



A quarterly newsletter about employee benefits and current issues

Second Quarter 2009

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*Kenneth J. Mason, Partner
Spencer Fane Britt & Browne*

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*David Y. Stevens, Associate
Spencer Fane Britt & Browne*

▶ **DEPARTMENT OF LABOR UPDATES GUIDANCE ON ERISA BONDING REQUIREMENTS**

Part 4 of title I of the Employee Retirement Income Security Act of 1974 ("ERISA") sets forth the rules that apply to fiduciaries of ERISA-covered employee benefit plans.

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*Robert A. Browning, Partner
Spencer Fane Britt & Browne*

▶ **ERISA SEVERANCE PLAN PROTECTS EMPLOYER**

The economic recession has caused many employers to reevaluate their severance policies. We find that employers often strive to ensure that those policies do not amount to enforceable promises to provide similar benefits to similarly situated employees, but rather are non-ERISA, ad hoc arrangements. That strategy, however, may be short-sighted.

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*Gregory L. Ash, Partner
Spencer Fane Britt & Browne*

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IRS PROVIDES GUIDANCE ON AUTOMATIC ENROLLMENT

Earlier this year, the IRS finalized regulations it had proposed in November of 2007 on the subject of automatic enrollment in salary deferral plans. These final regulations respond to a number of comments on the proposed regulations. In addition, they reflect statutory changes made by both the 2006 Pension Protection Act (“PPA”) and the 2008 Worker, Retiree, and Employer Recovery Act (“WRERA”). They apply to “automatic contribution arrangements” under 401(k) plans, as well as similar arrangements under 403(b) and governmental 457(b) plans.

For the most part, these regulations deal with either *qualified* automatic contribution arrangements (or “QACAs”) or *eligible* automatic contribution arrangements (or “EACAs”). However, much of the guidance concerning the notification requirements applies to the pre-PPA safe-harbor contribution formulas, as well. These notification rules are addressed near the end of this article.

QUALIFIED AUTOMATIC CONTRIBUTION ARRANGEMENTS

By complying with the QACA rules, a plan avoids the need to perform nondiscrimination testing with respect to both salary deferrals

and matching contributions (the ADP and ACP tests). In addition to the required safe-harbor employer contributions, a QACA must provide for a minimum level of “default” salary deferrals on behalf of any eligible employee who fails to make an affirmative deferral election. These default deferrals must start at no less than 3% of an employee’s compensation and then increase annually until they reach at least 6% of compensation.

Default Employee Deferrals

Under the proposed regulations, the increase from 3% to 4% of compensation had to occur by the first day of the second plan year after the 3% rate took effect, with subsequent increases occurring on the first day of succeeding plan years. These final regulations help to clarify the schedule for implementing these increases. For instance, they provide that this schedule should be measured from a participant’s first default deferral *under the QACA*. Thus, an employer that converts an existing automatic contribution arrangement into a QACA may not simply retain an employee’s prior default deferral election (unless that default was at least 3% of compensation). Instead, such an employee’s default deferral percentage must be increased to 3% in connection with the QACA’s implementation. Moreover, even if the non-QACA default deferral percentage was 3% or greater, the employee must be

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subject to the QACA deferral *increases* in later years.

Moreover, an employee's absences from employment must generally be ignored when determining the proper default deferral percentage for that employee. For instance, assuming a plan operates on a calendar plan year, an employee whose default deferral percentage was at 4% when terminating employment in October of 2010 – and who still fails to make an affirmative deferral election upon his reemployment in March of 2011 – must have his default deferral percentage increased to 5% upon that reemployment. This will require accurate recordkeeping by the plan's sponsor and/or third-party administrator.

In response to recordkeeping concerns, the IRS has provided an exception to this requirement. This exception applies to any employee who is absent from employment for a full plan year. In that case, the employee may be treated as a new employee upon reemployment. For instance, had the employee in our example terminated employment in October of 2010, but not returned to employment until March of **2012**, he could be placed back in the 3% default deferral band.

The IRS has also clarified the options available under a QACA at the end of the six-month suspension of salary deferrals

required in connection with certain hardship withdrawals. Unless the plan reinstates such an employee's prior affirmative deferral election at the end of the six-month suspension period, it must automatically enroll the employee in the QACA. The appropriate default deferral percentage will depend on whether the employee had previously made default deferrals under the QACA and, if so, whether the six-month suspension period lapped over from one plan year to the next.

Another topic addressed by the final regulations is the permissibility of scheduling mid-year increases in the default deferral percentages. The proposed regulations seemed to assume that all such increases would take place as of the first day of a plan year. Under the final regulations, mid-year increases in the default deferral percentages are permissible – so long as they are made on a uniform basis and take place at least as rapidly as they would have under the procedures described in the proposed regulations.

For example, an employer might wish to increase each employee's default deferral percentage on the employee's anniversary date of plan participation, rather than waiting until the first day of the following plan year. That approach should be permissible. Another permissible approach would be to increase each employee's default deferral percentage on the date salary increases are granted.

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Finally, these final regulations make clear that the default deferrals must be calculated using a safe-harbor definition of compensation. Unlike the other QACA changes, however, this aspect of the final regulations is prospectively effective. It applies only to plan years beginning on or after January 1, 2010.

Safe-Harbor Employer Contributions

Other QACA guidance relates to the safe-harbor employer contributions. For instance, the final regulations make clear that these contributions (either the specified matching contributions or the 3% non-elective contributions) must be made on behalf of all employees who are eligible to defer under the plan. They may not be limited to those employees who fail to make an affirmative election. Nor may they be limited to nonhighly compensated employees.

The final regulations also make clear that these safe-harbor contributions are subject to the same in-service withdrawal restrictions as qualified nonelective contributions (“QNECs”) and qualified matching contributions (“QMACs”). This means that, unlike elective contributions, they may not be withdrawn for financial hardship. This same restriction applies to employer contributions made under the pre-PPA safe-harbor formulas.

ELIGIBLE AUTOMATIC CONTRIBUTION ARRANGEMENTS

There are two primary advantages of complying with the EACA rules. First, although a plan with an EACA remains subject to the ADP and ACP tests (unless it *also* qualifies as a QACA), the plan has six months after the close of a plan year in which to make any corrective contributions or refunds needed to avoid the 10% excise tax for that year. Outside of an EACA, this correction deadline is only 2½ months after the close of the plan year.

Second, participants in an EACA who are automatically enrolled in the plan may be given a period of up to 90 days in which to request a refund of the deferrals made under the default deferral election. If not for this special EACA rule, no such refund could be made until the employee had either terminated employment or experienced one of the other permissible withdrawal events (such as attainment of age 59½). This right to make refunds of default deferrals may allow a plan sponsor to avoid having to pay for the maintenance of numerous small account balances.

Default Investment Elections

The final IRS regulations make it somewhat easier to maintain an EACA. For instance, they reflect WRERA’s repeal of the

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requirement that default deferrals under an EACA be invested in a “qualified default investment alternative” (or “QDIA”).

Although adopting a QDIA for this purpose may still be prudent – because it can shield a plan’s fiduciaries from liability for investment losses – the failure to do so will no longer undermine compliance with the EACA rules.

Given the recent controversy concerning a common type of QDIA – targeted retirement date funds – employers might well decide to forego this protection from fiduciary liability by establishing a more conservative investment fund for default deferrals. This would also relieve employers of the additional notice obligations applicable to QDIAs.

Limited EACAs

The proposed regulations seemed to require that any EACA be established as of the first day of a plan year. This was a result of the dual requirements that (i) all participants in an EACA receive a written notice at least a reasonable period of time before the beginning of each plan year, and (ii) all eligible employees be included in the EACA. A number of commentators asked the IRS to relax this requirement. Although the final regulations do not eliminate the annual notice requirement, they do allow for the mid-year implementation of a limited EACA. They do so by allowing an EACA to be

defined in a way that includes fewer than all employees who are eligible to make deferrals under the plan.

For instance, a sponsor might define a plan’s EACA as including only newly eligible employees. Because such employees need not receive a notice before the beginning of the plan year – but only at the time they become eligible to make deferrals – such a limited EACA could comply with the notification rules. Employees in such an EACA could thus be offered the right to request a refund of any default deferrals within 90 days after the first such deferral is taken from their pay.

Due to another constraint set forth in the final regulations, however, such a limited EACA may not take advantage of the special six-month period for correcting nondiscrimination violations. This is because only EACAs that cover all of a plan’s eligible employees may rely on this rule. This restriction does not apply, however, until the first plan year beginning on or after January 1, 2010. It thus appears that this six-month correction period will be available to even limited EACAs for the 2008 and 2009 plan years.

This ability to define an EACA in a way that excludes certain eligible employees carries another potential advantage for sponsoring employers. The final regulations state that a

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plan may define an EACA in a way that excludes employees who make an affirmative deferral election. Adopting this approach would allow an employer to dispense with providing the annual notice to these employees, thereby simplifying the notification process. (Of course, beginning in 2010, such a plan would lose the right to take six months to make any corrective refunds or contributions.)

Multiple EACAs Within a Single Plan

These final regulations also allow a single plan to contain multiple EACAs. A sponsor may wish to adopt this approach as a way of specifying different default deferral percentages for different groups of employees. (Unlike a QACA, an EACA need not specify any *minimum* default deferral percentage, nor need it comply with any schedule for *increasing* those percentages.)

Unfortunately, this multiple EACA approach is sharply constrained by a “uniformity” requirement. This mandates that all participants in an EACA be subject to the same default deferral percentage (or formula for determining that percentage), and that all EACAs within the same plan be aggregated for this purpose. Although there are limited exceptions to this aggregation rule (for collectively bargained employees – including employees within different bargaining units – employees of different employers within a

multiple employer plan, and employees within different “qualified separate lines of business”), most plans will likely find it necessary to have a uniform default deferral percentage.

Refunded Employee Deferrals

A number of provisions in the final regulations modify or clarify the rules applicable to refunded default deferrals. For instance, the 90-day window for an employee to request a refund of default deferrals must begin on the date those amounts are withheld from the employee’s paycheck. The IRS rejected commentators’ requests that this window begin on the date those deferrals are deposited into the plan’s trust. The IRS also noted that a plan may allow *fewer* than 90 days in which to request a refund, so long as employees have at least 30 days to make the request.

A refund may not be conditioned on the absence of an employee’s subsequent deferral election. Accordingly, an employee who has had default deferrals taken from one or two paychecks must be given the right to request a refund of those amounts, even while making an affirmative deferral election with respect to subsequent paychecks.

If an employee does timely request a refund, the plan must refund all of the default

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deferrals made up to the date of the request (as adjusted for investment gains or losses). Moreover the plan may refund a few subsequent default deferrals – so long as these are limited to deferrals made by the earlier of the following two dates: (1) the pay date for the second payroll period that begins after the refund request is received, or (2) the first pay date that occurs at least 30 days after the request is received.

The regulations do not specify a deadline for making a refund, but simply note that a plan must process any refund request in accordance with its ordinary timing procedures for processing and making distributions. Because these refunds are not eligible for rollover treatment, they are subject to “voluntary” income tax withholding, under the same rules that apply to periodic distributions from a plan.

NOTIFICATION RULES

In response to commentators’ requests, the final regulations do ease the notification rules that apply to new employees. The proposed regulations required that new employees be notified of their rights under a QACA or EACA before becoming eligible to participate in the deferral arrangement – even if they became eligible on their first date of employment. Although the final regulations retain this general rule, they go on to state that – if it is not practicable to

provide this notice before an employee becomes eligible to participate – the notice may be provided as soon as practicable *after* that eligibility date.

This relief is conditioned on certain requirements, however. First, an employee must be permitted to elect salary deferrals from all eligible compensation earned on or after the date he or she becomes eligible. Effectively, this means that the notice must be provided before the pay date for the payroll period that includes the employee’s eligibility date. (Of course, even absent an automatic enrollment feature, such a timely notice could be required in order to administer the plan in accordance with its terms.)

Second, because an employee in an EACA must be given a reasonable period of time in which to decide whether to make an affirmative deferral election, a default deferral may not take effect until a reasonable period of time after this notice has been provided. The final regulations impose an absolute deadline, however, on when a default deferral election must be effective. This is the earlier of the following two dates: (1) the pay date for the second payroll period that begins after the notice is provided, or (2) the first pay date that occurs at least 30 days after the notice is provided.

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EFFECTIVE DATES

For the most part, the regulatory provisions concerning QACAs are retroactively effective for plan years beginning on or after January 1, 2008. The sponsor of any plan that has already implemented a QACA will therefore want to examine these final regulations closely to determine whether any corrective actions might be needed.

The EACA provisions in these final regulations do not apply until plan years beginning on or after January 1, 2010. Prior to that time, EACAs must merely comply with a good faith interpretation of the statute. According to the IRS, compliance with either the proposed or final regulations will constitute such good-faith compliance.

As noted above, two provisions of these regulations carry special effective dates. These are the requirements that (1) default deferrals made under a QACA be calculated in accordance with a safe-harbor definition of compensation, and (2) all EACAs within a single plan be aggregated for purposes of complying with the uniformity requirement. Both of these provisions apply to plan years beginning on or after January 1, 2010. Presumably, even a good-faith interpretation of the statute would not require compliance with these regulatory provisions prior to that date.

Any QACA must be implemented as of the first day of a plan year. Subject to the limited exception for an EACA covering only newly eligible employees, the same is true for EACAs. Accordingly, any employer sponsoring a calendar-year plan will want to target January 1, 2010, for implementing any new QACA or EACA.

Kenneth A. Mason, Partner
Spencer Fane Britt & Browne LLP



LATEST CMS GUIDANCE ON MANDATORY MSP REPORTING

As of January 1, 2009, most group health plans became subject to the Mandatory Medicare Secondary Payer Reporting Program. On March 16, 2009, the Centers for Medicare and Medicaid Services (“CMS”) issued the latest version (“Version 2.2”) of the Group Health Plan User Guide for use by responsible reporting entities (“RREs”) under this Program.

The recent updates are generally clarifications, but they could be significant for certain RREs. While FSAs and HSAs are not reportable, HRAs are considered to be reportable group health plans. CMS has now clarified, however, that RREs need not report HRA coverage information until

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October 2010. The reason for this delay is to allow RREs time to gather the information needed to report on HRA coverage. CMS has indicated that it will provide further guidance on reporting HRA coverage at a later date.

The new User Guide also points out that CMS prefers RREs to use the Medicare "health insurance claim number" of a Medicare enrollee, if available, rather than the individual's social security number.

RREs should download the latest User Guide from the CMS web page and review any other updates that may be applicable.

David Y. Stevens, Associate
Spencer Fane Britt & Browne LLP

DEPARTMENT OF LABOR UPDATES GUIDANCE ON ERISA BONDING REQUIREMENTS

Part 4 of Title I of the Employee Retirement Income Security Act of 1974 ("ERISA") sets forth the rules that apply to fiduciaries of ERISA-covered employee benefit plans. These "fiduciary responsibility" rules include the requirement to hold plan assets in trust, a fiduciary's duties of loyalty, prudence, diligence and diversification, and the prohibition on certain transactions between

the plan and parties-in-interest. One of the lesser-known (but still important) rules is the requirement (under Section 412 of ERISA) that every person who "handles" funds or other property of the plan be bonded.

HISTORICAL BACKGROUND

Although the Department of Labor ("DOL") published extensive temporary regulations regarding the ERISA bonding requirement in 1985, those regulations have never been formally finalized. And until recently, the DOL had not issued any significant guidance regarding the bonding requirement for over 20 years. In 2006, the Pension Protection Act ("PPA") amended Section 412 of ERISA to increase the amount of the bond required for plans that hold employer securities. The PPA also created a new exemption from the bonding requirement for entities that are both (i) registered as brokers or dealers under the Securities Exchange Act of 1934, and (ii) subject to the fidelity bond requirements of a "self-regulatory organization" (as that term is defined in the Securities Exchange Act).

In November of last year, the DOL issued Field Assistance Bulletin No. 2008-04, which consists of 44 "frequently asked questions" (and answers) about the ERISA bonding requirement. Although the Bulletin was designed to provide guidance to the regional offices of the DOL (as they review Form 5500 annual reports and perform audits of

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ERISA-covered employee benefit plans), the guidance is also helpful to plan sponsors, fiduciaries, and service providers. The Bulletin is intended to clarify the existing regulations, to answer questions not addressed in the regulations, and to address the PPA changes to the bonding requirements.

OVERVIEW OF FIELD ASSISTANCE BULLETIN

The following are some of the key points made by the DOL in the Field Assistance Bulletin:

1. Bond Basics -- An ERISA fidelity bond protects a funded pension or welfare plan from losses due to fraud or dishonesty, regardless of whether the person causing the loss engaged in criminal conduct or gained financially. The plan must be the named insured on the bond, and fiduciaries and others who handle plan assets must be covered by the bond.

A fidelity bond is not the same as fiduciary liability insurance. A bond protects the plan from losses attributable to the actions of those with access to the plan's assets. By contrast, fiduciary liability insurance generally protects the fiduciary from losses due to a breach of fiduciary duty. An ERISA bond protects only against losses due to fraud or dishonesty – it does not

protect the plan from all losses that may be caused by a fiduciary's breach of duty. However, an ERISA bond is not limited to the actions of fiduciaries – it protects the plan from losses attributable to the dishonest or fraudulent act of any person who "handles" plan assets.

2. Who Must be Bonded -- Every person who "handles funds or other property" of the plan (referred to as "plan officials") must be bonded, unless they are covered by an exemption. Plan officials are not limited to fiduciaries. (In fact, fiduciaries must be bonded only if they "handle" funds or property of the plan and are not covered by an exemption.) Plan officials could include plan administrators, claims processors, service providers, and any other individuals who could cause a loss of plan assets by virtue of their access, responsibilities, or authority.

An individual "handles" plan funds or property if he or she has the power to transfer funds, negotiate property for value, or disburse or direct disbursement of cash or property. This includes supervisory or decision-making responsibility over such activities.

3. Responsibility for Satisfying the Bonding Requirement -- The Bulletin clarifies that the responsibility for ensuring that plan officials are bonded may fall on

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more than one person simultaneously. Each plan official who handles plan funds or property is directly subject to the bonding requirement. However, a plan fiduciary who permits another person to handle plan funds or property must also ensure that the person handling the funds is properly bonded.

Thus, if a named fiduciary hires or appoints a trustee for the plan, the named fiduciary must ensure that the trustee either is subject to an exemption from the bonding requirement or is properly bonded. The bond may be purchased by the covered plan official, by the plan sponsor, or by a plan fiduciary, and the cost of the bond may be paid out of plan assets.

4. Exemptions -- Section 412 specifically excludes from the bonding requirement any fiduciary that is a bank or insurance company subject to state or federal supervision or examination and that meets certain capitalization requirements. As noted above, the PPA also added a statutory exemption for certain entities registered as brokers or dealers under the Securities Exchange Act if certain requirements are satisfied.

The DOL has also issued regulatory exemptions for banking institutions and trust companies that are subject to regulation and examination by certain federal agencies (such as the Federal Reserve), and for insurance companies that provide or

underwrite welfare or pension benefits in accordance with state law. Unlike the statutory exemption described above, these exemptions apply even if the bank or insurance company is not a fiduciary of the plan.

5. Amount of Bond -- Generally, each official must be bonded in an amount equal to at least 10% of the amount of funds he or she "handled" in the previous year. However, the bond amount cannot be less than \$1,000, and the DOL generally cannot require an official to be bonded for more than \$500,000. Beginning in 2008, the PPA increased the maximum bond limit for plans holding employer securities to \$1 million. The DOL may, following notice and a hearing, require a bond greater than the \$500,000/\$1 million limits described above.

CONCLUSION AND RECOMMENDATIONS

There are many reasons why plan sponsors and fiduciaries should understand (and make sure that they are in compliance with) the ERISA bonding requirements. A plan is required to report, on Schedule H or I of Form 5500, whether the plan is covered by a fidelity bond, as well as the amount of the bond. This makes it very easy for the DOL to monitor compliance with the bonding requirements, and the existence and adequacy of a fidelity bond is one of the routine aspects of any DOL audit of an ERISA-covered plan.

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More importantly, a plan fiduciary who fails to ensure that plan officials are properly bonded may be personally liable for any losses to the plan caused by a dishonest plan official. Thus, plan sponsors and fiduciaries are urged to review this recent guidance to make sure that all individuals who "handle" assets of plans subject to ERISA are properly bonded.

Robert A. Browning, Partner
Spencer Fane Britt & Browne LLP

ERISA SEVERANCE PLAN PROTECTS EMPLOYER

The economic recession has caused many employers to reevaluate their severance policies. We find that employers often strive to ensure that those policies do not amount to enforceable promises to provide similar benefits to similarly situated employees, but rather are non-ERISA, ad hoc arrangements. That strategy, however, may be short-sighted. A recent decision from a federal court in California serves as a reminder that ERISA-covered severance plans often give employers more protection than informal, "one-off" arrangements. (*Pierce v. Wells Fargo Bank*)

The lawsuit involved a dispute between Wells Fargo and a senior executive of a

company that Wells Fargo acquired. The acquired company sponsored a change-in-control severance plan (the "CIC Plan") that was treated as an ERISA welfare plan. The CIC Plan provided severance benefits to eligible employees who were terminated or denied similar positions following a corporate merger or change in control. The senior executive claimed that he had been told he would be entitled to severance benefits even if he refused to take a comparable position with Wells Fargo following the acquisition. Acting on those representations, the executive declined to take a position with Wells Fargo, and instead submitted a claim for severance benefits. When that claim was denied, he sued in state court for breach of contract, negligence, and fraud – theories that could have resulted in an award of punitive damages.

Wells Fargo (the surviving entity) removed the case to federal court and filed a motion to dismiss, arguing that the claims were preempted by ERISA because they related to benefits offered under an ERISA plan. The executive responded that his claims were not based on the CIC Plan, but instead were premised on the oral promises made to him, and thus should be evaluated under state law.

The court sided with Wells Fargo, finding that the benefits the executive sought were essentially the same as those provided

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under the CIC Plan. Thus, his remedies were limited to those afforded under ERISA (which does not authorize punitive damage awards). Because the executive was offered, but refused to take, a comparable position with Wells Fargo following the change in control, he was ineligible for severance benefits under the CIC Plan's express terms. And because federal courts have long held that oral representations cannot be used to supersede the written terms of an ERISA plan, the executive's reliance on the alleged misrepresentations about his eligibility was misplaced.

By structuring its severance policy as an ERISA plan, the employer in this case was

able to (i) dictate the forum in which the dispute was resolved; (ii) limit its exposure to the benefits provided under the plan; (iii) avoid the risk of punitive damages; and (iv) defeat a claim based on what may have been unauthorized oral promises. In exchange for the protection that ERISA affords, employers like Wells Fargo need only create written plans and summary plan descriptions (which can be the same document) and comply with limited reporting and disclosure obligations. In many instances, the protection is well worth the administrative costs.

Gregory L. Ash, Partner
Spencer Fane Britt & Browne LLP

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630 N. Rosemead Blvd., Suite 300, Pasadena, CA 91107
(626) 351-2300 / (626) 371-0447 Fax
www.garnerbenefits.com