employee benefits update

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ERISA SECTION 404(c)

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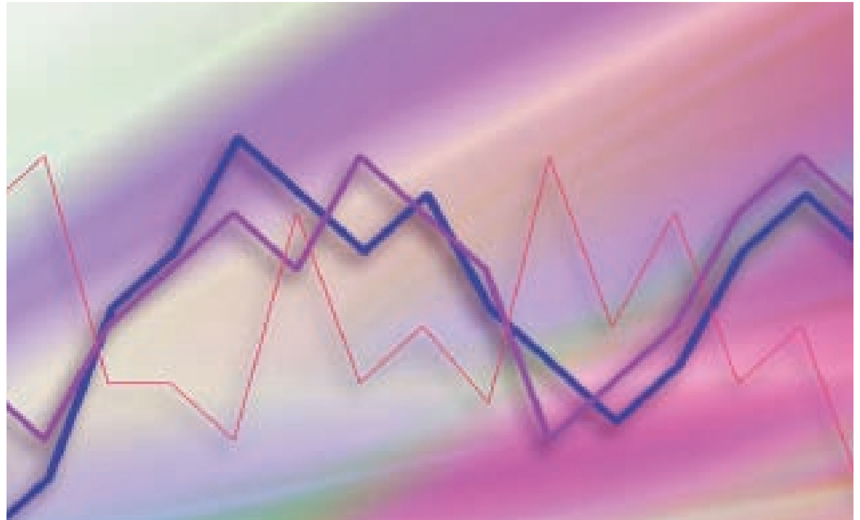
Changes that every employer needs to know about

The Pension Protection Act of 2006 (PPA) has been making headlines recently. And within PPA's many provisions is something that many employers should be aware of — changes to ERISA Section 404(c) governing fiduciary liability.



404(c) basics

ERISA Sec. 404(c) applies to individual account plans, specifically profit sharing plans, money purchase plans and 401(k) plans. It generally requires plans to:

- Provide reasonably diversified investments,
- Allow participants to make reasonable investment changes during the year, and
- Give proper information on investing and investments.

If the plan does this, it's released from ensuring that the investments were correctly made or that the assets held are sufficient for retirement or other purposes — even when losses occur.

If a plan follows the rules, it's released from ensuring that the investments were correctly made or that the assets held are sufficient for retirement or other purposes — even when losses occur.

Plan fiduciaries aren't liable for losses on individual transactions if the participant exercised actual control of the transactions and the losses were directly and necessarily a result of the participant's investment instructions. Ultimately, the employee is responsible for his or her own investment decisions without probable recourse to the employer.

4 affected areas

As mentioned, PPA made several changes to Sec. 404(c). Affected areas include:

1. Fiduciary protection. Most important, PPA directed the DOL to amend its 404(c) regulation to provide fiduciary protection for certain types of "default investments." A default investment occurs where the plan, either through the plan document or fiduciaries, directs the participant's investment money. The participant doesn't direct the investment of his or her account.

Under PPA, fiduciaries will have Sec. 404(c) protection for default investments if they meet two criteria: 1) The investment option must consider different asset classes, and 2) The option must take into account risk and reward.

2. Blackout protection. A "blackout period" is a period of more than three consecutive business days during which plan participants are limited in their right to direct or diversify account assets or obtain plan loans or distributions. This will occur when a plan changes providers or specific investments.

When a plan goes through a blackout period, the fiduciaries won't have 404(c) protection unless they satisfy the blackout requirements — including the Sarbanes-Oxley blackout notice requirements. If the

fiduciaries satisfy these requirements, and if the plan already satisfies 404(c), the fiduciaries will continue their 404(c) protection during the blackout period. The DOL will be providing further guidance on fiduciary duties during blackouts.

3. New investments. If a plan moves plan investments to a new investment choice with similar risk-and-return characteristics (and satisfies other specified requirements), the plan will have 404(c) protection for the new investments — even though the plan sponsor or fiduciaries made the decision to move into that new investment.

But plans must be cautious and follow specific requirements. This includes giving participants the opportunity to direct their investments before the change in investment choices. And the plan must have been 404(c) compliant before making the change.

4. Participant notice. A new ERISA 404(c) rule treats some plan participants meeting certain notice requirements as exercising control over the assets with respect to contributions and earnings that, absent investment direction from the participant, are invested according to regulations prescribed by the Secretary of Labor.

The notice must follow the existing 401(k) safe harbor rules relating to notices being accurate, comprehensive and understandably written. This is effective for plan years beginning after Dec. 31, 2006.

Significant changes

PPA has made some significant changes to Sec. 404(c). Most of them are beneficial to plans and participants, but the changes can also mean big trouble for those unaware or misinformed.

Should your health plan use debit cards?

The IRS recently published new guidelines covering the use of debit, credit and stored-value cards (prepaid employer-sponsored cards) under health flexible spending accounts (FSAs) and health reimbursement arrangements (HRAs). The notice provides three methods employers may use to validate the legitimacy of expenses billed to these cards and clarifies their use in dependent care arrangement programs (DCAPs).

3 methods to consider

1. The copayment substantiation method. This allows for automatic authentication if the health plan matches copayments in specific multiples. If the transaction at a health care provider doesn't exceed more than five times the copayment amount, the debit card system will automatically approve the transaction.

Any deviation from the preauthorized copayment amount will need to be submitted for review and substantiation. The merchant at the point of sale provides information to the employer (or third-party administrator) electronically. If the claim is for a valid medical expense, no further substantiation is required.

For example, Jane is enrolled in her company's FSA, which reimburses claims using debit cards. The plan has a $15 copayment for office visits and a $10 copayment for prescriptions. Jane visits two doctors and receives three prescriptions in one day. Her employer's debit card automated system matches the doctor visits for a total of $30 in copayments ($15 for each of the two doctors).

Because the amount of the transactions is an exact multiple not exceeding five times $15, the system approves the transactions and doesn't require further substantiation. The system also approves the three prescriptions for a total of $30 — again because the amount doesn't exceed five times the copayment amount and won't require further validation.

(Automatic reimbursements of recurring expenses can occur for an employee who refills a prescription

drug on a regular basis for the same amount without substantiation or review.)

But what if Jane uses the debit card to buy the three prescriptions plus two over-the-counter medicines included in her employer's FSA program, bringing the total bill to $42? Because the transaction amount isn't an exact multiple of the prescription copayment, the employer must verify the purchase with a receipt or proof of purchase before making payment.

2. The inventory information approval system. An inventory information approval system uses stock keeping units (SKUs) to approve or reject merchant transactions. Employers choose health care providers and non–health care providers (those that generally provide over-the-counter medications and other qualifying items) to include, and the system reviews and compares purchased items to qualifying medical expenses as defined by the Internal Revenue Code.

For example, Mike is an FSA participant who wants to buy several qualifying items as well as several nonqualifying ones. At the time of purchase, however, the employer's card system compares the SKUs from all of the items purchased against those that qualify as medical expenses and prohibits him from buying any of the nonqualifying items with the debit card.

The system also ensures total transactions don't exceed the plan's FSA election limits or HRA employer-provided amounts. Recordkeeping requirements for inventory information approval systems are effective for plan years beginning after Dec. 31, 2006.

3. Direct third-party substantiation. Under this method, the third party — such as a doctor's office or pharmacist — provides an explanation of benefits (EOB) to the employer. The employer then approves the expense without need for further review.

For instance, Steve participates in his company's FSA, and his health care provider has agreed to provide his employer with an EOB for services it renders. Because the EOB provides independent third-party verification, Steve's copayment amount is authorized automatically and the system doesn't require additional receipts or information.

In such cases, Steve wouldn't use a debit card; he would pay the provider directly.

Using a third-party administrator

The use of debit, credit and stored-value cards can be expensive for employers to implement on their own. The substantiation processes can be involved and time consuming. To help implement a new system, employers might want to use a qualified third-party administrator.

Many third-party administrators are providing systems complete with Internet services so participants and sponsors can quickly review their accounts. The cost of using an administrator varies based on the employer's size and the system's complexity, but can benefit both the employer and, in turn, the employees.

DCAP fundamentals

DCAPs allow employees to pay for certain dependent care expenses with before-tax dollars. Debit cards may now also be used in DCAPs — but with an important difference from the other plans.

Under FSAs, payments made to participants must reimburse qualified transactions up to the amount of the initial annual election, even if not subtracted from the participant's payroll. HRAs function somewhat similarly in that the reimbursement amount has already been disclosed as the amount of the annual employer contribution.

But, with DCAPs, employers cannot reimburse participants for dependent care expenses *before* the participant incurs the expense. Expenses are incurred when the services are provided — not when billed, charged for or paid by the participant. This causes a dilemma when the employee needs to pay ahead before the amount is actually credited. Fortunately, the IRS allows employers to reimburse participants for amounts already credited.

The future will be automated

More and more employers, merchants and service providers are becoming automated. Using an electronic card system such as a debit or credit card can streamline an employer's health benefits program and encourage employee participation.

2007 retirement plan limit increases

Type of limitation	2006	2007
Elective deferral for 401(k), 403(b), 457(b)(2), 457(c)(1)	$ 15,000	$ 15,500
Annual benefit for defined benefit plans	$ 175,000	$ 180,000
Annual contribution for defined contribution plans	$ 44,000	$ 45,000
Annual compensation for benefit purposes for qualified plans and SEPs	$ 220,000	$ 225,000
Highly compensated employee threshold	$ 100,000	$ 100,000
SIMPLE contribution	$ 10,000	$ 10,500
Catch-up contribution for 401(k), 403(b), 457(b)(2), 457(c)(1)	$ 5,000	$ 5,000
SIMPLE catch-up contribution	$ 2,500	$ 2,500
SEP coverage	$ 450	$ 500
IRA contribution	$ 4,000	$ 4,000
IRA catch-up contribution	$ 1,000	$ 1,000
Social Security taxable wage base	$ 94,200	$ 97,500

Increasing participation

How the new automatic enrollment plan may help

A common complaint among employers who sponsor retirement plans is the low participation among eligible employees. The Pension Protection Act of 2006 (PPA) established new rules for automatic enrollment in defined contribution plans — including 401(k) plans — that may help boost participation. Although automatic enrollment closely resembles the existing safe harbor plan and shares certain provisions, both have their own advantages and disadvantages.

Out with the old …

Before PPA, automatic enrollment rules stated that an employer could deduct elective contributions from an employee's compensation if the employee hadn't elected to opt out of the contributions. The employer had to give the participant adequate notice of the deduction. By 2000, the IRS had sanctioned automatic enrollment for both new employees and existing employees who hadn't already enrolled in the plan.

In 2004, the IRS clarified the amount that a plan could deduct from an employee's compensation in an automatic enrollment. The employer had to show sufficient support for any increased deduction amount and give the employee notice and the opportunity to opt out of the plan.

But many employers were reluctant to implement automatic enrollments — often called "negative elections." Two reasons were fiduciary concerns and possible interference with state wage withholding laws. And employers didn't want to manage the small account balances of employees who opted out of the plan and stopped pay deductions shortly after beginning contributions.

… and in with the new

Under PPA (as under the old rules), once an employee meets the plan's eligibility requirements, the plan can automatically deduct salary deferral contributions from his or her compensation at a predetermined rate unless the employee makes an affirmative election not to participate in the plan.

For automatic enrollment plans that provide a default salary deferral contribution, PPA establishes a new nondiscrimination test safe harbor. Plans must have a default salary deferral contribution of at least 3% during the first year of participation. The rate has annual increases of 1% increments until it reaches 6% or the employee stops the increases. Employers can continue the automatic increases up to 10% of compensation.

Both plans offer employers the opportunity to avoid nondiscrimination testing and relief from top-heavy contributions.

To take advantage of the safe harbor, the plan must do three things:

1. Provide an employer nonelective contribution of at least 3% of compensation, or match 100% of elective deferrals up to 1% of compensation and match the next 5% at 50%,
2. Provide 100% vesting on the employer match or nonelective contribution after two years of service, and
3. Satisfy notice requirements — plans must give participants a notice explaining their rights under the arrangement, give them the opportunity to elect not to have elective contributions made on their behalf or to positively elect to have contributions made in a different amount, and give them a reasonable period of time *after* receipt of the notice and *before* the first elective contribution is made to make the election.

Plan sponsors who satisfy the safe harbors can avoid performing the average deferral percentage (ADP) and actual contribution percentage (ACP) tests. Plans can begin implementing the new safe harbors in plan years beginning in 2008.

Some things stay the same …

The new automatic enrollment plan may look and act very similar to the already existing safe harbor 401(k) plan. They both have mandatory vesting on the employer contributions and mandatory employer matching on the employee's elective deferral contributions.

For example, in a traditional safe harbor 401(k), the employer must either make a nonelective contribution of at least 3% of compensation or match 100% of elective deferral contributions up to 3% of compensation, and match 50% on the next 2% of compensation. This matches closely with the safe harbor rules under PPA.

Safe harbor 401(k) plans and automatic enrollment plans both have to satisfy notice requirements so as to not perform ADP and ACP nondiscrimination testing. Every year that the plan is a safe harbor plan, the employer must give all eligible employees written notice, before the plan year begins, of his or her rights and obligations under the plan. For traditional safe harbor plans, the notice must be given 30 to 90 days before the beginning of the plan year; a specific time limit has not yet been established for automatic enrollment plans. The notice requirements are the same for the automatic enrollment plan.

Both plans offer employers the opportunity to avoid nondiscrimination testing and relief from top-heavy contributions. If either the safe harbor or automatic enrollment plan is top heavy, many employers view the mandatory contributions and employee notice requirements as a disadvantage.

… and some things change

Although the traditional safe harbor 401(k) and the new automatic enrollment plan share many of the same features, they are separate plans. For instance, traditional safe harbor plans have immediate vesting requirements, while automatic enrollment plans allow the employer to use a two-year cliff vesting schedule for employer contributions.

Mandatory employer matching varies under the two plans. In automatic enrollment plans, employers must match 3½% of compensation for an employee who defers at least 6% of compensation. In comparison, in a traditional safe harbor plan, employers must match 4% of compensation for an employee who defers at least 5% of compensation.

For example, under the traditional safe harbor plan, an employee whose compensation is $100,000 and who defers 10% ($10,000) will receive 4% of compensation ($4,000) in a match contribution. Under the automatic enrollment plan, the same employee will receive a match contribution of 3½% of compensation ($3,500).

Explore your needs

Both plans have advantages and disadvantages that may make each type of plan more or less desirable to a vast array of different company types. As with any new retirement plan design, employers must explore their needs — as well as their employees' needs — before introducing either one.

Pension Protection Act sets new vesting schedules

Each defined contribution retirement plan can impose a vesting schedule on employer contributions to the plan. In years past, the IRS provided different vesting schedules for employer matching contributions and profit sharing contributions. But, under the Pension Protection Act of 2006, the rules have changed.

As of Jan. 1, 2007, profit sharing contributions must follow the same maximum vesting as matching contributions. Both matching contributions and profit sharing contributions can now vest under either a three-year cliff vesting schedule or a six-year graded vesting schedule as follows:

3-year cliff schedule

Years of service	Vesting percentage
0 – 2	0%
3	100%

6-year graded schedule

Years of service	Vesting percentage
0 – 1	0%
2	20%
3	40%
4	60%
5	80%
6	100%

If you elected to have a seven-year vesting schedule under the former rules, you will need to change it to a six-year schedule to meet the new requirements.

The plan sponsor could decide to have the new vesting schedule apply to only contributions made on or after Jan. 1, 2007, or to new and old monies. In that case, the profit sharing contributions made before Jan. 1, 2007, will still vest under either a five-year cliff vesting schedule or a seven-year graded vesting schedule. Administratively, it's less cumbersome to have all old and new monies fall under the new vesting schedule.

Plans should have changed their plan document if their profit sharing vesting schedules didn't satisfy one of these two new schedules. Otherwise, participants who receive payments of the benefits after Jan. 1, 2007, may receive less than the new law requires.

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