

## **IDENTIFYING AND ADDRESSING ERISA AND EMPLOYEE BENEFIT ISSUES**

Jamison H. Hinkle  
Smith, Anderson, Blount, Dorsett, Mitchell & Jernigan, LLP\*

### **I. INTRODUCTION**

An understanding of employee benefits law is important to the business lawyer for many reasons.

- A. **You need to know the types of benefits that are available.** Benefits continue to make up an increasingly larger portion of compensation packages, and there are numerous professionals and consultants whose job it is to recommend that your client offer certain benefits, or who will offer to administer benefit packages for your client. Your corporate clients may come to you for advice when deciding whether to offer a new benefit to their employees, or to ask you for help in structuring an incentive package to attract a new executive.
- B. **You need to have a basic understanding of the rules** governing tax-qualified plans, so you can help guide your clients to appropriate persons to assist with compliance.
- C. **Your business client may ask for help in complying** with the numerous information and reporting requirements that must be met in order to get the tax benefits associated with many employee benefits, or that are required by the Employee Retirement Income Security Act ("ERISA").
- D. **You may discover that your business client has made mistakes** in the administration of its benefit plans, and you must help them correct the problem.
- E. **You may be called upon to evaluate the benefits program of a business your client wishes to acquire**, in order to recommend how best to integrate the seller's plans with your client's plans. If you represent the seller, your client may ask for help in protecting its employees' benefits and evaluating the benefits offered by the buyer.

---

\* Portions of this manuscript were updated and adapted for 2004 from a manuscript initially revised and presented at the North Carolina Bar Foundation's 2000 and 2002 Basics of Business Law Programs.

This manuscript discusses each of these areas, with the goal of helping the business lawyer recognize some of the important issues in employee benefits law. Although an entire seminar can be (and has been) given on each of these topics, it is hoped that the topics discussed here will give you some background in this area, and alert you to problems that may need attention or special expertise.

## II. EMPLOYEE RETIREMENT INCOME SECURITY ACT

A. What Is ERISA? The Employee Retirement Income Security Act of 1974 (P.L. 93-406, 88 Stat. 829, 29 USCA § 1001 *et seq.*) was originally enacted in 1974, and has been frequently amended since that time. It is divided into four Titles, each of which is further divided into subtitles and parts.

1. Title I: Protection of Employee Benefit Rights
2. Title II: Amendments to the Internal Revenue Code Relating to Retirement Plans
3. Title III: Jurisdiction, Administration, Enforcement; Joint Pension, Profit-Sharing, and Employee Stock Ownership Plan Task Force, etc.
4. Title IV: Plan Termination Insurance

From a practical standpoint, Title I is the section of ERISA of most importance to employers. Subtitle B of Title I contains the reporting and disclosure rules (Part 1), rules regarding participation and vesting (Part 2), funding rules (Part 3), fiduciary responsibility provisions (Part 4), administration and enforcement provisions (Part 5), continuation coverage rules for group health plans (Part 6), and requirements relating to portability, access and renewability of group health plans (Part 7).

B. What Types of Plans are Covered by ERISA?

1. General Rule. In general, Title I of ERISA applies to any employee benefit plan if it is established or maintained -
  - a. by any employer engaged in commerce or in any industry or activity affecting commerce; or
  - b. by any employee organization or organizations representing employees engaged in commerce or in any industry or activity affecting commerce; or
  - c. both.

*See* ERISA § 4(a); 29 USCA § 1003(a).

2. Employee Benefit Plan. An employee benefit plan is defined as "an employee welfare benefit plan or an employee pension benefit plan or a plan which is both an employee welfare benefit plan and an employee pension benefit plan." ERISA § 3 (3); 29 USCA §1002(3).
3. Employee Pension Benefit Plan. ERISA defines an employee pension benefit plan as follows:

Except as provided in subparagraph (B), the terms "employee pension benefit plan" and "pension plan" mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program--

- (i) provides retirement income to employees, or
- (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond,

regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits.

ERISA § 3(2)(A); 29 USCA § 1002(2)(a).

4. Employee Welfare Benefit Plan. ERISA defines an employee welfare benefit plan as follows:

The terms "employee welfare benefit plan" and "welfare plan" mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or (B) any benefit described in section 302(c) of the Labor Management Relations Act, 1947 [29 USCA § 186(c)] (other than pensions on retirement or death, and insurance to provide such pensions).

ERISA § 3(1); 29 USCA § 1002(1).

5. Major Exceptions to ERISA.

- a. The provisions of Title I of ERISA do not apply to:
  - i. governmental plans, as defined in ERISA § 3(32), 29 USCA § 1002(32);
  - ii. certain church plans, as defined in ERISA § 3(33), 29 USCA § 1002(33);
  - iii. plans maintained solely for the purpose of complying with applicable worker's compensation, unemployment compensation or disability insurance laws;
  - iv. plans maintained outside the U.S. primarily for the benefit of persons substantially all of whom are non-resident aliens; and
  - v. unfunded excess benefit plans, as defined in ERISA § 3(36), 29 USCA § 1002(36).

ERISA § 4(b); 29 USCA § 1003(b).

- b. In addition, ERISA's participation and vesting rules do not apply to certain types of plans, the most important of which are:
  - i. employee welfare benefit plans,
  - ii. any plan which is unfunded and maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (the "top hat" exception);
  - iii. plans established and maintained by a society, order or association described in I.R.C. § 501(c)(8) or (9);
  - iv. individual retirement accounts and annuities under I.R.C. § 408; and
  - v. excess benefit plans.

ERISA § 201, 29 USCA § 1051.

- c. ERISA's funding rules do not apply to certain types of plans, the most important of which are:
  - i. employee welfare benefit plans;
  - ii. certain insurance contracts described in ERISA § 301(b), 29 USCA § 1081(b);
  - iii. any plan which is unfunded and maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (the "top hat" exception);
  - iv. plans established and maintained by a society, order or association described in I.R.C. § 501(c)(8) or (9);
  - v. individual retirement accounts and annuities under I.R.C. § 408;
  - vi. excess benefit plans; and
  - vii. individual account plans (other than a money purchase plan).

ERISA § 301(a); 29 USCA § 1081(a).

- d. ERISA's rules governing fiduciaries (such as the requirement that fiduciaries post a bond, that the plan be evidenced by a written document, and that a separate trust be maintained to hold plan assets) do not apply to any plan which is unfunded and maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (the "top hat" exception). *See* ERISA § 401, 29 USCA § 1101.

### III. TYPES OF EMPLOYEE BENEFITS

- A. Pension Benefit Plans. Plans that provide a retirement benefit fall into two main categories: tax-qualified plans and non-qualified plans.

- 1. Qualified Plans.

- a. Defined Benefit Plans. A defined benefit plan **defines the benefit** a participant will receive at retirement. It promises a definitely determinable benefit to the participant for a stated period of time (usually for life) after retirement.

- i. The retirement benefit is usually (although not always) a function of the participant's years of service with the employer and his or her compensation, and may take into account the participant's expected benefits from Social Security.
  - (A) Example. XYZ Hospital sponsors a defined benefit plan for its eligible employees that promises a monthly benefit after retirement at age 65 equal to  $1/12$  of the sum of (a) plus (b), where
    - (a) = 1% of the participant's average compensation during all her years of service with the Hospital, multiplied by her years of service; and
    - (b) = .65% of her "average compensation" in excess of the applicable Social Security Covered Compensation in effect for the plan year in which the participant reaches the plan's normal retirement age of 65.
  - (B) Example. Big Corp., a textile manufacturing company, sponsors a defined benefit plan for its eligible employees that requires participants to contribute 4% of their compensation each year. Upon retirement at age 65, participants will receive an annual benefit equal to  $1/2$  of their total contributions to the plan.
- ii. An actuary helps the employer determine the amount it must contribute to the plan each year in order to have enough money in the plan to pay the benefits as they come due, and to meet the minimum funding rules of Part 3, Subtitle B, of Title I of ERISA.
- iv. Some of the benefits promised under the plan may be insured by the Pension Benefit Guaranty Corporation ("PBGC") in the event of the plan's failure.
- v. The determination of the amount of benefits and the amount to be contributed to the plan each year to fund those benefits is not dependent on the employer's profits. *See* Treas. Reg. § 1.401-1(b)(1)(i).
- vi. Cash Balance Plans. One type of defined benefit plan that has received lots of press is the cash balance plan. In its simplest form, a cash balance plan bases the participant's

benefit on the value of a hypothetical account. A hypothetical contribution is credited to the account each year, and a hypothetical interest rate is credited on the account balance each year. If the employee leaves, he or she typically takes a lump sum distribution of the balance then in his or her hypothetical account. Such plans provide larger benefits early on to younger workers, unlike traditional defined benefit plans that make larger contributions to older workers.

b. Defined Contribution Plans. A defined contribution plan **defines the contribution** that will be made to the plan for the participant's benefit. A separate account is maintained for each participant, and the retirement benefit will be paid based on the contributions made to the account over the years, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants that are allocated to the participant's account. *See* I.R.C. § 414(i). If a plan is not a defined contribution plan, it is a defined benefit plan. *See* I.R.C. § 414(j).

i. Profit Sharing Plans. A profit sharing plan allows participants to share in the profits of the employer. The plan must have a definite, predetermined formula for allocating contributions made under the plan among the participants, and for distributing the funds in the plan upon the occurrence of certain events, such as death, disability, retirement, termination of service, or attainment of a stated age. *See* Treas. Reg. § 1.401-1(b)(1)(ii).

(A) The employer need not have current or accumulated profits in order to make a contribution to a profit sharing plan. *See* I.R.C. § 401(a)(27).

(B) The amount of the annual contribution to the plan can be set each year by the Board of Directors if the plan so provides.

ii. 401(k) Plans. A 401(k) plan is actually a feature that can be added to a profit sharing or stock bonus plan. Also known as a cash or deferred plan, 401(k) plans allow participants to choose between receiving a portion of their compensation in cash, or having the employer contribute that amount to the plan on the participant's behalf. The plan is so-called because the rules governing this plan feature are found in Section 401(k) of the Internal Revenue Code.

401(k) Safe Harbor Plans. By design, this 401(k) plan will automatically satisfy certain nondiscrimination requirements if the plan provides for one of two stated contribution formulas and participants are given a notice before the beginning of the plan year that tells them their rights and obligations under the Plan. The contribution can either be a specified matching contribution or a profit sharing contribution of at least 3% of each employee's compensation. *See* § 401(k)(12).

- iii. Money Purchase Pension Plans. A money purchase pension plan is a defined contribution plan, because each participant has a separate account under the plan. However, it is a pension plan because the plan contains a fixed formula for determining the employer's contribution to the plan each year, and that contribution must be made, regardless of whether the employer has current or accumulated profits for the year. *See* Treas. Reg. § 1.401-1(b)(1)(i). The contribution is usually expressed as a percentage of each participant's compensation, *i.e.*, 10% of compensation. Following recent changes in the tax laws, these plans have become less popular.
- iv. Target Benefit Plans. A target benefit plan is a money purchase pension plan that sets a "targeted" benefit to be met by actuarially determined contributions. In the first year of funding the plan, the same actuarial assumptions are made as if the employer were funding a defined benefit plan. However, the benefit the participant receives is based on the value of his or her individual account. The initial actuarial assumptions are not revised if the plan's investment experience is better or worse than expected. Thus, the participant's actual benefit at retirement may be greater or less than the target.
- v. Stock Bonus Plans. Another special form of profit sharing plan, a stock bonus plan distributes its benefits in the form of employer stock. *See* Treas. Reg. § 1.401-1(b)(1)(iii). Contributions may be made by the employer in stock, or in cash. If made in cash, the Trustee invests the cash in stock purchased from the company or its shareholders, pursuant to a price formula set forth in the plan. *See* Treas. Reg. § 1.401-1(b)(3).
- vi. Employee Stock Ownership Plans ("ESOPs"). An ESOP is a stock bonus plan designed to invest in qualifying

employer securities. The plan document must specifically state that it is an ESOP and that it is designed to invest primarily in qualifying employer securities. *See* Treas. Reg. §§ 54.4975- 11(a)(2); -11(b). Unlike stock bonus plans, ESOPs may borrow money to finance the purchase of the employer securities.

vii. SIMPLE Plans. Simplified retirement plans for small businesses, known as the “Savings Incentive Match Plan for Employees” (“SIMPLE”) retirement plans, allow small employers to provide for employees’ retirement without having to meet all of the requirements of a regular qualified plan. Generally, employers make contributions on behalf of employees in a predetermined minimum amount (generally 2% to 3% of employee’s compensation). Simplified reporting rules also apply. SIMPLE plans are available to employers who have no more than 100 employees who received \$5,000 or more in compensation during the preceding year, and who have no other employer-sponsored retirement plan. *See* I.R.C. § 408(p).

c. Individual Retirement Accounts. IRAs are accounts set up by individuals to save for retirement. Any person with earned income is eligible to establish an IRA, *see* I.R.C. § 219, although participants in other qualified plans may find their ability to deduct contributions to the IRA limited or eliminated altogether. In addition to traditional IRAs, several new types of IRAs have been legislated in recent years.

i. Roth IRAs. As authorized by the Taxpayer Relief Act of 1997 (“TRA 97”), Roth IRAs provide taxpayers with the opportunity for the earnings on the account to be tax-free. Contributions to the Roth IRA are not deductible when made, however. *See* I.R.C. § 408A(a) *et seq.* These provisions were effective January 1, 1998.

ii. Coverdell Education Savings Accounts. Taxpayers may deposit up to \$2,000 per year into a Coverdell ESA for a child under age 18 when the account is established. In 2002, the beneficiary can be older than 18 if he or she is a special needs beneficiary. The account will grow tax free until distributed, and no tax will be owed on the distribution if used for the beneficiary’s qualified education expenses at an eligible educational institution. *See* I.R.C. § 530(a) *et seq.*; I.R.S. Pub 970.

iii. Archer Medical Savings Accounts. Although technically not an IRA, medical savings accounts are similar to a traditional IRA in that contributions are not taxable to the taxpayer until withdrawn in retirement. Section 220(i) of the Internal Revenue Code allowed a limited number of medical savings accounts to be established each year during the 1997-2002 pilot period. These accounts are trust or custodial accounts that are created exclusively for the purpose of paying the qualified medical expenses of the account owner. The purpose of the accounts is to allow taxpayers to increase their medical deductibles, knowing that they can use their savings in their MSA to meet expenses not covered by the deductible. Individuals who do not need the assets in their MSA, either due to good health or prudence in their utilization of medical services, may withdraw them at retirement, when presumably their tax rate is lower. Taxes on the amounts in the account are deferred until withdrawn. *See* I.R.C. § 220(a); Notice 96-53, 1996-2 C.B. 219.

iv. Health Savings Accounts, Health Reimbursement Accounts, and Defined Contribution Health Plans. Over the last two years, new “defined contribution” health plan arrangements have developed as a successor to the Archer MSAs. Effective as of January 1, 2004, for example, eligible individuals are able to establish new Health Savings Accounts or (“HSAs”) as a tax-favored method of saving for health care costs. An HSA is similar to an IRA or an MSA and is established using a tax-exempt trust or custodial account to save and pay for qualified medical expenses of the HSA holder (and dependents). An HSA must be trustee by a bank, insurance company or other non-bank trustee approved by the IRS. In order to establish and contribute to an HSA, however, individuals must be covered by qualifying high deductible health plans (“HDHP”) and not covered under any other type of health plan with very limited exceptions. Account holders can make tax-deductible contributions to their own HSAs and/or receive tax-free employer contributions made on their behalf. Once contributed, funds in the HSA grow tax free. The maximum annual contribution to an HSA for 2004 is the lesser of the HDHP’s annual deductible or \$2,600 for single coverage and \$5,150 for family coverage.

d. 403(b) Annuities. Tax-sheltered annuities under Internal Revenue Code Sec. 403(b) are available to employees of non-profit

organizations, educational institutions, and governmental agencies. The tax advantages are similar to those of qualified plans, but these annuities are not subject to the same requirements. Recent legislation has sought to bring these types of plans more in line with traditional retirement plans however.

- e. Individually Designed Plans vs. Master and Prototype Plans. In the past, most employers that wanted to establish a qualified retirement plan for employees had a plan and trust document individually drafted by an attorney, or had the attorney review and revise a specimen plan document provided by an institution, such as an insurance company, that was installing the plan for the employer. The plan was then submitted to the Internal Revenue Service for a determination that the plan, as drafted, was qualified under the Internal Revenue Code. This process was often lengthy, as the Service had to review each plan completely, and plan documents were often in excess of 50 pages.

In order to streamline the determination letter process, the IRS has encouraged the use of master and prototype (M&P) plans by employers.

- i. A **master or prototype plan** can be sponsored by an institutional sponsor such as a bank, insured credit union, insurance company, mutual fund company, or broker or by practitioners such as a law or accounting firm. The sponsor has previously submitted the basic plan document to the National Office of the IRS for a ruling on the form of the document.
- ii. The sponsor provides the basic plan document to its clients or customers, who then "customize" the plan by executing an adoption agreement.
  - (A) Standardized Plan. If the employer chooses to adopt a standardized version of the sponsor's plan, in certain cases it may rely on the opinion letter the sponsor received from the IRS. *See Rev. Proc. 2004-6, § 8.01-8.05, 2004-1 I.R.B. 209.* In such event, no separate IRS submission is required. The trade-off for this ease of adoption is that a standardized plan is usually very simple -- no bells and whistles.

**CAUTION:** An employer may **not** rely on the sponsor's opinion letter without obtaining its own determination letter if the employer maintains at

any time, or has maintained at any time, any other plan, including a standardized form plan, that was qualified and covered some of the same participants covered by the plan in question, and such other plan is not a "paired plan" with the plan in question. *See* Rev. Proc. 2004-6, § 8.05(2), 2004-1 I.R.B. 209. Thus, if an employer wishes to adopt a standardized profit sharing plan on a master or prototype form offered by the local bank, and the employer once had an old defined benefit plan which it terminated 10 years ago, but which covered some of the same participants to be covered by the new plan, the employer must get a determination letter on the new plan. It may not rely on the sponsoring bank's opinion letters from the National Office.

- (B) NonStandardized Plan. A M&P sponsor may also offer adopting employers a choice of non-standardized adoption agreements. Use of a non-standardized adoption agreement lets the employer customize the plan to its workforce, and add more features to the plan.

An employer that adopts a nonstandardized plan may also rely on the M&P opinion letter for basic plan qualification assurances rather than having to submit an individual determination letter request. The M&P opinion or determination letter, however, cannot be relied upon by a nonstandardized plan adopter with respect to certain nondiscrimination rules governing participation and coverage, benefit amounts, permitted disparity, and compensation definitions. Nonstandardized M&P adopters, however, can obtain some additional assurance if they elect to use a "safe harbor" allocation or benefit formula and a safe harbor compensation definition.

Employers not adopting safe harbors and wishing for definitive qualification rulings will have to submit the adoption agreement to the Internal Revenue Service for a determination of the plan's qualified status as adopted by the employer on IRS Form 5307. Because the Service must only review the adoption agreement (typically 12-20 pages) instead of the entire plan document, the determination letter process is shortened

considerably compared to the process for obtaining determination letters on individually designed plans. *See* Rev. Proc. 2004-6, § 8.04, 2004-1 I.R.B. 211.

- iii. The IRS encourages employers to use prototype plans through a system of user fees charged to review a plan.
  - (A) The fee for a determination letter for an individually designed plan not requesting a determination with respect to any general tests for nondiscrimination purposes is \$700.
  - (B) The fee for a determination letter for the adoption of a regional prototype plan \$125.
  - (C) Effective for applications filed after December 31, 2001, there is no fee for a determination letter for a plan maintained by an employer with 100 or less employees.

*See* Rev. Proc. 2004-8, 2002-1 I.R.B. 245.

- iv. Employers may still choose to adopt an individually designed plan if they want to do so or have particular design issues that cannot be adapted to a M&P plan.
- f. Volume Submitter Plans. A volume submitter plan is an individually designed plan that a practitioner has previously submitted to the IRS for an advisory letter. This pre-approved “sample” plan is then used by the practitioner as the basis for drafting plans for its clients. Presumably, IRS review of the adopting employer’s determination letter application will be expedited because the IRS has already blessed the specimen plan.
- 2. Non-qualified Plans. Employers often offer additional non-qualified retirement benefits to employees, which are not subject to the stringent requirements of qualified plans, such as non-discrimination rules, funding requirements, annual reporting, etc. Such benefits are not deductible by the employer until actually paid, and if properly structured, are not taxable to the employee until paid.
  - a. Deferred Compensation Plans. Deferred compensation plans may be funded or unfunded.
    - i. Unfunded Plans. Unfunded plans are used to defer an executive's receipt of compensation that has been earned.

Current taxation to the executive is avoided by preventing the executive's "constructive receipt" of the income until the end of the deferral period. If:

- (A) the deferral is agreed to before the compensation is earned;
- (B) the deferred amount is not unconditionally placed in trust or in an escrow account for the benefit of the executive but instead paid from general assets as liabilities come due; and
- (C) the promise to pay the deferred compensation is merely a contractual obligation of the employer, and is not evidenced by notes or secured in any way;

then the executive will not be in constructive receipt of the income when earned, and will not be taxed on it until it is paid to him or her. *See* Rev. Rul. 60-31, 1960-1 C.B. 174.

- ii. Funded Plans. In a funded plan, amounts are generally set aside in a trust or some type of custodial reserve account beyond the reach of the employer and the employer's general creditors. However, the executive is not generally considered to have earned the compensation until there is no longer any substantial risk that the benefit could be lost or forfeited by the employee. Once that substantial risk of forfeiture is gone, the benefit becomes taxable income to the employee, whether or not the employee actually receives a distribution from the plan at that time. A substantial risk of forfeiture exists if the executive's rights in the deferred amounts are conditioned upon:

- (A) the future performance of substantial services by the executive, or
- (B) the refraining from the performance of substantial services, or
- (C) the occurrence of a condition related to the executive's acquisition of an ownership interest in the deferred amounts,

and the possibility of forfeiture is substantial if the conditions in (A), (B) or (C) are not met. *See* Treas. Reg. §

1.83- 3(c)(1). For example, if the agreement provides that the executive will forfeit all benefits under the plan if he or she leaves the company within 10 years of signing the agreement, a substantial risk of forfeiture exists during that 10 year period.

- b. Phantom Stock Plans. Phantom stock plans are deferred compensation plans that measure the growth of the compensation deferred by reference to "phantom" shares of stock allocated to the executive. The amounts deferred are "invested" in the company's stock, and the value of those phantom shares is paid to the executive at the end of the deferral period.
- c. Rabbi Trusts. Named for the ruling obtained by a synagogue on a deferred compensation arrangement for its rabbi, a rabbi trust is an irrevocable trust set up to hold the amounts deferred by the executive. The IRS has held in a series of private letter rulings that such amounts will not be taxed to the executive until received if the trust is subject to the claims of the employer's general creditors. *See* PLR 8113107. Use of a rabbi trust protects the executive by preventing the employer from spending the deferred compensation amounts. They may also provide protection in the event of a takeover by a company that refuses to honor the target's deferred compensation obligations. Contributions are also not deductible by the employer until paid to the executive.
- d. Secular Trusts. Secular trusts are designed to provide more protection to the executive than a rabbi trust. These trusts hold the employer's deferred compensation contributions for the executive, and the trust assets are **not** subject to the claims of the employer's creditors. Since the employer's contributions to the trust are generally taxable to the executive when they are made, a secular trust provides that distributions will be made from the trust each year to enable the executive to pay his or her income taxes on the contributed amounts. These contributions are also deductible by the employer when made.
- e. Other Funding Methods. Revocable trusts and corporate owned life insurance ("COLI") are other methods commonly used to set aside funds to meet an employer's deferred compensation obligations to its executives. As long as the funding medium is subject to the claims of the employer's creditors, the deferred compensation plan is typically considered "unfunded," because the amounts have not been set aside with the executive's name on them, so to speak.

f. Potential Changes in Nonqualified Deferred Compensation Rules. As of the writing of this manuscript, several bills have been introduced in Congress over the last year which could alter the current rules and earlier authority relied on in order to establish nonqualified deferred compensation plans and rabbi trust arrangements. While this legislation did not pass in 2003, similar legislative reforms are expected in 2004 and thus could significantly alter the playing field with respect to nonqualified deferred compensation, top hat, and other similar executive compensation arrangements.

B. Welfare Benefit Plans. Welfare benefit plans provide medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services. Examples of some common welfare benefits are as follows:

1. Health Insurance/Major Medical. Such plans may be provided through the purchase of insurance, or they may be self-insured. Under a self-insured plan, claims are paid from the general assets of the employer, or from a trust established by the employer for this purpose. Most self-insured plans have a stop-loss limit, to protect the plan from catastrophic claims. Claims above the stop-loss amount are insured.
2. Life Insurance. Life insurance is a popular benefit, and takes many forms. In addition to corporate owned life insurance used to meet deferred compensation obligations (*see III.A.2.e.*), employers may offer other types of life insurance as well.
  - a. Group Term Life Insurance. Employers may provide up to \$50,000 of group term life insurance to employees, without the premiums paid by the employer being taxable to the employees as income. *See* I.R.C. § 79.
  - b. Supplemental Term Life Insurance. Often employees are given an opportunity to purchase additional term insurance at favorable group rates. The "cost" of the excess group term coverage is computed by the employer and reported as taxable income to the employee each year on his W-2 form. The cost is computed using the PS-58 rates provided by the IRS. *See* Treas. Reg. § 1.79-3(d)(2); Treas. Reg. § 1.79-3T.
  - c. Split Dollar Life Insurance. Under a simple split dollar arrangement, the employer assists the employee in the purchase of life insurance by paying some or all of the premiums for the employee. Upon the employee's death, the employer receives an amount equal to the amount it paid in, or the cash surrender value

of the policy, whichever is greater. Although this is just one of many variations on the split dollar concept, all involve a "sharing" of costs and proceeds. Recent changes to the split-dollar rules and particularly the tax consequences of such arrangements on insured employees has complicated the use of such arrangements and may limit their popularity in some cases.

3. Travel Accident Insurance. Employers may provide policies that provide a death benefit in the event the employee is killed while traveling on business for the employer, and provide benefits in the event of the employee's serious injury as a result of accident while traveling on business.
4. Short-Term and Long-Term Disability Insurance, and Accidental Death and Dismemberment ("AD&D") Insurance. Disability plans are generally intended to provide salary continuation or partial salary replacement benefits in the case of temporary or permanent disability or injury which prevents an employee from working (or earning the same level of salary made prior to the disability). The plans may be insured or self-insured although most long-term disability and AD&D insurance benefits are provided through insurance.
5. Section 125 Flexible Benefits or "Cafeteria" Plans. Under a cafeteria plan, employees are given a choice between receiving taxable benefits (typically cash) and non-taxable benefits, and will not be taxed on the taxable benefits they could have received. The non-taxable benefits are provided on a pre-tax basis, thus providing more "bang" for each benefit dollar. Contributions to the plan may be made by the employer, by the employee (generally through salary reduction), or both. A cafeteria plan is not really a separate benefit, but rather an "umbrella" funding arrangement that encompasses the employer's existing benefit structure. *See* I.R.C. § 125; Prop. Treas. Reg. §§1.125-1, -2.
6. Dependent Care Assistance Plans. An employer may provide a dependent care assistance plan alone or in conjunction with a cafeteria plan that allows employees to pay dependent care expenses on a pre-tax basis. This is typically done through a flexible spending or reimbursement account which the employee contributes to under a salary reduction agreement. These pre-tax dollars are then used to reimburse the employee for eligible dependent care expenses. These plans must satisfy certain non-discrimination tests in order to qualify for preferential tax treatment. *See* I.R.C. § 129.
7. Medical Expense Reimbursement Plans. A medical expense reimbursement plan is designed to help employees pay for medical expenses not covered by the employer's health insurance program. For example, deductibles, co-payments, vision expense, orthodontia and other

uninsured dental expense, prescription drugs, medical equipment, and any other medical expense that would be deductible under I.R.C. § 213 can be paid through a medical expense reimbursement plan on a pre-tax basis. Typically offered as a flexible spending or reimbursement account under a cafeteria plan, these plans must comply with the requirements of I.R.C. §§ 105 and 106, as well as with the cafeteria plan rules. *See* Treas. Reg. § 1.125-2, Q & A 7(b)(1).

On September 3, 2003, the IRS revised prior guidance and ruled that medical expense reimbursement plans generally can reimburse participants for the purchase of over-the-counter medicines and other non-prescription health-related products. This change is an about-face from the IRS's initial guidance that generally limited reimbursements solely to prescription drugs. *See* Rev. Proc. 2003-102 (September 3, 2003).

8. Educational Assistance Plans. Some employers may offer educational assistance to employees under programs that are taxable to the employee, but which are designed to encourage employees to broaden their knowledge of subjects related to their employment. Employers may also offer educational benefits unrelated to the employee's job. These benefits are on a tax-favored basis under a plan which meets the requirements of I.R.C. § 127. This provision is scheduled to expire on December 31, 2010.
9. Severance Plans. Some employers provide that an employee who is involuntarily terminated from employment prior to retirement will receive certain benefits. Such payments are typically made in a lump sum or in a limited number of installments from the general assets of the employer, or from a fund set up for this purpose. Most severance plans are subject to ERISA's requirements, although a one-time payment that requires no administration or interpretation may be exempt. If the plan provides for deferral of payments until retirement age, it will be an employee pension benefit plan for purposes of ERISA, not a welfare benefit plan.
10. Vacation, Sick Leave and Similar Payroll Practices. Plans or programs that provide an employee with paid time off, or which pay the employee for foregoing time off, may take the form of vacation plans, sick leave, leaves of absence, paid holidays, personal time, parental and family leave, jury duty policies, etc. The Family and Medical Leave Act of 1993 requires many employers to provide up to a total of 12 weeks of unpaid leave during a 12 month period to employees for the birth or adoption of a child, or due to the serious health condition of the employee or his or her family member. *See* 29 USCA § 2612(a)(1).

To the extent that such vacation or sick leave plans are funded entirely by the employer's general assets and not through insurance, the arrangements generally are considered "payroll practices" rather than an employee

welfare benefit plan and thus are exempt from ERISA. For example, short-term disability plans providing temporary sick leave or disability benefits paid entirely out of an employer's general assets are generally considered payroll practices and thus exempt from ERISA. However, the same short-term disability benefits funded through the purchase of an insurance policy would generally fall within ERISA's employee welfare plan definition. Similarly, certain limited group or group-type insurance arrangements involving little or no employer administration or support are generally exempted from ERISA. *See* DOL Reg. § 2510.3-1(b).

C. Other Types of Benefits. Employers may also offer other types of non-cash benefits to employees that are not normally covered by ERISA to the extent they do not fall under the definition of an employee pension benefit plan or an employee welfare benefit plan. Examples of these types of benefits are:

1. Stock Options. Options to acquire the employer's stock at a set price during a given period of time are typically given to provide incentives to key managers and executives. Increasingly, stock options are also being given to rank and file employees. Stock options may be statutory stock options meeting the requirements of I.R.C. § 422, or they may be non-statutory options.

a. Incentive Stock Options ("ISOs"). Incentive stock options are statutory options. An executive who receives an ISO will not be taxed on any income until the stock acquired under the option is sold, even if the price paid for the stock pursuant to the option was less than its fair market value at the time of exercise. In order to qualify as an ISO, an option must meet the requirements of I.R.C. § 422(b), which include a requirement that the plan be approved by the company's shareholders, restrictions on the length of the option grant period and the period over which options can be exercised, the sequence in which options can be exercised, and the transferability of the options.

b. Non-statutory Stock Options. Non-statutory options are not subject to the same requirements that ISOs must meet, and thus are very flexible compensation planning tools. In their most common incarnation, these options are not considered to have a readily ascertainable value when granted, and thus the executive is not treated as having compensation income until the option is exercised. *See* I.R.C. § 83(e)(3). In that case, the executive receiving a non-statutory option is taxed on the difference between the price paid for the stock when the option is exercised, and the fair market value of the stock at the time of exercise. Since this income is treated as compensation, there is a corresponding compensation deduction for the employer at that time.

2. Stock Appreciation Rights ("SARs"). Stock appreciation rights are incentive compensation based on the increase in market value of the company's stock. They are generally granted in connection with the grant of stock options, and when exercised, they provide the executive with a benefit equal to the difference between the value of the company's stock at the time the SAR is granted, and the stock's value at the time the SAR is exercised. The increase in value may be paid to the executive in cash, in stock, or both. One common use of SARs is to provide an executive with cash to pay the income taxes incurred when he or she exercises non-statutory stock options. The related SARs are exercised at the time the options are exercised, and the SARs are paid to the executive in cash.
  
3. Long-Term Incentive Plans. Long-term incentive plans, also known as performance plans, are designed to reward executives for meeting predetermined, measurable performance goals. Typically, "units" are awarded based on goals achieved, and are paid out at some later date in shares of the company's stock, in cash, or in some combination of shares and cash. The executive is taxed on the fair market value of the shares when they are received. *See* I.R.C. § 83; P. Ltr. Rul. 7850053.

#### IV. QUALIFICATION RULES

Plans which are intended to be "qualified plans" under the Internal Revenue Code must meet certain requirements in order to be eligible for the favorable tax treatment provided under the Code. These requirements are found in the Code beginning at I.R.C. § 401 *et seq.* Contributions by the employer to a qualified retirement plan are deductible by the employer when made, within certain limits, but are not considered income to the employee until withdrawn from the plan. In addition, the earnings generated by the plan's trust fund are not taxed until withdrawn from the plan.

An employer that establishes a retirement plan often seeks a ruling, known as a "determination letter," from the Internal Revenue Service that the plan as drafted meets the requirements of the Code and is therefore a qualified plan. Employers are not required to seek this ruling, but most do. *See* III.A.1. e and f of this outline for a discussion of the streamlined determination letter application process for master and prototype and volume submitter plans. Of course, qualified plans must **operate** in compliance with the requirements of the Code in order to remain tax-qualified.

Some of the more important qualification requirements are outlined below.

- A. General Rules. In order to be a qualified plan, the plan must be a "written program", and it must be communicated to the employees. *See* Treas. Reg. § 1.401-1(a)(2). In addition, the plan must be for the exclusive benefit of employees or their beneficiaries. I.R.C. § 401(a). It must be established by the employer with the bona fide intention of continuing it indefinitely. *See* Treas. Reg. § 1.401-1(b)(2).

- B. Coverage and Participation Rules. The plan must benefit a significant portion of the employer's employees. This is shown by passing one of several coverage tests. The **percentage test** requires that the plan benefit at least 70% of the employer's non-highly compensated employees ("NHCEs"). The **ratio test** requires that the plan benefit a percentage of the NHCEs which is at least 70% of the highly compensated employees ("HCEs") benefiting . An alternative test, known as the **average benefits test**, is met if the average benefits for the NHCEs is at least 70% of the average benefits for the HCEs **and** coverage is extended to a nondiscriminatory classification of employees. All of these terms are defined and fleshed out in greater detail in the Code and accompanying regulations. See I.R.C. § 410(b)(1); § 414(q).

In addition to the coverage rules, a defined benefit plan must also meet minimum participation requirements. It must benefit the lesser of 50 employees or 40% of the employer's employees. I.R.C. § 401(a)(26)(A). Each plan must meet this requirement. An employer's plans may not be aggregated to pass this test.

- C. Vesting in Employer Contributions. A qualified plan must provide that an employee's interest in the contributions the employer makes to the plan on his or her behalf will become "vested" (*i.e.*, nonforfeitable) over a period of time, not to exceed certain limits. In addition, the plan must provide that the employee will become fully vested in his or her benefit under the plan at normal retirement age. I.R.C. § 411(a). Employers may choose a vesting schedule which is at least as rapid as one of two schedules provided in the Code:

1. 5-year vesting schedule. Under this schedule, also known as 5-year cliff vesting, an employee must be fully vested in his employer-derived accrued benefit after completing 5 years of service. I.R.C. § 411(a)(2)(A). This vesting schedule is easy to administer. Employees are either vested, or they aren't. There are no forfeitures to bother with.
2. 3 - to 7- year vesting schedule. This vesting schedule provides graduated vesting, with no vesting until 3 years of service have been completed. After 3 years, employees are 20% vested in their accrued benefit, with an additional 20% vesting each year in years 4 through 7, resulting in 100% vesting after 7 years of service. I.R.C. § 411(a)(2)(B). This vesting schedule appeals to some employers because it gives employees increasing ownership of their accrued benefit over time, and rewards longer service.
3. Accelerated Vesting for Matching Contributions. Effective for plan years beginning after December 31, 2001, employer matching contributions must be vested more quickly. The 5-year cliff vesting schedule is shortened to a 3-year cliff, and the 3 – to- 7- year schedule is shortened to a 3-6 year schedule (20% vesting after 2 years of service, with an additional 20% vesting each year in years 3 through 6, resulting in 100% vesting after 6 years of service.) I.R.C. §§ 411(a)(2)(B); (a)(12).

4. Employees are always 100% vested in the contributions they make to the plan, such as salary deferrals under a 401(k) plan. I.R.C. § 411(a)(1); Treas. Reg. § 1.411(a)-1(a)(2).
- D. Funding the Plan. Qualified plans are funded by employer and employee contributions to a trust fund established under the plan. Defined benefit plans, which base contributions on actuarial projections, are required to meet certain minimum funding requirements each year. These rules tell the employer the minimum amount that must be contributed for a year in order to avoid underfunding the plan (*i.e.*, how much must be contributed so that the trust fund will contain sufficient assets to pay the promised benefits as they come due). I.R.C. § 412(a). Defined contribution plans (other than money purchase pension plans) are not subject to the minimum funding rules, because they do not provide for a future benefit that must be funded on an ongoing basis. *See* I.R.C. § 412(h)(1).
- E. Limits on Contributions and Benefits. A qualified plan must not provide for benefits or contributions that exceed certain overall limitations in the Code. I.R.C. § 401(a)(16); § 415(a).
1. Defined Contribution Plans. Annual additions to an employee's account (*i.e.*, employer contributions, employee contributions, and reallocations of other employees' forfeitures, but not plan earnings) may not exceed the lesser of (a) \$40,000, as adjusted for COLA, and (b) 100% of the employee's compensation for the year. I.R.C. § 415(c)(1). This is an increase from the prior limits of \$30,000/25% of compensation.
  2. Defined Benefit Plans. A defined benefit plan must provide that the maximum annual benefit payable at Social Security retirement age (currently age 62) to an employee will not exceed the lesser of (a) 100% of his average compensation during the three consecutive calendar year period during which he or she was an active plan participant and had the highest compensation from the employer, or (b) a specified dollar amount that is indexed annually for inflation (\$165,000 in 2004). I.R.C. § 415(b)(1)(B); § 415(b)(3).
- F. Nondiscrimination Rules. A qualified plan may not discriminate in favor of highly compensated employees either by design or in operation. I.R.C. § 401(a)(4). Detailed and complex regulations provide tests that must be met **each year** and safe harbors that can be incorporated into the plan to show that impermissible discrimination does not exist in a plan or group of plans. The plan must not discriminate with respect to the amount of contributions or benefits under the plan. Treas. Reg. § 1.401(a)(4)-1(b)(2). In addition, the benefits, rights and features provided under the plan must be available to employees in a non-discriminatory manner. Finally, the effect of plan amendments and terminations must be non-discriminatory.

- G. Distributions from Qualified Plans. Employees are not subject to income taxes on their interest in a qualified plan until the assets are distributed to them. The plan may provide for distribution in the form of a lump sum, in installment payments, or in the form of an annuity. Different methods of distributions have different tax consequences. Distributions must begin when an employee reaches age 70 1/2, unless he or she is still employed, or after the death of the employee. Certain minimum distribution rules govern how rapidly benefits must be distributed from the plan in those instances.

Employees who receive distributions from a qualified plan upon termination of service with the employer will be subject to a 20% withholding of income tax unless the plan distribution is directly transferred to another qualified plan or individual retirement account. I.R.C. § 3405(c)(1)(B). In addition, employees who receive distributions before attaining age 59 1/2 may be subject to a 10% penalty, in addition to the income tax owed on the distribution. I.R.C. § 72(t)(1). There are exceptions to this rule, however. See I.R.C. § 72(t)(2). Additional excise taxes may also apply if the employee does not take a large enough distribution (See I.R.C. § 4974).

## V. INFORMATION AND REPORTING REQUIREMENTS

- A. What Does ERISA Require? Some of the more important of ERISA's information and reporting requirements are discussed below.
1. Written Plan Document. Each employee benefit plan must be evidenced by a written document that sets forth the terms of the plan. See ERISA § 402(a)(1). The written plan may consist of more than one document.
  2. Trust Document. All assets of an employee benefit plan must be held in trust by one or more trustees. See ERISA § 403(a). For purposes of this requirement, it is important to identify what are "plan assets." For example, if a plan is unfunded, has no assets, and benefits are payable solely from a corporation's general assets, the plan does not have to establish a trust. See, e.g. *Patti v. R.H. Macy & Co.*, 1987 WL 13278 (S.D. NY 1987).
  3. Plan Audit. An employee benefit plan that has 100+ participants is required to be audited by an independent qualified public accountant each year unless exempted from ERISA's annual report requirements. See ERISA § 103(a)(3)(A); 29 USCA § 1023(a)(3)(A). See II.A.5.a. and c. of this outline for a discussion of the applicable exemptions.

Small plans (less than 100 participants) are required to file a report of an independent qualified public accountant unless at least 95% of the plan's assets are held by certain financial institutions or the plan meets a bonding requirement. Labor Reg. § 2520.104-41(c).

4. Summary Plan Description. Employers are required to provide a plain-English description of each benefit plan to each participant and beneficiary receiving benefits within 4 months of the adoption of the plan (for new plans) and within 90 days after an individual becomes a participant or beneficiary in the plan (for new participants), and file a copy of the SPD with the Department of Labor if so requested. *See* ERISA §§ 101(a)(1), 102(a)(1), 104(b)(4), 101(b)(1), 104(a)(1)(C); 29 USCA §§ 1021(a)(1), 1022(a)(1), 1024(b)(4), 1021(b)(1), 1024(a)(1)(C). SPDs must be updated at least every 5 years if the plan has been amended during that time, and in any event must be updated at least every 10 years. *See* ERISA § 104(b)(1); 29 USCA § 1024(b)(1).

Summary of Material Modifications. The SPD must be updated for any changes in the terms of the plan within 7 months after the end of the plan year in which the change is adopted. However, any material reduction in benefits under a group health plan must be communicated to participants within 60 days after the adoption of the change. Changes to the plan are communicated by delivering a Summary of Material Modifications to each employee. *See* ERISA §§ 101(a)(2), 102(a)(1), 104(b)(1); 29 USCA §§ 1021(a)(2), 1022(a)(1), 1024(b)(1). An employer that updates the SPD in a timely manner to reflect the change need not prepare a separate Summary of Material Modifications. *See* Labor Reg. § 2520.104b-3(b).

5. Annual Report. Each year, an employee benefit plan subject to the reporting requirements of ERISA (*see* II.B.5.) must file an Annual Report with the IRS, which shares the information with the Department of Labor, and if the plan is a defined benefit pension plan, with the Pension Benefit Guaranty Corporation. *See* ERISA §§ 101(b)(4), 103(a)(1)(A), 4065; 29 USCA §§ 1021(b)(4), 1023(a)(1)(A). This report, filed on the Form 5500 series of forms issued by the IRS, fulfills the requirement found in ERISA and the Internal Revenue Code that each benefit plan file an annual report. *See* Treas. Reg. §301.6058-1(a); Labor Reg. §§ 2520.103-1, 2520.104a-1(a); PBGC Reg. § 2611.3(c). It is due by the last day of the 7th month following the end of the plan year, unless an extension has been obtained (July 31 for a calendar year plan).
  - a. Form 5500. In general, all plans are required to file Form 5500 each year, with the appropriate schedules. *See* Labor Reg. § 2520.103-1(b).
  - b. Forms can be downloaded from the IRS website at [www.irs.gov](http://www.irs.gov). Click on Forms and Publications and enter “5500” as the form number.

- c. Exemptions for Certain Welfare Benefit Plans. Certain welfare benefit plans are exempt from ERISA's requirement of filing an annual report. The most important of these exemptions are:
  - i. Plans that covered fewer than 100 participants at the beginning of the plan year if the plan is fully insured, unfunded, or a combination of fully insured and unfunded. *See* Labor Reg. § 2520.104-20.
  - ii. Plans that have 100 or more participants and that are part of a specified group insurance arrangement, but only if the annual report is filed by the trust or other entity that holds the insurance contracts. *See* Labor Reg. § 2520.104-43.
  - iii. Unfunded or insured plans maintained for a select group of management or highly compensated employees, provided that such plans comply with a simplified alternative method of reporting described in Labor Reg. § 2520.104-23. (Exhibit A) *See* Labor Reg. § 2520.104-24.
  - iv. Plans that cover only (A) an individual or an individual and his/her spouse, who wholly owns a trade or business (whether incorporated or not), or (B) partners or partners and their spouses in a partnership. Labor Reg. § 2510.3-3(b).
- 6. Summary Annual Report to Participants. Each year, the employer must summarize the information on the Form 5500 series and provide it to each participant covered under the plan and to each beneficiary receiving benefits. *See* ERISA §§ 101(a)(2), 104(b)(3); 29 USCA §§ 1021(a)(2), 1024(b)(3). This requirement is generally met in the form of a Summary Annual Report (“SAR”), which must be provided to plan participants and beneficiaries within 9 months after the close of the plan year. *See* Labor Reg. § 2520.104b-10(c). As with Form 5500 filings discussed above, some plans, particularly unfunded welfare benefit plan and welfare plans with fewer than 100 participants, are generally excepted from having to distribute SARs.
- 7. Maintenance of Plan Records. Employers are required to keep all records and data, including vouchers, worksheets, receipts, and applicable resolutions, to enable the verification of the accuracy of the reports, certifications and descriptions filed with respect to ERISA plans. *See* ERISA § 107. Even if a plan is exempt from certain reporting and disclosure requirements, it is not exempt from the retention of records requirement. Employers must also maintain records with respect to each of its employees sufficient to determine the benefits due, and must supply

those records to the plan administrator (if the plan administrator is not the employer). *See* ERISA § 209(a)(1).

B. What Does the Internal Revenue Code Require?

1. Pension Benefit Plans.

- a. Annual Information Returns. The Internal Revenue Code also contains a requirement that pension, annuity, stock bonus, profit sharing and other funded deferred compensation plans must file an annual return giving information concerning the qualification, financial condition and operations of the plan. *See* I.R.C. § 6058(a). This return requirement is met by filing the Form 5500 series of forms discussed above. The term "funded deferred compensation plans" includes tax-sheltered annuities under I.R.C. §403(b)(7) and funded governmental and church plans, whether or not qualified. *See* Treas. Reg. § 301.6058-1(a)(2). Exemptions to the annual return requirement are available, and are comparable to the exemptions to ERISA's annual report requirement discussed at V.A.5.c. These exemptions are listed in the instructions to Form 5500.

2. Welfare Benefit Plans.

- a. Annual Reports. The rules discussed above concerning annual information returns for pension plans also apply to welfare plans.
- b. Information Returns Under I.R.C. Sec. 6039D. In the past, certain fringe benefit plans were required to file information returns by Section 6039D of the Internal Revenue Code. Plans under Sections 79 (group term life insurance), 105 and 106 (accident and health plans), 125 (cafeteria plans), 127 (educational assistance plans), 129 (dependent care assistance plans, and § 137 (adoption assistance plans) were required to file these returns, which were filed on Schedule F to Form 5500.

Previously, the IRS has announced that until further notice, annual information returns do **not** need to be filed for fringe benefit plans described in I.R.C. §§ 79, 105, 106 and 129, leaving cafeteria plans under I.R.C. §125, educational assistance plans under I.R.C. § 127 and adoption assistance plans under I.R.C. § 137 as the only specified fringe benefit plans required to file information returns under I.R.C. § 6039D. *See* Notice 90-24, 1990-13 I.R.B. However, on April 8, 2002, the IRS announced that employers maintaining these types of plans no longer need to file annual information returns on Schedule F to Form 5500. This applies to all past plan years for which information returns were filed, too.

C. Reporting Requirements Under the Securities Laws.

1. Disclosure of Executive Compensation. If a company's stock is registered with the Securities and Exchange Commission, the company is required to disclose the compensation of certain executive officers and directors in registration, proxy and information statements and in annual reports. The rules governing this reporting require comprehensive disclosures. The goal is to disclose executive compensation in a way that can be deciphered by the reader of the applicable statement or report, so that the use of charts, graphs and narrative is now required to describe compensation schemes. The executive compensation disclosure rules are contained in the SEC's Regulation S-K, and can be found at 17 C.F.R. § 229.402, and for small business issuers, in Regulation S-B, 17 C.F.R. § 228.402.
2. Section 16 of the Securities Exchange Act of 1934. Shares of the employer's stock held for the benefit of a participant in an employee benefit plan may be subject to the reporting requirements of Section 16 of the Securities Exchange Act of 1934 when those securities are acquired or sold. In certain circumstances, trust holdings of the employer's stock and transactions in that stock may need to be reported by the trustee of the trust, and perhaps by the plan participant for whom the securities are held. Reporting is done on SEC Forms 3, 4, and 5. While the due date for filing appropriate Section 16 forms was generally the 10th day of the month following the month of the transaction, effective August 29, 2002, the Sarbanes-Oxley Act significantly accelerated the filing deadline for filing Form 4. A Form 4 must now be filed by the end of the second business day following the day of the transaction. Because the failure to file timely reports during the year may result in fines as well as additional disclosures that must be made in the company's proxy, it is important that all registered companies become familiar with the requirements of Section 16.

**VI. IMPORTANT ISSUES IN PLAN ADMINISTRATION**

- A. Pension Benefit Plans. Several areas may be trouble spots for employers in the administration of their pension benefit plans, particularly if they administer the plans themselves. Since these problems can affect the qualified status of the plan, they should be identified and corrected if possible.
  1. Maximum Contribution Limits Under I.R.C. § 415. Section 415 of the Code limits the amount that can be contributed each year to a qualified defined contribution plan on behalf of a participant to the lesser of \$40,000 or 100% of the participant's compensation. *See* I.R.C. § 415(c)(1). For plan years beginning prior to December 31, 2001, the limit was the lesser of \$30,000 or 25% of a participant's compensation. A defined benefit plan must provide that the maximum annual lifetime

annuity benefit that a participant can accrue under the plan is no more than the lesser of \$90,000 (indexed for inflation), or 100% of the participant's average compensation for his highest paid three consecutive year period. *See* I.R.C. §§415(b)(1), (b)(3). Although the increased limits have eased the problem somewhat, through oversight or ignorance, employers sometimes violate these requirements, risking disqualification of the plan. This is particularly true when the employer sponsors multiple plans, although this risk has decreased since the combined plan limits of I.R.C. § 415(e) were repealed for plan years after 1999.

2. Non-discrimination testing. Qualified retirement plans must not discriminate in favor of highly compensated employees. Regulations under Section 401(a)(4) of the Internal Revenue Code provide complex testing rules and safe harbors that an employer's plans must satisfy in order to prove that they do not discriminate in violation of the Code.
  - a. Defined Contribution Plans. A defined contribution plan may not discriminate in favor of highly compensated employees in the amounts contributed to participant accounts. The regulations provide three safe harbor methods of allocating contributions (*see* Treas. Reg. §§ 1.401(a)(4)-2(b)(2), -2(b)(3), 1.401(a)(4)-8(b)(3), as well as detailed methods of general testing and cross testing for plans that do not meet one of the safe harbors. *See* Treas. Reg. § 1.401(a)(4)- 2(c)(1).
  - b. Defined Benefit Plans. Benefits provided under a defined benefit plan must not discriminate in favor of highly compensated employees. By testing either a plan's contributions or benefits, a plan can show that it is non-discriminatory in amount. *See* Treas. Reg. § 1.401(a)(4)-1(b). Several safe harbor plan designs are available to show that a plan's benefits are non-discriminatory in amount. *See* Treas. Reg. § 1.401(a)(4)-3(a)(1). In the alternative, a complicated general test must be undertaken, which involves the determination and comparison of actual benefits under the plan. *Id.* More complicated alternative methods of showing non-discrimination are also available if a plan does not meet a safe harbor or satisfy the general test.
3. 401(k) Testing. Plans under I.R.C. § 401(k) must satisfy additional discrimination tests each year. The "ADP test" (for actual deferral percentage), compares the contributions to the plan of the highly compensated employees as a group to the contributions of the non-highly compensated employees as a group. It is not uncommon for the highly compensated employees ("HCEs") to want to make the maximum contribution possible to the 401(k) plan, but without sufficient support (in the form of plan participation) by the non-HCEs, violations of I.R.C. § 401(k)(3)(A) will occur, and the plan will be disqualified.

In general, a 401(k) plan is not discriminatory if either of the following tests is met:

- a. The 1.25 Test. The actual deferral percentage of the eligible HCEs as a group may not be more than the actual deferral percentage of all other eligible employees multiplied by 1.25; **OR**
- b. The 2.0 Test. The excess of:
  - i. the actual deferral percentage for the group of eligible HCEs over
  - ii. the actual deferral percentage for the group of all other eligible employees,

is not more than 2 percentage points, **and** the actual deferral percentage for the group of eligible HCEs is not more than the actual deferral percentage for the group of all other eligible employees, multiplied by 2.

*See* I.R.C. § 401(k)(3)(A).

A similar test, the “ACP test” (for annual contribution percentage), must also be performed if the employer provides matching contributions or the plan permits employees to make after-tax contributions. *See* I.R.C. § 401(m)(2).

Proper 401(k) plan administration requires periodic testing of the plan each year to make sure that the contributions of the HCEs as a group are within the limits set by I.R.C. § 401(k)(3)(A). If problems are encountered, they can often be corrected by reducing the deferral percentages of the HCEs, or by making additional contributions to the plan, or by returning excess contributions to the participant. *See* I.R.C. § 401(k)(8); Treas. Reg. §§ 1.401(k)-(1)(f)(3), -(1)(f)(4), -(1)(f)(7). These corrective steps must be completed before the close of the following plan year, and may necessitate the filing of an amended tax return by the affected participant.

Employers can avoid some of these testing issues by adopting a “safe harbor” 401(k) plan under I.R.C. § 401(k)(12). In return for providing a minimum level of employer contributions and 100% vesting in participant accounts, 401(k) plans that meet the requirements of § 401(k)(12) are automatically deemed to pass the discrimination tests.

4. Annual Reports for "Top Hat" Plans. Certain unfunded or insured plans maintained for a select group of management or highly compensated

employees are exempt from ERISA's requirement to file an annual report, provided that such plans comply with a simplified alternative method of reporting described in Labor Reg. § 2520.104-23. (Exhibit A). *See* Labor Reg. § 2520.104-24. This one-time filing is often overlooked, subjecting the plan to ERISA's regular annual reporting rules.

5. Qualified Domestic Relations Orders ("QDROs"). In general, a participant's benefit under a qualified retirement plan may not be assigned, alienated, pledged, hypothecated or encumbered in any way. An exception to that general rule is made for distributions from the plan that are made pursuant to a qualified domestic relations order ("QDRO"). *See* I.R.C. § 414(p). If the plan receives a domestic relations order that creates or recognizes the existence of the right of a third party, called the alternate payee, to receive all or a portion of the participant's benefits under the plan, the plan is required to honor that order. An employer must have a procedure in place to evaluate any domestic relations order it receives, in order to determine whether it is in fact a qualified order, and the first person they usually call when they receive one is their attorney. Domestic relations orders not satisfying the requirements of a QDRO can not be honored.
6. Mandatory Withholding on Distributions from Qualified Plans. The Unemployment Compensation Amendments Act of 1992 ("UCA") changed the law regarding income tax withholding on qualified plan distributions and the rollover of qualified plan distributions to IRAs or to another plan. In general, under these rules, for plan distributions made after December 31, 1992, the plan administrator must advise the participant (or beneficiary) receiving a distribution of the right to have the plan transfer an "eligible rollover distribution" directly to another qualified plan or directly to an IRA the participant designates. If the participant elects not to have the plan make a direct rollover of an eligible rollover distribution, the distribution is subject to a mandatory 20% withholding requirement, and the plan must transmit the withheld amount to the IRS. The plan administrator must obtain the participant's written election with respect to the direct transfer option before the distribution is made. The IRS has provided a notice that meets the requirements of the law. Plans must comply with the notice and election requirements in order to maintain the plan's qualified status.
7. Avoiding Disqualification Due to Operational Defects. Since 1991, the IRS has been taking steps to encourage sponsors to identify and correct operational defects that threaten the qualified status of the plan. The idea is to help sponsors identify past problems, correct them, and operate the plan correctly in the future, all with sanctions less severe than outright disqualification or the usual fines that the IRS might assess if operational failures were discovered on audit. In Rev. Proc. 98-22, the IRS combined all of its previously established correction programs for qualified plans

under the name “Employee Plans Compliance Resolution System”, or “EPCRS”. *See* Rev. Proc. 98-22, 1998-12 I.R.B. 11. The program was further refined and streamlined again in Rev. Proc. 2003-44. *See* Rev. Proc. 2003-44, 2003-25 I.R.B. 1051. These programs include two voluntary programs, and a program to correct defects found on audit. There is also a voluntary correction program for tax-sheltered annuity plans under I.R.C. § 403(b) and one for simplified employee pension plans. These correction programs have changed in response to taxpayer comments over the years, and the IRS has indicated a willingness and intent to update EPCRS annually.

a. Voluntary Correction Programs. The IRS’ voluntary correction programs encourage plan sponsors to come forward when they identify problems in plan administration, and fix those problems. To encourage such “true confessions”, sanctions are often much less than if the problem had been discovered by the IRS on audit.

i. Self-Correction Program (“SCP”). This program is available to correct fairly routine **operational** violations in qualified plans without directly involving the IRS. The use of the SCP Program is limited or prohibited when plan amendments are required for corrections, when there have been failures to timely amend the plan for changes in the law, or for violations relating to the misuse or diversion of plan assets, among other things. Employers using EPCRS must demonstrate that they have established procedures and practices that are designed to promote compliance with the qualification requirements of I.R.C. § 401(a). Using the procedure, the employer must make full correction of the error for each year the defect exists. It must also restore current and former participants and their beneficiaries the benefits and rights they would have had if the mistake had not occurred.

Under SCP, a plan sponsor can correct “insignificant” operational defects at any time. “Significant” operational failures, however, must be corrected by the end of the second year following the year in which the failure occurred. *See* Rev. Proc. 2003-44, § 9.02, 2003-25 I.R.B. 1064.

ii. Voluntary Correction Program (“VCP”). This program allows a plan sponsor to correct **operational** defects and be assured that the plan will not be disqualified for those defects. In recent years, the program has been expanded as to the types of defects that can be corrected under the program. Sponsors pay a fixed compliance fee and receive

a compliance statement from the IRS describing the corrections to be made. If the sponsor makes the corrections in a timely manner, the IRS will treat the plan as qualified.

As part of VCP, the IRS provides standardized “fixes” for certain commonly-encountered operational defects, such as (a) failure to provide the minimum top heavy benefit under I.R.C. § 416; (b) failure to satisfy the nondiscrimination tests of I.R.C. §§ 401(k)(3), 401(m)(2), or 401(m)(9); (c) failure to distribute elective deferrals in excess of the Code § 402(g) limit; (d) exclusion of an eligible employee from plan participation; (e) failure to timely pay the minimum distribution required under § 401(a)(9); (f) failure to obtain participant and/or spousal consent for a distribution subject to the consent rules of §§ 401(a)(11), 411(a)(11) and 417; and (g) failure to satisfy the § 415 limits in a defined contribution plan. *See* Rev. Proc. 2003-44, Appendix A, 2003-25 I.R.B. 1072. Anonymous (John Doe) and Group Submissions are also permitted.

- iii. Correction of Defects in 403(b) and Simplified Employee Pension (“SEP”) Plans. The EPCRS also offers voluntary correction programs for operational defects in 403(b) plans and simplified employee pension plans, SIMPLE plans, and audit corrections through Audit CAP (discussed below). *See* Rev. Proc. 2003-44, § 1.03, 2001-25 I.R.B. 1055.
  - b. Audit Correction Program. EPCRS also contains a correction program for defects discovered on audit. This program, known as the Audit Closing Agreement Program, or “Audit CAP,” gives IRS field agents the flexibility to negotiate a closing agreement with a plan sponsor under audit as an alternative to plan disqualification. It is available for all types of qualification failures found on audit.
8. Failure to File Annual Reports. The DOL has instituted a Delinquent Filer Voluntary Compliance Program (“DFVC”) for delinquent filers of annual reports on the Form 5500 series. This program uses reduced civil penalties to encourage delinquent plan administrators to comply with their plans’ annual reporting obligations. In order to participate, a plan administrator must enter the program before the Department of Labor notifies the administrator of a failure to file a timely annual report. Plan Administrators who fail to file a timely annual report and do not participate in the DFVC Program may be assessed a penalty of up to \$50 per day, without limit, for each day the report is late. Nonfilers who fail to

file any annual report may be assessed a penalty of up to \$300 per day up to a maximum of \$30,000 per year, until a complete annual report is filed.

The DFVC Program offers plan administrators the chance to file late reports at significantly reduced penalties. Under the DFVC Program, penalties are limited to \$10 per day capped at a maximum fee of \$750 for small plans (i.e., generally those with less than 100 participants) and \$2,000 for large plans. There is also a “per plan” filing cap of \$1,500 for small plans and \$4,000 for large plans regardless of the number of annual reports which were missed. However, there is no “per sponsor” or “per plan administrator” cap available for sponsors who have failed to file annual returns for multiple plans. In such cases, the retroactive adoption of a separate “Wrap Plan” may be used to limit multiple plan filing omissions into a single plan omission and qualify the plan sponsor for the “per plan” cap. *See* 67 Fed. Reg. 15052 (March 28, 2002).

Failure to file annual reports occurs most often with respect to “severance policies”, which employers do not realize are ERISA welfare benefit plans, with “top hat” plans for executives, and with other minor welfare benefit programs (e.g., vision plans, dental plans, etc.). While insurers and third party administrators (“TPAs) often help plan administrators in preparing or filing Form 5500s for group health and other plans, such services often are not included in the general services provided by TPAs thus it is good idea to confirm that Plan Administrators are aware of, and have been complying with, the Form 5500 filing requirements for all ERISA plans, even if large insurers or TPAs routinely assist in the administration of the plans.

Administrators of “top hat plans” who failed to make the one-time filing with DOL required to obtain relief from annual reporting requirements on such plans, as described in VI.A.4. above, may get back into the good graces of DOL by participating in the DFVC program. This is done by completing and filing the one-time filing generally required to exempt “top hat” plans from the ERISA reporting and disclosure obligations as well as filing page 1 of Form 5500, and paying a penalty of \$750. This penalty applies regardless of the number of plans maintained by the same plan sponsor or the number of plan participants. A plan sponsor maintaining more than one top hat plan is not required to file a separate statement for each plan.

Note that participation in the DFVC program does not preclude the assessment of non-filing or late filing penalties by other federal agencies, such as the IRS. However, the IRS has generally indicated that it will suspend assessment of late-filing or similar penalties for plans participating in the DOL’s DFVC Program.

9. Breach of Fiduciary Duties. On March 15, 2000, the Department of Labor announced the establishment of an interim Voluntary Fiduciary Correction (“VFC”) Program. This program is modeled after the DFVC Program but designed to encourage plan sponsors to identify and correct breaches of fiduciary duties under Title I of ERISA rather than late annual return filings. On April 29, 2002, the DOL issued final VFC Program rules and guidelines that became effective April 29, 2002. *See* 67 Fed. Reg. 15062 (March 28, 2002).

Plan sponsors may use VFC if the plan is not currently under investigation by the DOL **and** there is no evidence of criminal activity. The sponsor must file an application identifying the fiduciary breach and the correction to be made. Corrections are specified by the DOL in the VFC announcement, and are not negotiable. If the requirements for the program are met, DOL will issue a “no-action” letter with respect to the identified breach only. Note that a DOL no-action letter does not shield the plan or its fiduciaries from any criminal investigation or IRS enforcement action.

Transactions available for VFC relief include: (a) delinquent participant contributions; (b) loans to parties-in-interest; (c) certain loans at below market interest rates; (d) purchases or sales of assets from or to a party-in-interest; and (e) issues associated with fiduciary compensation.

Further information regarding the VFC program can be found in the final announcement published at 67 Fed. Reg. 15062 (March 28, 2002) as well as on the U.S. Department of Labor’s website at [www.dol.gov/ebsa](http://www.dol.gov/ebsa).

## B. Welfare Benefit Plans.

1. Consolidated Omnibus Budget Reconciliation Act (“COBRA”) Compliance. Employers with 20 or more employees on a typical business day during the year who sponsor health plans (other than governmental and church plans) are required to offer participants and their covered dependents the opportunity to continue coverage under the plan at their own expense in the event of certain “qualifying events.” Examples of qualifying events are the employee's termination of service or reduction of hours, divorce or legal separation, bankruptcy of the employer (and in some cases the employee), or a dependent child's “aging out of the plan.” The purpose of COBRA's continuation coverage requirements is to avoid the sudden loss of health insurance by workers and their families, and has been construed liberally to effect that intent. Employers are charged with providing notices to employees and their dependents regarding the availability of coverage, cost involved, length of coverage, and the time for making the appropriate elections. Employers subject to COBRA that do not have adequate compliance procedures in place run the risk of being forced to pick up coverage for persons who did not receive appropriate notices, often at significant costs to the employer and its plan. The rules

governing COBRA continuation coverage are numerous, and can be found in I.R.C. § 4980B.

It should also be noted that although employers with fewer than 20 employees are exempt from federal COBRA requirements, most states, including North Carolina, have comparable state group health continuation coverage rules and requirements (often referred to as “mini COBRA” or “state COBRA” rules) that apply to all employers regardless of size. As a result, state group health continuation coverage and/or group health insurance conversion privileges must be considered for small employers that escape the federal COBRA rules.

2. Failure to File Annual Reports. The DOL delinquent filer program also applies to welfare benefit plans. It is discussed at VI.A.8. above.
3. Health Insurance Portability and Accountability Act of 1997 (“HIPAA”) Compliance. Effective for plan years beginning after December 31, 1997, the provisions of the Health Insurance Portability and Accountability Act of 1996 (“HIPAA”) require employers who offer group health coverage to employees to amend their plans to include new levels of protection for employees. The most important of these new requirements from a compliance standpoint is the requirement that employers issue certificates of coverage to all employees and their covered dependents when their coverage under the health plan ends. These certificates show the period the employee or dependent was covered under the group health plan.

Upon presentation to a new employer, the certificate can be used to reduce or eliminate the new health plan’s pre-existing exclusion conditions for certain medical conditions the covered person might have before enrolling in the new plan. Thus, the person’s health insurance becomes “portable” from employer to employer. Employers need to have in place compliance procedures that will allow them to issue certificates of coverage to terminating employees, and to properly review certificates presented to them by new employees, to avoid violating the provisions of HIPAA. In addition, employees must be notified of their rights under HIPAA, either through a separate notice or an updated summary plan description for their health plan.

Beginning April 14, 2003 large health plans (i.e., generally those with more than \$5 million in annual receipts) became subject to the HIPAA Privacy Rule regulating covered health plans’ use and disclosure of participants’ protected health information (“PHI”). Small health plans became subject to the HIPAA Privacy Rule on April 14, 2004.

As a result of the new Privacy Rule regulations, health plans were generally required to adopt specific plan amendments relating to the plan’s use of PHI and to develop and adopt detailed HIPAA Privacy Policies and

Procedures governing various plan and human resource operations involving PHI access, uses, and disclosures, etc. In addition, covered health plans were generally required to issue Notices of Privacy Practices to all participants in the plan and to enter into Business Associate (or "BA") agreements with plan vendors and agents who may come into contact with PHI as a result of providing services for the plan. Given the scope of the HIPAA Privacy Rule requirements and the recent compliance deadline, it is likely that many health plans are still working to implement the required changes and may not be fully compliant with the Privacy Rule at this time. Attorneys reviewing benefit issues in the context of mergers and acquisitions should add these new HIPAA Privacy compliance initiatives to their due diligence requests.

## **VII. EMPLOYEE BENEFITS IN MERGERS AND ACQUISITIONS**

- A. Introduction. In the past, employee benefits were seldom dealt with when a company was acquired or sold. Purchase agreements contained a paragraph or two that simply stated what the parties intended to do about benefits. After the deal was closed, the parties determined how to handle the benefit issues, and often found that vague promises to provide "comparable benefits" were easier made than kept. Today, the parties to these transactions (and their attorneys) are more aware of employee benefits, and the provisions of purchase agreements often contain lengthy provisions addressing the fate of seller's plans. Although a thorough discussion of employee benefits in the context of the purchase or sale of a business is beyond the scope of this paper, it is possible to set forth the basic issues a corporate attorney needs to be aware of when negotiating the deal.
- B. Documents to Obtain. The buyer's attorney should request copies of the following documents, preferably early on in the negotiations. A thorough review of the documents will allow for any problems to be addressed in the purchase agreement and perhaps corrected before closing.
1. Plan Documents. Buyer should request copies of all documents evidencing the seller's benefit plans, including plan documents, and any amendments to the plans not yet reflected in the main document. These documents may take the form of formal plan documents, insurance policies and contracts, deferred compensation agreements, etc. Note which benefit plans, if any, are not evidenced by some sort of writing.
  2. Trust Documents. Benefit plans that are funded through a trust should have a separate trust document. Sometimes the trust provisions are incorporated in the plan document, rather than in a stand-alone trust document. You should also ask for copies of any amendments to the trust not reflected in the main document.
  3. Determination Letters for Qualified Plans. Obtain copies of the latest determination letters issued by the Internal Revenue Service on any

qualified plan of the seller. If determination letter applications are pending, you might want to obtain a copy of the application package and any correspondence the seller has had with the Service during the review process. This is particularly true if it is anticipated that the Service will not issue the determination letter before closing and the buyer is assuming or continuing the seller's plan.

4. Summary Plan Descriptions and Summaries of Material Modifications. Obtain copies of the most recent Summary Plan Descriptions prepared for each of seller's benefit plans, as well as any Summaries of Material Modifications to those plans.
5. Annual Reports (Form 5500 Series). Obtain copies of the most recent annual reports filed on the Form 5500 series for each of seller's plans, along with all accompanying schedules. Also ask for copies of any correspondence with the IRS with respect to any previous year's filing, if the matter or question has not been resolved.
6. Actuarial Reports for Defined Benefit Plans. If the seller maintains a defined benefit pension plan, obtain copies of the most recent actuarial report on the plan.
7. Employee Handbooks or Manuals. Obtain a copy of any employee handbook or personnel manual distributed to employees by the seller. These often contain descriptions of less formal benefit programs that are not evidenced by other written plan documents.
8. Copies of any notices or communications that have been given to employees concerning the benefit plan in question. Ask for copies of recent communications with employees concerning the benefit plans that are not reflected in or incorporated in the documents obtained in 1 - 7 above.
9. Financial Statements for Retirement Plans. Obtain copies of the most recent financial statements for the plan. If the plan is not subject to the audit requirements of ERISA § 103(a)(3)(A) (see V.A.3. of this outline), the only financials may be those contained in Form 5500 or 5500-C filed with respect to the plan.
10. Reports filed with governmental agencies, such as PBGC. In addition to the annual reports discussed above, obtain copies of any other filings with governmental agencies, such as the annual premium filing made for a defined benefit plan with the Pension Benefit Guaranty Corporation.
11. Results of non-discrimination testing. Ask to see the results of any special testing done to the plan to comply with discrimination, contribution limit,

or minimum participation rules covering qualified plans and certain welfare plans, such as self-insured health plans and cafeteria plans.

12. Agreements with investment advisors, plan administrators, and other service providers. If the plan employs a plan administrator or investment advisor, ask to see copies of the agreements with those service providers.
  13. Fiduciary liability insurance and bond. Obtain copies of any fiduciary liability insurance policies, and evidence that plan fiduciaries are properly bonded as required by ERISA.
  14. Documentation relating to any pending controversies or audits. If the plan is currently being audited or has recently been audited, ask to see documents and correspondence related to the audit. Similarly, if the plan is involved in litigation, or litigation is threatened, obtain the necessary documents to assess the situation.
  15. Collective bargaining agreements. If the seller has any collective bargaining agreements, ask to review them to see what provisions are made for employee benefits.
- C. Representations and Warranties. The buyer will typically ask the seller to give representations and warranties regarding seller's benefit plans. The seller should always review these carefully, and edit them accordingly. For example, a purchase agreement will often contain reps and warranties that seller's plans are in compliance with provisions of ERISA that are applicable only to defined benefit pension plans or to multi-employer (*i.e.*, union) plans. If seller's plan does not fall into these categories, those representations are not applicable and should not be made. In addition, as with any representation and warranty, due diligence should be undertaken to make sure the reps and warranties asked for can be made. For example, a representation that the plan has not engaged in any prohibited transactions with a party in interest in violation of I.R.C. § 4975 and ERISA § 1106 can not be made if the plan has made loans to participants that do not comply with ERISA's specific provisions regarding plan loans, since compliance with those rules is a prerequisite to falling under the plan loan exception to the prohibited transaction rules.
- D. Options with Respect to Pension Benefit Plans. A buyer has three options with respect to the seller's pension benefit plans.
1. Assume or Continue the Plan. The buyer may choose to continue the seller's plan as the successor employer. This may be done by maintaining the plan as a separate plan, or by merging it into a similar plan maintained by the buyer.
  2. Terminate the Plan. The buyer and seller may decide to terminate the plan. In this case, if the plan is a pension benefit plan, participants

become 100% vested in their accrued benefit under the plan. Appropriate paperwork and reporting must be undertaken with the IRS (and with PBGC if the plan is a defined benefit plan), and assets are distributed to participants, or perhaps rolled over at the participant's direction to an individual retirement account or to one of buyer's plans that has agreed to accept them.

3. Freeze the Plan. If the plan is frozen, no further contributions are made to it if it is a defined contribution plan, and if it is a defined benefit plan, benefits cease accruing under it. Participants are generally 100% vested in their accrued benefit. However, the plan is maintained until all benefits are paid out, as they come due under the terms of the plan (*i.e.*, generally upon the retirement, death, disability or termination of service of the employee). Because the Internal Revenue Code requires qualified plans to meet certain minimum coverage requirements, at some point a frozen plan will run afoul of these rules due to attrition. Also, since a frozen plan continues to require care and feeding in the form of updated documents, annual reports, and disclosures to participants who still have accounts under the plan, this is generally not a preferred option.

- E. COBRA Compliance. The parties should take care to specify in the purchase agreement which party will be responsible for COBRA compliance. This issue can arise with respect to the seller's employees (including former employees) and their dependents who currently have (or should have been offered) COBRA coverage, as well as with respect to seller's employees who will experience a qualifying event as a result of the acquisition. On January 10, 2001, the IRS issued final regulations under COBRA that, among other things, allocate COBRA responsibility in corporate transactions if the purchase agreement or contract does not adequately cover the issue or if the party assigned COBRA liability under the agreement later ceases to provide group health coverage for employees or otherwise fails to satisfy their COBRA obligations. *See* Treas. Reg. § 54-4980B-9.

In the absence of express assignment of responsibility for providing COBRA continuation coverage in the purchase agreement, the regulations generally keep the COBRA coverage obligations with the Seller. However, if the Seller is dissolved or otherwise ceases to sponsor a group health plan after the sale and the Buyer is deemed a "successor employer" under the COBRA rules, then the COBRA coverage obligations for certain of the Seller's former employees (even those terminated and on COBRA prior to the deal) may shift to the Buyer. This is true even in asset deals where the Buyer has not agreed to expressly assume Seller's plans or benefit obligations and liabilities. As a result, COBRA coverage provisions deserve special attention when negotiating purchase agreements. Buyers will frequently request sellers to indemnify them with respect not only to past COBRA violations on the part of seller but with respect to any future expenses related to general COBRA coverage obligations shifted to Buyer as a result of final rules.

EXHIBIT A

DEFERRED COMPENSATION

ERISA MEMORANDUM STATEMENT

DATE: \_\_\_\_\_, 20\_\_

TO: Top Hat Plan Exemption  
Employee Benefits Security Administration  
Room N-5644  
U.S. Department of Labor  
200 Constitution Avenue, N.W.  
Washington, D.C. 20210

FROM: Employer Name: \_\_\_\_\_  
EIN: \_\_\_\_\_  
Address: \_\_\_\_\_

This statement is made with respect to a non-qualified deferred compensation plan is maintained by the Employer identified above under the requirements of 29 C.F.R. § 2520.104-23(a).

The Employer currently maintains \_\_\_\_\_ non-qualified deferred compensation plan(s) for Executives who are members of a “select group of management” or who are “highly compensated”, as follows:

<u>Name of Plan</u>	<u>No. of Participants</u>	<u>Plan Administrator</u>
---------------------	----------------------------	---------------------------

Respectfully submitted,

By: \_\_\_\_\_  
Title: \_\_\_\_\_