

EB FUNDAMENTALS FOR TAX EXECUTIVES

**Tax Executives Institute
Los Angeles Chapter
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EB FUNDAMENTALS

PRESENTATION AGENDA

- Introduction
- ERISA
- Fiduciary Duties & Liability
- Qualified Retirement Plans
- Health & Welfare
- [Executive Compensation & Fringe Benefits]
- Best Practices

INTRODUCTION

BUSINESS OPPORTUNITIES

- Taxes
 - Income Tax Avoidance for Employees (lower costs for Biz?)
 - Health Care (Medical, Dental, Vision)
 - Fringe Benefits (Adoption, Child Care, Transport, Café, Gym, etc.)
 - Income Tax Deferral for Employees (e.g., Retirement Plans)
 - Company Income Tax Deferral (e.g., Pensions) / Immediate Deduction
 - Payroll Tax Avoidance for Company and Employees
- Employee Recruitment, Morale, & Retention
- Compliance & Risk Reduction

BUSINESS RISKS & ISSUES

- Taxes
 - Penalties & Excise Taxes
 - Tax Qualification
- Audits (e.g., IRS, DOL, EEOC)
- Claims and Litigation (including class actions)
- Other Government Actions (e.g., PBGC insertion in M&A deal, EEOC injunctive lawsuits)
- Employee Recruitment, Morale, & Retention

EMPLOYEE BENEFITS – LAW IS COMPLEX & BROAD

- Federal Statutes and Regulations
 - Tax Code
 - ERISA* (* = *significant tax components*)
 - Patient Protection & Affordable Care Act (PPACA)*
 - Other (e.g., HIPAA, FMLA, GINA, ADEA, USERRA*)
- State Laws (e.g., Cal-COBRA, paid sick leave)
- Regulations (e.g., IRS, DOL, PBGC, EEOC, HHS)
- Case Law

DIFFERENT TYPES OF PLANS

- Defined Benefit Plan
- Defined Contribution Plan
- Welfare Plan
 - Group Health Plan
- Nonqualified Plan
- Non-Plan
 - No “ongoing administrative scheme”
 - Payroll practice

VARIOUS PLAN ROLE(S) – WHICH DO YOU PLAY?

- Participant
- Business
 - Compliance
 - Strategy & Design
 - Operation
- Fiduciary
- Advisor / Consultant

HOW DO BENEFITS ISSUES ARISE? (EXAMPLES)

- Business Question(s)
 - Various Depts. (e.g., Finance, Tax, HR, Legal, Compliance)
 - M&A (e.g., benefit-related liabilities can be substantial)
 - Vendor Contracts
- Audit
- Participant Inquiry or Claim
- Vendors – Errors, Questions
- Lawsuit

ERISA

ERISA – WHAT IS IT? THE BASICS

- Comprehensive federal law
 - Employee Retirement Income Security Act of 1974
- Regulates employee benefit plans
 - Protects participants and beneficiaries
 - Requires disclosure and reporting
 - Provide uniformity in the administration of plans for employers
 - Establishes “standards of conduct, responsibility, and obligation for fiduciaries”
 - Provides for “appropriate remedies, sanctions, and ready access to the Federal courts.” ERISA § 2(b).

HISTORICAL BACKGROUND

- Protections for Employees and Participants
 - Shorter Vesting Periods
 - Stricter Funding Rules
 - Restrictions on Plan Termination
 - Studebaker: “ERISA’s Enron”

ERISA

- Enacted in 1974
- Title I of ERISA (DOL)
 - Generally procedural (e.g., reporting/disclosure, fiduciary duties, prohibited transactions)
 - Applies to “pension” and “welfare” plans
- Title II of ERISA (IRS)
 - Tax-Qualification Rules (Code Section 401(a))
 - Generally substantive (e.g., coverage, vesting, non-discrimination)
 - Applies only to “pension” plans
- Preempts state regulation (except state insurance regulation)

ENFORCEMENT

- DOL Fines and Penalties
- ★ ■ IRS Disqualification and Penalties
 - Audit CAP penalties
 - Excise Taxes
- Lawsuits
 - Participants (Individual or class action)
 - DOL

ERISA REPORTING AND DISCLOSURE (EXAMPLES)

- To Participants and Beneficiaries
 - Summary Plan Description (SPD)
 - Summary of Material Modification (SMM)
 - Benefit Statements
 - Summary Annual Report (SAR)

- To DOL / IRS / PBGC
 - ★ ▪ Annual Report (IRS Form 5500)

- To Plan Sponsors

SETTLOR VS. FIDUCIARY FUNCTIONS (KEY CONCEPT)

- Settlor Functions
 - Establishment, design, and termination
- Fiduciary Functions
 - Implementation of plan provisions
 - Participant communications
 - Review of claims
 - Handling plan assets
 - Choosing investment options
 - “Firestone” deference
- Procedural prudence is key
- Plan drafting can help

PROHIBITED TRANSACTIONS

- Section 406(a): Transactions between a plan and a “party in interest”
 - “Party in interest” includes employer, certain employees, plan fiduciaries, and service providers
 - Various exceptions apply (e.g., employer securities, loans, reasonable compensation for services)
 - Rules are not intuitive
- Section 406(b): Self-dealing between a plan and a fiduciary
 - No exceptions
- Subject to **IRS Excise Tax (Section 4975)**

PLAN ASSETS

- Subject to fiduciary duties
- Trust requirement
- No reversion to employer, except in limited circumstances
- Participant contributions
 - “Reasonably segregated”

FIDUCIARY DUTIES & LIABILITY

WHO IS A FIDUCIARY? YOU?

- Plan sponsor (the company)
- Plan administrator (often a committee)
- Individuals
 - By designation (personal/title)
 - Service on a committee
 - Functional - i.e., you are a fiduciary to the extent you exercise discretion or control with respect to the plan

WHAT FIDUCIARY RULES DO YOU HAVE TO FOLLOW?

- Internal Revenue Code
 - Tax qualification rules for qualified plans (e.g., 401(k))
 - Exclusive benefit
 - Plan document requirement
- ERISA
 - Fiduciary rules set forth affirmative duties
 - Avoid prohibited transactions and fiduciary breaches
- Plan terms and rules

ERISA'S BASIC FIDUCIARY RULES

- Fiduciary “Do’s”
 - Exclusive Benefit/Purpose Rule (duty of loyalty)
 - Prudence Rule (duty of care)
 - Diversification/Investment Rule
 - Plan Documents Rule
- Settlor vs. fiduciary functions
- Co-fiduciary liability
- Fiduciary “Don’ts”
 - Prohibited transactions
 - Self-dealing

EXCLUSIVE BENEFIT RULE

- Duty to act solely for benefit of participants and beneficiaries
- Fiduciaries typically wear two hats: the fiduciary role and the business role
- Conflicts of interest: question of degree
 - May need to step aside



BUSINESS FUNCTION EXCEPTION

- Business functions are not subject to fiduciary rules
 - Starting a plan
 - Terminating a plan
 - Plan design and modification
- Following the plan and implementing business decisions are fiduciary functions
- Distinguishing business and fiduciary functions can be tricky

PRUDENCE RULE

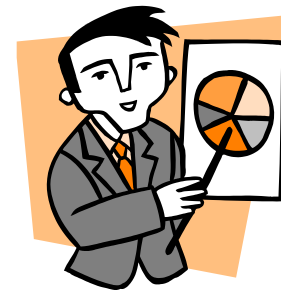
- Must discharge duties with the care, skill, prudence and diligence of a similarly situated prudent person
- Good outcome is not enough
- Absence is not a good defense

PRUDENCE RULE (CONT.)

- Largely a procedural rule
 - Was the fiduciaries' consideration adequate under the circumstances?
 - Was their investigation thorough enough?
 - Did they consider the appropriate factors?
 - Did they consult experts where appropriate?
 - Did they weigh/debate alternatives?
- Documentation

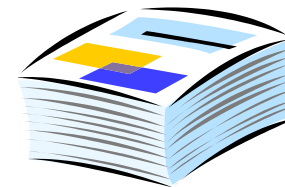
DIVERSIFICATION RULE

- Plan Administrator is generally responsible for all investment decisions regarding plan assets
- 401(k) plans – ERISA § 404(c) has a limited exception
 - Mandates certain amount of diversification in investment options
 - Procedural and disclosure requirements
 - Ongoing duty to monitor
 - Investment education vs. advice
- Employer stock – special rules



PLAN DOCUMENTS RULE

- Fiduciaries must follow the plan documents unless they conflict with ERISA
 - Example: lawsuits regarding company stock funds in 401(k) plans
- Plan documents: Plan, trust, summary plan description (SPD), etc.



OTHER DUTIES OF THE PLAN ADMINISTRATOR

- Selection and oversight of plan service providers
 - E.g., recordkeeper, trustee, investment advisors, legal counsel, auditor, Form 5500 preparer, and others
- Selection and monitoring of investments
- Annual reporting
 - ★ ■ **Form 5500**
 - Summary Annual Reports for DC plans
 - Funding Notices and PBGC filings for DB plans

OTHER DUTIES OF THE PLAN ADMINISTRATOR (CONT.)

- ★ ■ Ensuring tax and legal compliance
- Maintenance and upkeep of plan documents and records
 - SPDs and Summaries of Material Modification
- ★ ■ IRS determination letter filings
- Handling participant claims and appeals

FIDUCIARY LIABILITY

- Liability is personal



- Indemnification by plan sponsor
 - May be offered through plan
 - May be offered directly by plan sponsor
 - Usually an exception for gross misconduct
- Insurance protection

LIABILITY FOR OTHER FIDUCIARIES

- Co-fiduciary liability for the breach of another fiduciary exists if—
 - A fiduciary knowingly participates in or acts to conceal another fiduciary's breach
 - By failing to comply with the fiduciary standards, a fiduciary enables another fiduciary to commit a breach
 - The fiduciary has knowledge of a breach by another fiduciary and does not act to correct it (which might require going to court)
- Duty to monitor delegations/appointments



PROHIBITED TRANSACTIONS (FIDUCIARY “DON'TS”)

- Transactions between a plan and a “party in interest” are generally prohibited
 - Loans or extensions of credit; sales, exchanges, or leases; transfers of property; furnishing of goods or services
- Various exceptions to PT Rules:
 - E.g., fiduciary participation in a plan, participant loans, reasonable compensation for services, employer stock
- Fiduciary self dealing prohibited (No Exceptions)



PROHIBITED TRANSACTIONS – CONSEQUENCES

- ★ Prohibited transactions are reported on IRS Form 5500 for the plan
- ★ Prohibited transactions trigger an excise tax under Internal Revenue Code section 4975
 - 15% initial excise tax
 - 100% additional tax for failure to correct

PROHIBITED TRANSACTIONS – EXAMPLES

- **Examples of Possible Violations**
 - Discounts for the company from plan vendors
 - Hiring a company affiliate as a service provider
 - Use of plan assets to pay company expenses
 - Gifts and commissions from vendors
 - Failure to comply with participant loan rules
 - Noncash contributions to DB plans

- **Definitely best to ask questions when you're not sure**

(TAX) QUALIFIED RETIREMENT PLANS

PLAN QUALIFICATION REQUIREMENTS

- Tax Advantages
 - Current deduction for employer
 - Deferred taxation for employee
 - Tax-deferred build-up of earnings
 - Huge “tax expenditure”
- Not Applicable to Nonqualified Plans

DEFINED CONTRIBUTION PLANS VS. DEFINED BENEFIT PLANS

- Defined Contribution (Individual Account) Plans
 - May include a 401(k) “cash or deferred arrangement”
 - Also include ESOPs
 - Defined *contribution* by employee and/or employer
 - Employee bears investment risk
 - Limited in-service distributions
 - No PBGC Insurance
- Defined Benefit Plans
 - Defined *benefit* at retirement
 - Employer bears investment risk
 - Generally no in-service distributions
 - PBGC Insurance

BASIC REQUIREMENTS

- Definite written program
- Communicated to employees
- Established and maintained by an employer
- Created or organized in the United States
- Maintained as a domestic trust in the United States

DOCUMENTARY COMPLIANCE

- Determination Letters
 - Inception
 - Termination
 - Five-year Filing Cycles being eliminated
- Remedial Amendment Period
- Interim and Discretionary Amendments

OPERATIONAL COMPLIANCE

- IRS Employee Plans Compliance Resolution System (EPCRS)
 - “Amnesty” concept – no penalty for turning yourself in
 - “Make whole” principle
 - Self-Correction (SCP): No fee
 - Voluntary Correction Program (VCP):
 - Fixed fee based on size of plan
 - No audit while application pending
 - Audit CAP
 - Fee is a percentage of the “Maximum Payment Amount,” which is the total tax payable in the event of plan disqualification

- Self-Audit

HEALTH & WELFARE

HEALTH & WELFARE PLANS ARE GENERALLY SUBJECT TO ERISA

- Medical, Dental, & Vision
- Health FSAs and HRAs
- Wellness Programs
- Flu Shots, Health Screenings, Nurse Hotlines
- Disability Insurance
- Life Insurance, AD&D & Other Death Benefits
- Day-Care Center
- Employee Assistance Plans (EAPs)
- Prepaid Group Legal Plans

ERISA HEALTH & WELFARE PLANS

- Most ERISA rules apply
 - Reporting and Disclosure
 - Participation & Nondiscrimination
 - Fiduciary Rules
 - Procedures
 - Penalties
 - Preemption (except for a MEWA)
- Exempt from vesting and funding rules

ERISA CLAIMS PROCEDURES

- DOL Claim Regulations
 - Rules depend on type of plan
 - Timelines
 - Notice requirements
 - No Conflicts of interest – Independence and Impartiality
 - Participant appeal rights
- Must be exhausted before lawsuit filed
- Courts generally defer to Plan decisions

AFFORDABLE CARE ACT – CORE REQUIREMENTS

- The ACA aims to expand health coverage through a series of provisions:
 - **Individual mandate:** Mandates all Americans, with some exceptions, to maintain a minimum level of health coverage or face a tax.
 - **Insurance Exchanges:** Creates health insurance Exchanges and provides Premium Tax Credits (PTCs) to assist eligible individuals with the purchase of coverage.
 - **Medicaid expansion:** Allows states to expand Medicaid up to 138% of federal poverty level.
 - **Employer mandate:** Mandates employers with 50 or more full-time equivalents to offer coverage to full-time employees and their dependents or pay taxes if an employee obtains Exchange coverage and a PTC.

AFFORDABLE CARE ACT (ACA) – BUSINESS FEES, TAXES & REPORTING

- Various new business Fees / “Taxes”
 - E.g., PCORI, Transitional Reinsurance Assessment Program

- Significant employer reporting obligations
 - E.g., W-2 reporting
 - Reporting under §§ 6055, 6056

ACA – SHARED RESPONSIBILITY PENALTY UNDER SECTION 4980H

- “Large employers” (employer with ≥ 50 full-time equivalent employees within the employer’s controlled group) may be subject to an excise tax if at least one full-time employee whose household income is between 100% and 400% of the federal poverty level receives a premium tax credit for exchange coverage and an employer either:

**Fails to offer
coverage to full-time
employees and their
dependents**

OR

**Offers coverage to
full-time employees
that does not meet
the law’s affordability
or minimum value
standards**

Annual Excise Taxes can be very expensive.

Can be thousands of dollar per full-time employee, even if only one full-time employee is receiving a premium tax credit.

AFFORDABLE CARE ACT – CADILLAC PLAN EXCISE TAX

- Code section 4980I imposes a non-deductible, 40% excise tax on high-cost health coverage
 - Applies to the excess of monthly cost of coverage over a specified threshold
 - Tax is paid by the insurer for insured plans, and by the employer or plan administrator for self-insured plans
 - Takes effect in 2020 (*delayed once already*)
- Employers will need to calculate the excise tax and report the excess benefit to the IRS and coverage providers
 - Potentially significant penalties may apply to employers who do not calculate the tax correctly, if there is an underpayment
- Limited guidance; many unanswered questions
- Absent a legislative fix, the Cadillac tax threshold is projected to dip below the minimum value threshold within 15-20 years.

ACA – TAX FOR FAILURE TO MEET GROUP HEALTH PLAN REQUIREMENTS

- Preexisting section 4980D imposes an excise tax for any failure to meet the Code's group health plan requirements
- Section 9815 incorporates certain ACA provisions into the Code's group health plan requirements
- Requirements subject to 4980D tax include the insurance market reforms, including the prohibition on waiting periods that exceed 90 days
- Tax: \$100 per day of noncompliance
- Taxpayers are to voluntarily report 4980D violations on Form 8928
- Insurance reforms apply to group health plan offered by an employer

HIPAA – BASIC OVERVIEW

- Portability Rules
- Insurance Market Rules
- Privacy and Security Rules
 - Privacy Notice
 - Policies and Procedures to safeguard personal health info
 - “Business Associate” requirements
- Applies to “group health plans”

HIPAA – BUSINESS ISSUES

- Business is a Plan Sponsor
 - May also be a plan administrator
- Personal Health Info – Privacy & Security Obligations
 - HITECH Act – strengthened rules
 - Data Breach Notification
- Risks of Non-Compliance
 - Excise Taxes
 - Civil Penalties & even Criminal Penalties
 - Lawsuits (perhaps w/ ERISA Attorneys' Fees)

COBRA – BASIC OVERVIEW

- Permits “Qualified Beneficiaries” to continue group health coverage by paying for it themselves
 - When coverage lost due to a “Qualifying Event” (termination, death, divorce, etc.)
 - Time limits (typically 18 or 36 months)
 - Typically pay full cost (or 102%)
- “Covered employees,” spouse, and dependent child
- Applies to “group health plans”

COBRA – BUSINESS ISSUES

- Notices and Communications
 - Initial COBRA Notice
 - COBRA Election Notice
 - Many others
- Risks of Non-Compliance
 - Excise Taxes
 - Statutory Penalties
 - ERISA Lawsuits (w/ Attorneys' Fees)

HEALTH & WELFARE – OTHER STATUTES

- Federal Statutes, including:
 - Americans with Disabilities Act (ADA)
 - Age Discrimination in Employment Act (ADEA)
 - Pregnancy Discrimination Act (PDA)
 - Title VII of the Civil Rights Act of 1964 (Title VII)
 - Genetic Information Nondiscrimination Act (GINA)
 - Mental Health Parity laws (MHPA, MHPAEA)
- State Laws, including:
 - State Continuation Coverage Laws (e.g., Cal-COBRA)

BEST PRACTICES

BEST PRACTICE: PRUDENT PROCESS

- Prudent Process – maintain and document
 - Have a three-person Committee (at least)
 - Meet on a regular basis and document the decision-making process
 - Consider establishing an investment policy
 - Choose vendors by getting bids and evaluating services/fees
 - Evaluate vendors on a regular basis
 - Ensure that plan provisions and procedures are properly followed



BEST PRACTICES: FEES & DISCLOSURE

- Focus on fees paid from the plan and 401(k) investment fees
- Compliance with disclosure regulations:
 - 404(c) information to 401(k) plan participants
 - 408(b)(2) service provider information to fiduciaries: Initial disclosures and any updates
 - Annual fee disclosure to 401(k) plan participants
 - Annual QDIA notice



BEST PRACTICE: “AN OUNCE OF PREVENTION IS WORTH A POUND OF CURE”

- Know and follow myriad rules and obligations
- Good fiduciary process
- Documentation
- Vendor selection, contracts, and oversight
 - Indemnification
- Periodic Self-Audits

BEST PRACTICE: CORRECT ERRORS

- Plan Qualification – IRS’s EPCRS (Rev. Proc. 2013-12, as modified by Rev. Proc. 2015-27)
- DOL Correction Programs
 - Voluntary Fiduciary Correction Program
 - Delinquent Filer Voluntary Compliance Program
- 409A Corrections under IRS Notices 2008-113, 2010-6, and 2010-80
- COBRA & HIPAA Corrections

Q & A





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APPENDIX

Extra/Bonus Materials (Reference)

ERISA – BONUS MATERIALS

TITLE I OF ERISA

- Part 1: Reporting and Disclosure
- Part 2: Participation and Vesting
- Part 3: Funding
- Part 4: Fiduciary Responsibility
- Part 5: Procedures, Penalties and Preemption
- Part 6: COBRA
- Part 7: Group Health Plans

CLAIMS PROCEDURES/CIVIL ENFORCEMENT

- Claims Procedures
 - Timelines for claims and appeals
 - Again, procedural prudence is key
 - If followed, decision entitled to deference
- Civil Enforcement
 - 502(a)(1)(B): Recover benefits, enforce rights, clarify right to future benefits
 - 502(a)(2): Breach of fiduciary duty
 - 502(a)(3): Injunctions and equitable relief
 - Participants, beneficiaries, fiduciaries, and the DOL have standing to sue

DOL CORRECTION PROGRAMS

- Voluntary Fiduciary Correction Program
 - Delinquent contributions
 - Party in interest transactions
 - Loan failures
 - Improper payment of expenses
 - Must “make the plan whole”
- Delinquent Filer Voluntary Compliance Program
 - Failure to file Form 5500
 - Per plan penalty applies

QUALIFIED PLANS – BONUS MATERIALS

DB PLAN REQUIREMENTS – ELIGIBILITY, VESTING & ACCRUALS

- Eligibility & Vesting
 - Coverage
 - Vesting
 - Non-Discrimination (Tax Code Section 401(a)(4))
- Benefit Accruals
 - Accrued Benefit
 - Backloading
 - Funding Rules
 - §411(d)(6): No takeaway of accrued benefit by amendment
 - But may reduce prospectively – 204(h) Notice

DB PLAN REQUIREMENTS - DISTRIBUTIONS

- **Survivor Benefit Rules**
 - Qualified Joint and Survivor Annuity (QJSA) for married participants, single life annuity if not married
 - Qualified Preretirement Survivor Annuity (QPSA) for surviving spouses
 - Spousal consent required to waive default forms
 - Notice requirements (30 to 180 days)
 - Relative value disclosures
- **Early Retirement Windows**
- **Anti-Alienation and QDROs (DC Plans as well)**

DC PLAN REQUIREMENTS – TYPES OF CONTRIBUTIONS

- Participant Contributions
 - Elective Deferrals
 - After-Tax Contributions
 - Roth Contributions
 - Catch-up Contributions
 - Rollover Contributions

- Employer Contributions
 - Matching Contributions
 - Profit-Sharing Contributions
 - Stock Contributions
 - Discretionary (or Non-Discretionary)

DC PLAN REQUIREMENTS – VESTING & BENEFIT LIMITS

- Vesting Rules Vary by Contribution Type
 - Immediate vesting in participant contributions
 - 3-year cliff or 6-year graded for company contributions
- ADP/ACP Tests
 - HCE contributions may not exceed non-HCE contributions by more than a stated limit
- Other Benefit Limits
 - 402(g): Elective deferrals
 - 415: Annual additions
 - 401(a)(17): Compensation taken into account

DC PLAN REQUIREMENTS – INVESTMENTS

- Participant-Directed Investment
 - ERISA Section 404(c) Protection
 - Fiduciary duties apply to selection of investment options
- Employer Stock
 - PPA requires diversification rights
- Fees (Disclosure is key)
- Default Investments & QDIA

QUALIFIED DEFAULT INVESTMENT ALTERNATIVES

- Typical Types of Funds
 - Life-cycle or target retirement date fund
 - Allocation among existing plan options by an investment service
 - Group-based product (e.g., a balanced fund)
- 30-Day and Annual Notice Requirements
 - “Springing” relief
- No Fees and Restrictions for 90 Days
- Grandfathered Stable Value Funds
 - Only applies to previously invested amounts

DC PLAN REQUIREMENTS – DISTRIBUTIONS

- After-Tax & Rollover – Anytime
- Elective Deferrals
 - Severance from employment
 - Death
 - Disability
 - Age 59 ½
 - Hardship
 - Loan
 - Qualified reservist distribution
- Company Contributions
 - More legal flexibility for employer plan design choices
- 10% Penalty under Tax Code Section 72(t)

DC PLAN REQUIREMENTS – OPTIONAL FEATURES

- Roth 401(k) Contributions
- Brokerage Window
- Testing Safe Harbor
- Automatic Enrollment
 - Qualified Automatic Contribution Arrangement
 - Eligible Automatic Contribution Arrangement