Compensation

1. Key Concepts in 409A

The American Jobs Protection Act of 2004 added Section 409A to the Code to regulate compensation deferral and payment elections under nonqualified plans. Code Section 409A covers any arrangement that enables an employee to defer receiving compensation to be earned until a subsequent year and thus delay taxation on the deferred compensation. Although Section 409A covers a broad array of arrangements, it does not apply to tax-qualified retirement plans (e.g., 401(k) plans), even though these plans also delay taxation on the compensation deferred thereunder.

The Section 409A rules essentially bar employees from accelerating the payment of deferred compensation. They also restrict the timing of initial compensation deferral elections and subsequent payment deferral elections. The penalties for not complying with these rules are severe. Noncompliance will cause an employee's deferred compensation (and related investment earnings) to become taxable and subject to a 20% additional tax penalty with a possible assessment of interest.

[6] "Constructive receipt" means that IRS treats an employee as receiving compensation when the employee has the right to currently access the compensation, even if the employee has not exercised the right to actually receive the compensation.

2. Requirements Under Code Section 409A

a. Compensation Deferral Elections

An employee generally must make a compensation deferral election prior to the year in which the compensation is earned. For example, deferral elections for compensation to be earned in 2011 must be made by December 31, 2010. However, there are many exceptions to the general rule, including the key exceptions described below.

(1) Newly Eligible Participants

Employees newly eligible to participate in a 409A plan can make their initial compensation deferral elections within 30 days of becoming eligible. However, the deferral election will apply only to compensation earned after the election.

(2) Performance-Based Compensation

Deferral elections for performance-based compensation can be made as late as six months before the end of the performance period. However, the performance period must be at least 12 months. The amount or payment of the compensation must be contingent upon the satisfaction of the performance-based objectives (e.g., bonus tied to achieving sales targets for a year) established at the beginning of the performance period. Also, whether the objectives would be achieved must be substantially uncertain when they are established.

(3) Ad Hoc Bonuses

An employee may elect to defer an ad hoc bonus if:

- the employee will forfeit the bonus if he or she terminates employment within 12 months after the bonus is awarded, and
- the deferral election is made within 30 days after the bonus is awarded and at least 12 months in advance of the earliest date at which the forfeiture condition could lapse.

(4) Excess Plans

Excess plans typically provide benefits based on a formula in a qualified plan that produces benefits that exceed the plan qualification limits designed to restrict benefits for the highly compensated employees. Accruing benefits under excess plans is usually automatic. The design of an excess plan may or may not allow an employee to choose the time and form of payment.

The 409A rules allow an excess plan to permit employees accruing a benefit to elect the time and form of payment within the first 30 days of the plan year following the year during which they first accrue a benefit. The election applies to benefits that were accrued in the prior plan year as well as those that accrue after the payment election.

b. Payment Elections

When employees make compensation deferral elections under a 409A plan, they must also elect the time and form of payment. Alternatively, the plan must specify the time and form of payment. A 409A plan may allow for payment no earlier than one of the following events:

- separation from service;[7]
- disability;[8]
- death;
- change of control;
- unforeseeable emergency; and
- at a fixed date specified by the plan or an employee's irrevocable election.

In certain circumstances, different forms of payment can be elected for different types of payment events. For example, a participant can elect to receive a lump sum payment at disability and installment payments at separation from service.

c. Anti-Acceleration Rule

Once an employee or the 409A plan has specified when the deferred compensation will be paid, the payment of the deferred compensation payment cannot be accelerated.[9] For example, the Section 409A regulations would treat the payment of a bonus simultaneously with the employee's relinquishment of an equivalent amount of deferred compensation under the 409A plan as a prohibited acceleration. Similarly, granting a loan to an employee that is secured by an offset under the 409A plan would also violate the anti-acceleration rule.

d. Beneficiary Payment Elections

The time and form of payment election for death or survivor benefits payable to a beneficiary must generally be made at the same time as the employee's payment election (e.g., whether the employee's beneficiary will receive a lump sum or an annuity). However, the Section 409A regulations allow an employee to subsequently change beneficiaries so long as the change does not affect the time or form of payment.

[7] Payment upon separation from service must be delayed at least six months for "specified employees." These are key employees as defined in the so-called "top-heavy" rules for qualified plans if their employer's stock is publicly traded.
[8] The definition of disability is strict. The employee must be unable to engage in any substantial gainful activity by reason of an impairment that can be expected to last for a continuous period of not less than 12 months or to result in death. Alternatively, the employee must be receiving disability benefits replacing lost wages for a period of not less than three months under the employer's accident and health plan.
[9] Payments made on separation from service, disability, death, change of control, etc. would not violate the anti-acceleration rule if the 409A plan provided for payments upon the occurrence of these events.

e. Payment Deferral Elections

Changes in payment options must be made at least 12 months prior to the first payment and postpone the first payment a minimum of five years. For example, suppose an employee initially elects to receive deferred compensation in a lump sum at age 65 but now wants to change to installment payments. The employee must make the payment deferral election by age 64 and cannot receive the first installment payment until age 70.

VI. FIDUCIARY RESPONSIBILITIES UNDER ERISA

A. Scope of Coverage

Title I of ERISA imposes numerous fiduciary requirements on retirement plans. However, these rules only apply to an "employee benefit plan" as defined under ERISA.

1. Tax-qualified Plans With Employees. A tax-qualified retirement plan maintained by an employer with employees is automatically subject to the fiduciary requirements of ERISA.

2. Tax-qualified Plans With No Employees. A Keogh plan, or any other tax-qualified retirement plan maintained by a sole proprietorship or a partnership without any employees, is not an employee benefit plan and is not subject to Title I of ERISA. However, such plans may be subject to certain reporting requirements (*e.g.*, filing annual Form 5500 returns with DOL).

3. IRA Plans. SEPs and SIMPLEs are technically subject to Title I of ERISA, however they are exempt from most of the requirements under Title I.

4. Nonqualified Plans. Nonqualified plans are technically subject to Title I of ERISA. However, nonqualified plans by their nature are unfunded, and they are exempt from the substantive requirements of Title I.

B. Definition of "Fiduciary"

Each plan subject to ERISA must have *at least one fiduciary* who ensures that the plan operates in accordance with the terms of the plan document, any trust agreement or insurance contract, and also with applicable laws and regulations. One individual or entity may function as a fiduciary for more than one plan.

A fiduciary is any individual or entity that has or exercises discretionary authority or control over the management or administration of a plan or the disposition of plan assets.[10] Typically, the plan sponsor is the "named fiduciary" of the plan, with principal responsibility for its oversight and management. A plan may have more than one fiduciary.[11] Advisers who

[10] ERISA §3(21).
[11] 29 CFR §2509.75-8, FR-12.

provide "investment advice" to a plan sponsor are also fiduciaries.[12] A fiduciary should be aware of others who serve as fiduciaries to the same plan, because all fiduciaries have potential liability for the actions of their co-fiduciaries.

Fiduciaries do not include any individuals who only perform ministerial functions and who do not have the power or authority to make decisions with respect to plan policy, interpretation, practices or procedures. For example, an individual who calculates benefits, processes claims, or makes recommendations about plan administration is not a fiduciary if the plan document does not give him the power or authority to make a decision about benefit payments or recommendations.[13]

Note: The test for determining fiduciary status is a functional one. For example, any person or entity that exercises any discretionary authority or control with respect to the plan is considered a fiduciary even if such individual or entity is not formally appointed to serve as a plan fiduciary.

C. Fiduciary Responsibilities

1. Fiduciary Standard of Care Under ERISA

A fiduciary must act **solely** in the interest of plan participants and their beneficiaries and alternate payees:

- With the exclusive purpose of providing benefits to plan participants and their beneficiaries;[14] and by
- Carrying out his or her duties prudently;[15]
- Following the terms of the plan documents (unless the documents are inconsistent with ERISA);[16]
- Diversifying plan investments;[17] and
- Paying only reasonable plan expenses.[18]

Fiduciaries must also comply with ERISA's reporting and disclosure requirements and maintain a fidelity bond.

a. Exclusive Purpose of Providing Benefits

A fiduciary's primary responsibility is to discharge his or her duties solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits for participants and their beneficiaries and alternate payees.[19]

---

[12] ERISA §3(21).
[13] 29 CFR §2509.75-8, D-2.
[14] ERISA §404(a)(1)(A)(i).
[15] ERISA §404(a)(1)(B).
[16] ERISA §404(a)(1)(D).
[17] ERISA §404(a)(1)(C).
[18] ERISA §404(a)(1)(A)(ii).

b. <u>Carrying Out Duties Prudently</u>

Fiduciaries must manage plan assets solely in the interest of participants and beneficiaries with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a similar situation and familiar with such matters would exercise.[20] With regard to the duty of prudence and plan investments, the DOL and the courts measure prudence by analyzing the process used to select an investment (*e.g.*, the scope and diligence of the fiduciaries' evaluation of the investment), rather than focusing solely on investment performance.

c. <u>Following the Terms of the Plan Document</u>

Fiduciaries must follow the terms of the plan documents unless the documents do not comply with ERISA (*i.e*., plan operations must comply with the terms of the plan document). Therefore, fiduciaries should be familiar with their plans and the plan documents. Furthermore, the fiduciaries should carefully review the documents periodically to ensure that the documents are legally compliant, and that the plans are operating in accordance with the terms of the plan document.[21]

d. <u>Diversifying Plan Investments</u>

The fiduciary is also responsible for diversifying the plan's investments in order to minimize the risk of large losses unless, under the circumstances, it is clearly not prudent to do so. Generally, fiduciaries should not invest a disproportionate amount of the plan's assets in a particular investment, particular type of investment or in investments concentrated in a particular geographic location. Special rules apply to plans that are intended to comply with Section 404(c) of ERISA, such as 401(k) plans where participants are responsible for investment allocations.

2. <u>Fiduciary Protection Under ERISA 404(c) Plans</u>

a. <u>General</u>

Participant-directed account plans must comply with ERISA §404(c) if fiduciaries wish to be shielded from potential liability for a participant's imprudent investment allocation decision. If a plan is not a §404(c) plan, the fiduciaries could be held responsible for participants' investment losses, even though they may be the direct result of the participant's own allocation decisions.

---

[19] ERISA §404(a)(1)(A)(i).
[20] 29 CFR §2550.404a-1(a).
[21] ERISA §404(a)(1)(D).

Note: Many fiduciaries believe that their participant-directed plans are §404(c) Plans when operationally the plans do not satisfy the requirements for a §404(c) Plan. Fiduciaries who want to limit their liability by maintaining a §404(c) Plan should closely monitor the plan to ensure that, in practice, it complies with ERISA §404(c).

b. Conditions of ERISA Section 404(c).

An individual account plan is a §404(c) Plan if it allows participants and beneficiaries to:[22] (1) exercise independent control over the assets in their individual accounts; and (2) choose from a broad range of investment options.

(1) Exercising Independent Control

A participant or beneficiary exercises control only if, under the terms of the plan, he has a reasonable opportunity to give investment instructions. The participant must also be given enough information to make informed decisions about the plan's investment options.[23] Under the relevant DOL regulations, participants must receive certain investment-related disclosures **before** an investment is made, and other disclosures must be made available upon request.

(2) Broad Range of Investment Options

A plan offers a broad range of investment options only if the available investment options provide each participant with a reasonable opportunity to:

- Materially affect the potential return on amounts in his individual account;[24]
- Choose from at least three investment options which; and
- Diversify the investment of the participant's account in order to minimize the risk of large losses.[25]

c. Fiduciary Duty to Select and Maintain Investment Menu.

If a plan satisfies the relevant condition of ERISA Section 404(c), participants are responsible for their investment allocation decisions, and the plan sponsor is only responsible for the plan's investment menu. Specifically, the plan sponsor must ensure the investment options in the menu are selected and monitored on an ongoing basis in accordance with its fiduciary duties of *prudence* and *diversification* under ERISA.

[22] 29 CFR §2550.404c-1(a)(1) and 29 CFR §2550.404c-1(b)(1).
[23] 29 CFR §2550.404c-1(b)(2)(i).
[24] 29 CFR §2550.404c-1(b)(3)(i)(A).
[25] 29 CFR §2550.404c-1(b)(3)(i)(C).

D. Fiduciary Investment Reviews

1. Investment Policy Statement ("IPS")

The DOL has made it clear that, in enforcing ERISA, it will not judge fiduciaries on the results they achieve, but on the processes they follow. Fiduciaries should maintain an IPS with respect to their respective tax-qualified retirement plans. A written IPS can help demonstrate compliance with ERISA's fiduciary standards. The IPS should include clear standards for choosing investments, how they are monitored, and when they should be replaced. The roles of interested parties should also be clearly stated. The policy should contain enough detail so that the user (or a regulator) can clearly understand how investment decisions should be made. The investment policy should be reviewed periodically and modified as necessary.

2. Continuous Monitoring

In accordance with the IPS, fiduciaries should continuously monitor plan investments. Ideally, investments should be reviewed at least annually. Monitoring should directly reference back to the IPS, and should also include a broad range of qualitative and quantitative metrics for each fund and/or manager. Fiduciaries must understand what the analysis means for the plan and the participants (*e.g.*, is the fund's performance reasonable based on current market conditions? what are the fees? are they reasonable with respect to the services being provided?).

3. Replace Funds that Do Not Meet Investment Criteria

Many fiduciaries are reluctant to replace poorly performing funds. A lack of timely action could demonstrate reluctance on the fiduciaries' part to perform their duties as required under ERISA. The IPS can help with the decision making process by providing specific standards that investments must meet, and investments that fail to meet such standards must be placed on a watch list or, if appropriate, replaced. If fiduciaries fail to act prudently as required under ERISA, they could be held personally liable for any resulting losses.

4. Documentation of Fiduciary Reviews

Fiduciaries should document their reviews of investment vehicles, including associated or hidden fees. The documentation should address key questions or discussions, and decisions made. The ability to provide documentation demonstrates a thoughtful process and helps demonstrate fiduciary prudence.

5. Utilize an Independent Third Party Investment Expert

Fiduciaries should solicit and consider the advice of independent third party investment experts. Vendors often provide reports and recommendations for analysis, placing funds on watch lists or replacing funds. However, where there is an inherent conflict of interest when a vendor reports on an affiliated fund, or even nonproprietary funds where long-term business relationships and revenue sharing arrangements are involved, fiduciaries should consider the conflicted nature of any such advice.

6. Evaluating Expense Ratios/Fees

Under ERISA, fiduciaries are responsible for ensuring that fees are reasonable. A fiduciary review of the reasonableness of fees should take into account all investment fees and expenses, including any fees that are shared among the plan's various providers under revenue sharing arrangements.

E. Reporting and Disclosure Requirements

Fiduciaries must comply with ERISA's reporting and disclosure requirements.[26] These rules require plan administrators and plan sponsors to report significant plan information to various federal agencies (*e.g.*, DOL, IRS and PBGC), and disclose plan information to plan participants and beneficiaries.

1. Summary Plan Descriptions

ERISA requires plan sponsors to provide summary plan descriptions ("SPDs") to participants. SPDs must describe the plan in non-technical terms that can be easily understood by the average participant. DOL regulations clearly describe the information that must be contained in an SPD.

2. Summaries of Material Modifications

When there is a "material modification" of the information required to be in an SPD, a Summary of Material Modifications ("SMM") must be distributed to plan participants.[27] The SMM is a written summary describing a material modification of a plan. The SMM must include enough detail to inform participants of their rights and obligations in connection with the material modifications. In addition, the SMM must not mislead, misinform, or fail to inform participants about the material modifications to the plan. The deadlines for distributing an SMM to plan participants and beneficiaries is 210 days after the close of the plan year during which the material modification was adopted.[28]

3. Annual Reports

The annual report**,** as its name indicates, is a report that is filed each year on a Form 5500. The report includes information about the plan for a specified plan year: plan type, plan administration, participation, and in some instances funding and other financial information. In general, information reported in an annual report must relate to the plan year for which the report is filed.[29] In general, the Form 5500 must be filed by the last day of the seventh month after the plan year ends.[30] If Form 5558, Application for Extension of Time To File Certain Employee

---

[26] ERISA §404(a)(1)(D).
[27] DOL Reg. §§ 2520.102-3, 2520.104b-3.
[28] DOL Reg. §§ 2520.104a-4(b), 2520.104b-3(a).
[Section 4]
[29] Instructions for Form 5500, Section 5, available on the DOL's Web site, *www.dol.gov*.
[30] Instructions for Form 5500, Section 2, When to File.

Plan Returns, is filed before the plan's annual report filing deadline, the plan is automatically granted a one-time extension of two and one-half months.[31]

4. Summary Annual Reports

A summary annual report ("SAR") is an abstract of the information in a plan's Form 5500 annual report.[32] The primary purpose of a SAR is to inform participants and beneficiaries of the plan's financial condition. In general, a plan must distribute its SAR to plan participants within nine months after the close of the plan year.

F. Purchasing a Fidelity Bond

Generally, every fiduciary and anyone who handles funds or other property of the plan **must be bonded** unless one of the limited exceptions under ERISA §412 applies. The bond must cover at least 10% of the amount handled by the bonded individual. The bond may not be for less than $1,000 and need not exceed $500,000 ($1,000,000 for plans holding any employer securities).[33]

Note: A fidelity bond is different from fiduciary liability insurance because the fidelity bond protects the plan against losses. Fiduciary liability insurance protects the fiduciary.

VII. WHICH TYPE OF RETIREMENT PLAN IS RIGHT FOR YOU?

Once the employer understands the various types of qualified requirement benefit plans available, a determination must be made as to which plan best meets its needs. In making such a decision, it is important to gather information about both (i) the nature of the employer and its business goals, and (ii) the needs of the employees who are targeted to benefit from the plan.

A. Nature of the Employer and its Business Goals.

1. How is the business organized?

2. What is the business's relationship with other entities?

   a. Is it part of a controlled group (Code Sections 414(b), (c) and (o))?

   b. Is it an affiliated service organization (Code Section 414(m))?

   c. Does it lease employees (Code Section 414(n))?

3. How long has it been in existence? Does it have predecessors or successors?

[31] Instructions for Form 5500, Section 2, When to File.
[32] DOL § 2520.104b-10(d)
[33] ERISA §412, as amended by §622 of the Pension Protection Act of 2006, effective for plan years after 2007.

4. What fringe benefits does the business presently offer? Are any changes currently being contemplated?

5. With whom must the business compete with respect to its benefits package?

6. Is the business unionized or concerned about an organizational campaign?

7. What are the ages, years of service and earnings of individuals to be covered?

8. Does the business experience significant employee turnover?

9. How much is the employer willing/able to spend for retirement benefits?

10. What is the employer's financial history and projections?

   a. Is it cash rich or poor; profit rich or poor?

   b. Does it have accumulated earnings problems?

   c. Is its business cyclical and, if so, to what degree?

11. What discretion does the business have with respect to funding a plan? Would it be able to make a commitment to fund quarterly?

l2. Does the business want employees to partially or fully share in the cost of funding a plan?

B. Needs of Employees.

1. Owners employed in the business

   a. Enhance current income

   b. Defer income for retirement

   c. Estate planning

2. Key employees (generally, long-term, highly compensated employees in management positions who are critical to the functioning of the business; see also definition in Code Section 416)

   a. Same needs as owners, plus

   b. Reward for past service/retention of a valuable employee

3. Rank and file employees (including salaried employees, union and non-union employees, salespeople, employees of a particular division or plant)

a. Reward for past service

b. Retention (i.e., benefits are comparable to those offered by competitors)

c. Retirement planning -- consider total benefits package, including:

(1) Federal programs (Social Security, Medicare)

(2) State programs (workers' compensation, mandated health benefits)

(3) Previous employers

C. Advantages and Disadvantages of Tax-Qualified Retirement Plans.

1. Advantages

The primary advantage of tax-qualified retirement plans for employers is the immediate and ongoing tax benefit. The employer enjoys an immediate deduction for contributions made to the plan trust. Although IRA plans also allow immediate deductions, the contribution limits under tax-qualified retirement plans are greater than those under IRA plans. Tax-qualified retirement plans also allow for a substantial amount of flexibility in plan design, unlike IRA plans which are only available in 2 rigid varieties (i.e., SEP and SIMPLE). In the case of nonqualified plans, no deductions are allowed until the employee finally receives a distribution of benefits (or is in constructive receipt of such benefits).

2. Disadvantages

The disadvantage of a tax-qualified retirement plans is the fact that they are subject to a legion of requirements and restrictions, including the requirement that the employer provide benefits in a nondiscriminatory manner.

3. Examples of Qualified Plans Specifically Designed to Meet a Business's Needs.

a. To maximally benefit owners, upper management and/or key employees:

(1) If the owners, upper management and key employees are generally older than the rank and file employees, an age-weighted or new comparability discretionary profit sharing plan (by which contributions are made to fund benefits payable at retirement) could be designed which would allow smaller contributions to be made on behalf of younger employees and larger contribution to be made on behalf of older employees (the theory being that, since younger employees have more time to accrue benefits, comparable retirement benefits would result).

(2) If there is generally a large turnover among the rank and file employees, a defined benefit pension plan could be designed using a benefit formula which takes into account years of service. Moreover, the accrual rates under defined benefit pension plans are significant, given the normal retirement benefit is $195,000 for the participant's life, for a present value benefit of over $2 million.

(3) A defined benefit pension plan could be designed using a benefit formula which takes into account final average pay.

(4) A defined benefit pension plan or defined contribution plan could be designed which is integrated with Social Security, such that employees above the Social Security wage base ($106,800 for 2010) would receive a greater benefit than employees below the wage base (see, however, limitations on permitted disparity contained in Code Section 401(l)).

b. To provide retirement benefits at minimal cost to the employer:

(1) A 401(k) plan can be funded in whole or in part with employees' own monies.

(2) The employer may choose to provide matching contributions (or discretionary profit sharing contributions) if it so desires.

c. To encourage long-term employment with the company:

(1) A defined benefit plan by its nature rewards older employees and employees with the most years of service (both highly and nonhighly compensated employees). Cost of living adjustments are generally built into such plans.

d. To give a company flexibility from year to year as to whether or not it will make contributions to a retirement plan:

(1) Profit sharing plans can be tied to company profits such that an employer has great flexibility with respect to its plan contributions.

e. To provide employees with a fixed contribution (where there is a desire, above all, for certainty):

(1) The annual contribution made under a money purchase pension plan is generally a fixed percentage of the employee's compensation.

D. Advantages and Disadvantages of IRA Plans.

1. SEP and SEP IRAs

a. Advantages

The advantage of SEPs is that they allow employers to deliver benefits that are similar to those under tax-qualified retirement plans. However, they are not subject to many of the tax-related and fiduciary requirements that apply to "full blown" tax-qualified retirement plans. Form 5500 filings are not required.

b. Disadvantages

The disadvantage of a SEP is that all eligible employees must receive SEP IRA contributions, and they must be fully and immediately vested. Participant loans are not permitted. Since pre-tax salary deferrals are generally not permitted, the employer finances the full cost of retirement benefits.

2. SIMPLE and SIMPLE IRAs

a. Advantages

Like SEPs, SIMPLEs allow employers to deliver benefits that are similar to those under tax-qualified retirement plans, without being subject to many of the tax-related and fiduciary requirements that apply to "full blown" tax-qualified retirement plans. For example, a SIMPLE is not subject to the top-heavy or nondiscrimination rules. In addition, a SIMPLE allows the employer and the employees to share the cost of providing retirement benefits. Form 5500 filings are also not required.

b. Disadvantages

A SIMPLE may only be established by small employers with few than 100 employees. In comparison to the 401(k) plan, one disadvantage of a SIMPLE is its lower salary deferral limit. The 2010 limit for a 401(k) plan is $16,500, but the SIMPLE limit is only $11,500. Another disadvantage is the requirement that the employer must make either a 100% match or a 2% non-elective contribution to all eligible employees.

E. Advantages and Disadvantages of Nonqualified Plans.

1. Advantages

If an employer seeks to deliver retirement benefits to an exclusive group of highly compensated employees, nonqualified plans are the most suitable type of plan vehicle.

Nonqualified plans are not subject to the numerous requirements and limitations that apply to tax-qualified retirement plans. Given their flexibility, the employer can pick and choose the individual employees who will be eligible, and the amount of benefits to be delivered are not subject to any limits or restrictions.

They can be designed as defined benefit or defined contribution plans, including salary deferral plans. Thus, the cost of providing benefits can be shared between the employer and employees.

2. Disadvantages

However, nonqualified plans by their nature cannot be funded, which means that plan contributions are notional (i.e., contributions are not made to a separate tax-qualified trust on an ongoing basis), which also means that the employer does not receive an immediate deduction.

Additionally, nonqualified plans cannot include a broad-based group of employees, since the inclusion of rank-and-file employees would trigger the minimum standards that apply to regular "employee benefit plans" subject to Title I of ERISA.