SPECIAL REPORT

Update on Employee Benefits and Retirement Plans

Editor's Note: This issue includes David Pratt's annual update regarding employee benefit plans. William Wang and Scott McMillen address two related topics, Roth IRA conversions and in-plan Roth conversions.—Gail Levin Richmond, Nova Southeastern University, Davie, FL

Employee Benefit Plans: Recent Developments

By David Pratt*

Definition of Fiduciary

ERISA section 3(21)(A) provides that a person is a fiduciary with respect to an ERISA plan to the extent that, inter alia, it renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so. In 1975, the U.S. Department of Labor (DOL) issued a regulation (§ 29 C.F.R. 2510.3-21(c)) providing that, to be a fiduciary, a person must render advice "on a regular basis" and pursuant to a mutual understanding that such services will serve as a primary basis for investment decisions. DOL also ruled that a valuation of closely-held employer securities that an ESOP would rely on in purchasing the securities would not constitute investment advice. Adv. Op. 76-65A.

In October 2010, DOL published a proposed rule expanding the definition of who is a fiduciary by virtue of providing investment advice. 75 Fed. Reg. 65263. Advice need not be provided on a "regular" basis, nor need there be the mutual understanding provided for in the existing regulation. Advice would include: advice, appraisals or fairness opinions concerning the value of securities or other property; recommendations as to the advisability of investing in, purchasing, holding, or selling securities or other property; or advice or recommendations as to the management of securities or other property. DOL requested comments on whether investment advice should encompass recommendations related to taking a plan distribution.

The proposal affects both ERISA plans and IRAs. The proposed effective date is 180 days after publication of the final regulation. The comment period ends on January 20, 2011.

It is likely that the proposal will be finalized. Attorneys, CPAs, and other advisors should refrain from inadvertently giving advice that could constitute investment advice under the expanded definition. Otherwise, they risk exposing themselves to fiduciary liability under ERISA.

Nonqualified Deferred Compensation

Code section 409A imposes additional taxes and penalties on nonqualified plans that fail to comply, in both form and operation, with its requirements. Notice 2008-113, 2008-51 I.R.B. 1305, permits the correction of certain *operational* failures, and limits the amount includible in income for certain operational failures.

Notice 2010-6, 2010-3 I.R.B. 275, allows voluntary correction of certain *document* failures, without current income inclusion or additional taxes under section 409A, if the document failure is corrected by December 31, 2010, and any associated operational failures are also corrected, in accordance with Notice 2008-113. Notice 2010-6 also modifies Notice 2008-113. Additional relief was provided by Notice 2010-80, 2010-51 I.R.B. 853, which modifies Notices 2008-113 and 2010-6.

Although Notice 2010-6 permits corrections after December 31, 2010, the relief is more limited and penalties may apply.

Disclosure

Under ERISA and the Code, arrangements between plans and service providers are prohibited transactions unless an exemption applies. ERISA section 408(b)(2) provides an exemption for "reasonable" service arrangements, if no more than reasonable compensation is paid to the service provider. On July 16, 2010, DOL issued an interim final regulation (75 Fed. Reg. 41600) requiring written disclosure of the services to be provided and the compensation to be received by "covered service providers" to "covered plans" before the parties enter into, renew, or extend such arrangements.

A "covered plan" means a pension plan within the meaning of ERISA section 3(2)(A) (and not exempted by ERISA section 4(b)), but does not

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include a SEP, a SIMPLE plan, or an IRA. DOL intends to develop separate disclosure requirements for health and welfare plans.

The regulation generally applies to (1) any ERISA fiduciary or registered investment adviser; (2) providers of recordkeeping or brokerage services to a participant-directed individual account plan; and (3) providers of accounting, auditing, actuarial, appraisal, banking, consulting, custodial, insurance, investment advisory (for plan or participants), legal, recordkeeping, securities or other investment brokerage, third party administration, or valuation services, if they (or affiliates or subcontractors) reasonably expect to receive indirect compensation or certain payments from related parties. Disclosure under the regulation is required only if the service provider (or an affiliate or subcontractor) reasonably expects to receive $1,000 or more in direct or indirect compensation. A service provider must also disclose any change to the required information, as soon as practicable.

Service providers must comply on or before July 16, 2011. The disclosures for new arrangements on or after that date must satisfy the rule, and prior arrangements must comply with the rule as of the effective date.

DOL noted that even arrangements that are outside the scope of the regulation must be “reasonable” to satisfy the statutory exemption. Also, ERISA section 404(a) obligates plan fiduciaries to assess the services to be provided, the reasonableness of the fees and expenses, and potential conflicts of interest.

The regulation does not supersede any state disclosure law, except to the extent that it prevents application of the regulation.

DOL has also issued a final rule on disclosure requirements under participant-directed individual account plans. (75 Fed. Reg. 64910 (Oct. 20, 2010)), effective for plan years beginning on or after November 1, 2011. Investment information must be furnished in a chart or similar format designed to facilitate comparison of the information for each investment alternative under the plan. The regulations include a model comparative chart, and note that “The cumulative effect of fees and expenses can substantially reduce the growth of your retirement savings.... Fees and expenses are only one of many factors to consider when you decide to invest in an option. You may also want to think about whether an investment in a particular option, along with your other investments, will help you achieve your financial goals.”

These rules do not apply to IRAs, SEPs, or SIMPLE plans.

Health Care Reform

President Obama signed the Patient Protection and Affordable Care Act, Pub. L. No. 111-148 (PPACA), on March 23, 2010, and the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152 (HCERA) on March 30, 2010 (collectively, the “Act”). For a timeline showing the changes that become effective in each year from 2010 through 2018, see http://healthreform.kff.org/timeline.aspx. This article will address only a few issues of immediate concern to tax practitioners.

Notice 2010-69, 2010-44 I.R.B. 576, provides that reporting heath care costs (required by section 6051(a)(14)), will not be required on 2011 W-2s.

DOL Technical Release 2010-02 provides a grace period through July 1, 2011, for compliance with the new claim review and appeal standards, if the plan sponsor is attempting in good faith to implement the new standards. HHS is encouraging states to provide similar grace periods for insured plans subject to state law.

Under prior law, self-insured health plans were subject to section 105(h), which prohibits discrimination in favor of “highly compensated individuals.” Notice 2011-1, to be published in 2011-2 I.R.B., delays the effective date of the application of section 105(h) to insured plans until further guidance is issued. The Act also extends these rules to fully insured, non-grandfathered group plans, for plan years beginning after September 22, 2010. Notice 2010-63, 2010-41 I.R.B. 420, addresses the new requirements. Under a discriminatory *self-insured* plan, discrimination results in additional income taxation to the highly compensated individuals. A discriminatory *insured* plan may be subject to suit under ERISA, and the plan sponsor may be liable for a penalty of $100 multiplied by the number of individuals discriminated against and the number of days the plan does not comply. I.R.C. § 4980D.

The Act treats the cost of a medicine or drug as a qualified medical expense only if the medicine is insulin or a prescribed drug. This rule applies to HSA and MSA distributions paid, and to FSA and HRA expenses incurred, after December 31, 2010. I.R.C. §§ 106(f), 220(d)(2) & 223(d)(2). The Service has issued Notice 2010-59, 2010-39 I.R.B. 396, to provide guidance concerning this change. The Act increases the additional tax on distributions from HSAs and MSAs that are not used for qualified medical expenses to 20% of the amount of the distribution included in gross income; this rule applies to distributions made after December 31, 2010. I.R.C. §§ 220(f)(4)(A) & 223(f)(4)(A).

Generally, cafeteria plans may not be amended retroactively. Notice 2010-59 gives plan sponsors until June 30, 2011 to adopt conforming plan amendments. For years beginning after December 31, 2010, the Act provides a simple cafeteria plan for small employers. I.R.C. § 125(j).

The Act also added a new section 45R, providing a temporary (for tax years beginning in 2010 through 2015) tax credit to small businesses that provide health coverage to employees. The Service has issued guidance in Notice 2010-44, 2010-22 I.R.B. 717, and Notice 2010-82, 2010-51 I.R.B. 857.

Defined Benefit Plan Funding

The Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (Pub. L. No.111-192) provides short term relief from the normal minimum funding requirements for defined benefit plans. The Service has issued Notice 2010-55, 2010-33 I.R.B. 253 (for single-employer plans), Notice 2010-56, 2010-33 I.R.B. 254 (for multiemployer plans), and Notice 2011-3, to be published in 2011-2 I.R.B.

Hybrid Pension Plans

In October, 2010, the Treasury Department issued final regulations (75 Fed. Reg. 64123) providing guidance on sections 411(a)(13) and (b)(5), enacted by the Pension Protection Act of 2006 (Pub. L. No. 109-280) and amended by the Worker, Retiree, and Employer Recovery Act of 2008 (Pub. L. No. 110-458). The regulations generally apply to plan years beginning after December 31, 2010. Treasury also released proposed regulations (75 Fed. Reg. 64197), addressing issues under section 411 that were not addressed in the final regulations.

Most hybrid pension plans must be amended to reflect the new requirements. Under Notice 2009-97, 2009-52 I.R.B. 972, the amendments are due by the end of the 2010 plan year. Notice 2010-77, 2010-51 I.R.B. 851, modified Notice 2009-97 and extended the deadline to the last day of the first plan year that begins on or after January 1, 2011.

The Small Business Jobs Act of 2010 (Pub. L. No. 111-240)

On September 27, 2010, the President signed the Small Business Jobs Act, which (1) allows 401(k) and 403(b) plans to give participants the option of transferring money from a pre-tax account to a Roth account within the plan and (2) allows governmental 457(b) plans to offer Roth accounts and Roth conversions, beginning in 2011. These changes are discussed elsewhere in this issue. *See* Scott D. McMillen, *In-Plan Roth Conversions.*

Generally, when a self-employed individual calculates net earnings for self-employment taxes, no deduction is allowed for health insurance costs. The Act permits a one-time exception to this rule for the taxable year beginning in 2010. I.R.C. § 162(l)(4).

The Act amends section 72(a) to provide rules governing the partial annuitization of an annuity, endowment, or life insurance contract, effective for amounts received in taxable years beginning after 2010.

The Act also (1) increases reporting penalties (I.R.C. §§ 6721 & 6722) for information returns required to be filed on or after January 1, 2011 (including 2010 1099s and W-2s), and (2) removes cell phones and similar telecommunication equipment from the definition of "listed property" (I.R.C. § 280F(d)(4)), effective for taxable years beginning after 2009. ■

Some Immediate and Long-Term Advantages of a Roth IRA Conversion

By William K.S. Wang*

Initial Analysis

Suppose I have three bank accounts, each with $100. The first two bank accounts are in traditional IRA accounts with a zero basis. (These traditional IRA accounts may have been converted from 401(k) accounts at a prior employer.) The third account I own outright.

For simplicity, assume the federal income tax rate is a flat 50% and will remain at that level forever. Further assume there will never be state income taxes. (This article could just as well have assumed some other rate, such as 33⅓%, but 50% requires an analogy to only three accounts, while 33⅓% requires an analogy to four accounts.)

In effect, the Service has a half ownership in my two traditional IRA $100 bank accounts. If I withdraw part or all of the money from the IRA, I must pay the Service half. The Service is like a 50% partner.

If I convert the $200 in the traditional IRA accounts to a Roth, I must pay $100 in income tax. In effect, for $100, I am buying out the Service's 50% partnership interest. In other words, if I give the Service the $100 bank account I own outright, the Service conveys to me its half ownership in the two traditional IRA $100 bank accounts.

I start out with $100 outright and $200 in a 50% partnership with the Service. I end up with $200 in a Roth IRA that I own outright. I give up $100 to get $100. From a net worth perspective, the result is a wash. My net worth remains $200.

Going forward, however, I have certain immediate and long-term advantages.

1. Interest on the $100 bank account that I owned outright was subject to income tax. Interest on the Roth IRA bank accounts is not subject to income tax, and all $200 of those accounts are now mine (versus only $100 earlier).

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