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R I C H A R D L . S A N D E R S O N , J R .

March 30, 2007

via e-mail: < >

Re: SKA Quarterly Newsletter, March 2007

Dear Clients:

As noted in our last Year-End Newsletter, 2006 was a very busy year in the employee benefits arena and it appears that the pace is not about to slow down in 2007. Since the last Newsletter the following significant events have developed:

1. The IRS issued Notice 2007-7 with respect to the Pension Protection Act of 2006 (“PPA”)
2. The DOL has begun issuing guidance under the PPA.
3. Courts and the IRS have been active with respect to cash balance plans
4. There have been Congressional hearings regarding the amount of fees charged to participants of 401(k) plans and several lawsuits filed as well.
5. The Tax Relief and Health Care Act of 2006 was enacted in late 2006, extending the Mental Health Parity Act provisions until the end of 2007 and liberalizing many of the Health Savings Account rules.

This Newsletter will briefly discuss these and other developments.

### 1. IRS Notice 2007-7

The Internal Revenue Service issued Notice 2007-7 in January, providing guidance for the following eight PPA 2006 provisions:

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- Interest rate assumptions under Code Section 415 and compliance mechanisms for retroactive adjustments;
- Hardship distributions attributable to a participant's beneficiary;
- Early distributions for certain public safety employees;
- Exclusion from gross income for distributions from certain governmental plans used to pay qualified health insurance premiums for certain eligible retired public safety officers;
- Rollovers by non-spouse beneficiaries;
- Bifurcated vesting schedules;
- Qualified charitable contribution deduction; and
- Notice requirements related to certain distributions.

These eight items generally have effective dates in 2007, and in some cases earlier. This Newsletter discusses the guidance for notice requirements for certain distributions since it requires immediate attention and the guidance for rollovers by non-spouse beneficiaries.

#### **Notice Requirements of Notice 2007-7**

The notice required under Code Section 402(f) (eligible rollover distributions), Code Section 411(a)(11) (mandatory distributions over \$5,000) or Code Section 417 (qualified joint and survivor annuities) may now be provided to a participant as long as 180 days before the annuity starting date or distribution date (increased from 90 days). The regulations under Code Section 411(a)(11) and ERISA Section 205 are to be modified to require a description of the consequences of failing to defer receipt of a distribution. The plan administrator is required to use a "reasonable attempt" to revise the notice under Section 411 even before regulations are issued. A notice describing the participant's right to defer receipt of a distribution will constitute a "reasonable attempt" if it includes the following:

- For a defined benefit plan, a description of how much larger benefits will be if the commencement of distributions is deferred. (Can use description that includes the financial effect of deferring distributions as described in Treas Reg Section 1.417(a)(3)-1(d)(2)(i), based solely on the normal form of benefit);
- For a defined contribution plan, a description indicating the investment options available under the plan (including fees) that will be available if distributions are deferred; and
- A description of any portion of the summary plan description that contains any rules that might materially affect a participant's decision to defer.

Since the new notice requirements apply for any notices required to be given after December 31, 2006, you need to pay immediate attention to the new notice requirements of 411(a) and attempt a reasonable description of the consequences of deferring distributions under either a defined benefit or defined contribution plan, even though the regulations have not yet been issued by IRS or DOL.

### **Rollovers by Non-Spouse Beneficiaries**

Prior to the PPA, only surviving spouses could roll-over the deceased's balance in a qualified plan to an IRA. Beginning in 2007, a qualified plan may, but is not required to, permit a direct rollover distribution for a non-spouse beneficiary. A non-spouse beneficiary includes a trust that is named as beneficiary under the plan. Special rules apply if the participant dies before his or her required beginning date under Code Section 401(a)(9).

## **2. DOL Guidance under the PPA**

### **Investment Advisors**

The PPA provides for a prohibited transaction exemption for the provision of advice to participants and the receipt of fees from such advice by a "fiduciary advisor." Fiduciary advisor is broadly defined to include banks, insurance companies, broker dealers, registered investment advisors, all of their affiliates and all of their employees, representatives and agents.

Advice must be given pursuant to an "eligible investment advice arrangement" which provides that either (1) any fees received by the advisor must not vary on the basis of the investment options selected or (2) the advisor must use a computer model. Advisors must be audited annually by an independent auditor regarding compliance with the exemption. Plan sponsors are still responsible for prudently selecting and monitoring investment advisors, but they are not responsible for specific advice provided by the investment advisor. See EBSA Field Advice Bulletin 2007-01 (February 7, 2007), which elaborates on the above discussion and provides that previous guidance (Interpretive Bulletin 96-1; Advisory Opinion 97-15A, 2005-10A, and 201-90A) on the subject remains unchanged.

### **Cross Trading**

The PPA added an exemption from ERISA's prohibited transactions and the Code's excise taxes for securities cross-trades. Securities cross-trades involve the purchase and sale of a particular security between two or more accounts of an investment manager without going to the open market. The DOL's Employee Benefits Security Administration issued interim final rules on February 12, 2007 providing the requirements for the contents of written policies and procedures necessary to satisfy the

PPA prohibited transaction exemption. Many trust agreements also have cross-trading provisions and these should be reviewed to make sure they are up-to-date in light of the recent legislative and regulatory developments.

### **3. Developments Regarding Cash Balance Plans**

#### **Judicial Developments**

The Supreme Court declined to hear the appeal in Cooper v. IBM, 457 F.3d 636 (7<sup>th</sup> Cir. 2006) where the 7<sup>th</sup> Circuit held that cash balance plans did not violate the Age Discrimination in Employment Act. Following Cooper, a District Court in the 7<sup>th</sup> Circuit held that Boeing's cash balance plan was not age-discriminatory nor did it violate ERISA's anti-backloading provisions. See Wheeler v. Pension Value Plan for the Employees of Boeing Co., (S.D. Ill. March 13, 2007). US Bank's cash balance plan was upheld as non-age discriminatory by the District Court in Sunder, III v. US Bank Pension Plan, (E.D. Mo. February 16, 2007). The District Court in the 3<sup>rd</sup> Circuit upheld Dun & Bradstreet's cash balance plan conversion as non-age discriminatory and the 3<sup>rd</sup> Circuit Court of Appeals held likewise with respect to PNC's cash balance plan conversion. See Finley v. Dun & Bradstreet, 39 EBC 2421 (D.NJ 2007); Register v. PNC Financial Services Group, Inc., 39 EBC 2409 (3<sup>rd</sup> Cir. 2007). However, a District Court in the 2<sup>nd</sup> Circuit found the Citigroup cash balance plan to be discriminatory. See In Re Citigroup Pension Plan Litigation, 39 EBC 2025 (SDNY 2006). Thus, there continues to be a split between the circuits as to whether cash balance plan conversions discriminate against older workers. Remember, however, that PPA 2006 clarifies that certain cash balance conversions on or after June 29, 2005 are not age discriminatory.

#### **IRS Determination Letters**

The Internal Revenue Service announced that it is ending its moratorium (since 1999) on issuing determination letters for plans that converted to cash balance plans. See IRS Notice 2007-6, 2007-3 IRB 272.

### **4. 401(k) Plan Fees**

We have been preaching about hidden fees in bundled arrangements for years. The ERISA plaintiffs' bar has now figured it out. As of January, 2007, at least a dozen class actions had been filed against 401(k)-type plans and their fiduciaries over excessive fees, involving names such as Bechtel, Boeing, Caterpillar, Fidelity Investments, International Paper, Kraft Foods Global, Principal Insurance and United Technologies. National Law Journal, January 8, 2007 (Sacher & Olson).

Often investment providers, whether on their own or whether "bundled" with third party administration services, will purport to provide "no cost" services. The employer

will pay nothing; the plan pays everything. The providers will be compensated by the mutual fund companies or other investments sold. Under these circumstances, the providers are almost invariably paid on a percentage of plan assets. The plan assets will generally grow with additional deposits and investment income. Yet these advisors' jobs won't necessarily grow. In short, they become a "profit drag" on the plan. Fee-based advisors can just as easily be paid out of plan assets, and in a way where the plan sponsor knows what it's paying for, and the amount paid is reasonable in relation to the service itself. In fact, ERISA requires that a plan pay only reasonable fees. ERISA Section 404(a)(1)(A)(ii).

One of our clients was recently enthused about a proposed "no fee" basis for "investment advice" and plan administration. When we reviewed the promises and documentation, the "investment advisor" was only serving as a stockbroker, and would not (and could not because of compensation by mutual fund commissions) acknowledge ERISA fiduciary responsibility (even though my client thought they were receiving legally responsible investment advice). Furthermore, this investment seller had recommended mutual funds with unusually high internal expense ratios. For example, there was a government bond fund with an expense ratio of 1.12%. A reasonable expense ratio for this type of fund would be more like 35 basis points (0.35%). Finally, the investment advisor and third party administrator were not being paid a flat fee, but were being paid a percentage of plan assets. When these things were brought to the attention of my client, they said "no thank you" to the investment provider, asked the third party administrator to give them a fee-based quote which would not escalate every year with plan assets, and solicited proposals for fee-based investment advice, which would be given on a fiduciary basis.

Carefully examine promises and documentation. Find out what you are really paying for services. Get the investment advisory services on a fiduciary basis. Otherwise, you or your client are setting yourselves up to be victims and breaching fiduciaries.

In light of the wave of litigation in this area, it may be time for a general fiduciary audit of your qualified plans. Please let us know if we can be of any assistance.

## **5. Tax Relief and Health Care Act of 2006**

The Tax Relief and Health Care Act of 2006 was enacted in December 2006. It extends the Mental Health Parity Act until December 31, 2007. There have been two proposed bills regarding mental health parity, namely Senate Bill S.558 and House Bill H.R. 1424. We'll track the progress of these bills and keep you posted.

The Tax Relief and Health Care Act of 2006 also has several provisions making health savings accounts more attractive. For example, unused balances in health

flexible spending accounts or health reimbursement accounts can be rolled into health savings accounts under certain circumstances. The IRS recently issued guidance relating to the one-time rollover of FSA or HRA balances to HSAs in IRS Notice 2007-22, 2007-10 IRB 170 (February 15, 2007). Of course, you need to have a high deductible health plan in order to qualify for the health savings account provisions.

## **6. Other Developments and Reminders**

### **Periodic Benefit Statements**

The PPA requires that plan sponsors now provide periodic benefit statements to plan participants. Effective for plan years beginning on or after January 1, 2007, defined contribution plans permitting self-directed investments must provide quarterly statements within 45 days after the end of the quarter. Thus, for a calendar year plan a quarterly statement for the quarter ending March 31, 2007 must be provided by May 15, 2007. The quarterly statement must include the participant's account balance, the vested portion of the benefit, the value of each investment to which the account has been allocated, the value of any employer securities, an explanation of the importance of having a balanced and diversified portfolio, and a notice directing the participant to a DOL website for information on individual investing and diversification.

Defined contribution plans that do not permit participants to direct investments must provide participant benefit statements annually and defined benefit plans are required to provide statements at least once every three years.

### **HIPAA Privacy Notice Reminders**

Small health plans (those with annual receipts of \$5 million or less) have until April 14, 2007 to send the 3-year reminder of the plan's Notice of Privacy Practices. This reminder can be part of the annual enrollment materials. Larger health plans were required to send the reminder by April 14, 2006.

### **Accelerated Vesting Reminder**

Remember that the PPA requires accelerated vesting for all employer contributions under defined contribution plans for plan years beginning after December 31, 2006. The vesting rules now require 3 year cliff vesting or a two to six year graded vesting schedule.

Please let any of your SKA professionals know if we can be of assistance in any of the items discussed in this Newsletter.