ALERT

IMPORTANT EMPLOYEE BENEFIT DEVELOPMENTS
Part 1

May 22, 2008

The employee benefit world has been very active and many of the legislative and regulatory changes could have a **significant impact on your benefit plans**. We have prepared this ALERT to highlight some of the more important recent developments.

This Alert is only one page long. It contains a short list of topics we have chosen to highlight, along with a very brief explanation of each topic. We know you are very busy and the last thing you need is a long, drawn out legal analysis of complex topics that may not affect you. This Alert is intended to just highlight important new developments so you can quickly decide what may or may not apply to you.

Also enclosed with this Alert is a Memorandum that goes into more detail on each topic. It will allow you to read a little more about the issues that affect you. It is also for those of you who are interested in understanding, in more detail, recent IRS and Department of Labor directives.

Here are some of the latest IRS and DOL developments that we feel employers should be aware of:

- **Nonqualified Deferred Compensation Plans - Final 409A Regulations.** These regulations are monumental. They apply to all nonqualified deferred compensation plans. (Note that they do not apply to qualified plans, such as 401(k) plans.) They go into effect next year. The penalties for not complying with these regulations are very severe. If you have not already done so, it is time to evaluate your plans, employment contracts, and other compensation arrangements to determine whether or not they are subject to these rules. If they are, you will probably need to amend your plan documents.

- **Qualified Plan Prototype Restatements.** After spending over two years reviewing the master plan language in defined contribution prototype retirement plan documents that were submitted for review by prototype sponsors across the country, the IRS finally granted its formal approval of those documents last month. Read the enclosed Memorandum to learn about the restatement requirements. If your company utilized the prototype document sponsored by Hinkle Elkouri, you should have already received an update on this topic in the mail. If for some reason you did not, please contact us as soon as possible.

- **401(k) Deposit Timing Rules.** The DOL recently issued proposed regulations that clarify the deadline - and establish a safe harbor time period - for employers maintaining "small" retirement and/or welfare benefits plans (i.e., plans with fewer than 100 participants) to deposit employee contributions into the plan. The proposed rules, discussed in the enclosed Memorandum, provide that an employer will be deemed to have timely transferred employee contributions into the plan if such contributions are deposited within seven days of the date of withholding.

For those of you who would like to know more about these developments, we hope the enclosed Memorandum is useful to you. If you have any questions about any of these developments or would like to discuss any of these topics in further detail, please feel free to call Eric Namee or Steven Smith at (316) 267-2000.

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May 22, 2008

MEMORANDUM

Important Employee Benefit Developments to Consider in 2008: Part 1

The employee benefits world has been very active over the past year. There have been numerous legislative and regulatory changes that have a significant impact on many employee benefit plans. This Memorandum is intended to address what we view as some of the more important developments affecting our clients. It is certainly not intended to be a comprehensive analysis. What we have tried to do is pick out and highlight the changes that are most likely to directly affect the majority of our clients. In order to keep this at a manageable length, this is the first in a three part series. We hope it is useful to you.

I. NONQUALIFIED DEFERRED COMPENSATION PLANS - FINAL 409A REGULATIONS

When Congress enacted Section 409A of the Internal Revenue Code (the "Code") back in 2004, it made sweeping changes to the rules governing "nonqualified deferred compensation plans." These changes are easily the most extensive changes in this area since the Code itself was first enacted in the early years of the Twentieth Century.

At the outset, it is important to note that the Code § 409A rules do not apply to *qualified* plans, such as 401(k) plans, profit sharing plans, defined benefit plans, and ESOPs. Code § 409A also does not apply to the following plans: (i) qualified annuity plans under Code § 403(a); (ii) annuity, custodial account, and retirement income plans under Code § 403(b); (iii) SEPs and SARSEPs under Code § 408(k); (iv) SIMPLE IRAs under Code § 408(p); (v) Code § 457(b) plans; (vi) bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans; (vii) Archer Medical Savings Accounts under Code § 220; and (viii) Health Savings Accounts ("HSAs") under Code § 223. Instead, Code § 409(A) applies to "nonqualified" plans as describe in detail below under item 1.

Although Code § 409A went into effect at the beginning of 2005, its full impact has not yet been felt. For the past three and a half years, we have been operating within an official transition period while waiting for final IRS guidance. During this transition period, plans have been required to operate in "good faith operational compliance" with Code § 409A, but formal plan amendments have not been required. That will soon change!

After a long wait, the final Treasury Regulations were published in April 2007 and will become effective on January 1, 2009. Thus, the current transition period will end at the end of this year, and it is imperative that all plans be in full compliance with the final regulations by that time. As described in more detail below, the penalties for non-compliance are nothing short of draconian.

In response to the final Treasury Regulations, we would suggest that employers do the following *as soon as possible*:

1. **Evaluate Plans, Contracts, and Arrangements.** Evaluate all plans, contracts, and arrangements that may be subject to Code § 409A to determine whether they need to be amended to comply with the final Treasury Regulations. Any plan, contract, or other compensation arrangement that makes a promise in one year to make a payment to an employee or executive in a future year – even if the payment is conditioned on certain things happening in the future – is potentially subject to Code § 409A. This includes the following types of plans, contracts, and arrangements:

   - **Excess Benefit Plans** that attempt to "make up" the benefits that a participant might "lose" under a "qualified plan" as a result of various limits found in the Code (such as "wraparound 401(k) plans," "excess 415 plans," or "pension benefit restoration plans");

   - **Supplemental Executive Retirement Plans** (also known as "top hat plans") that allow a "select group of management or other highly compensated employees" to defer the receipt of compensation separately from or outside of a "qualified" retirement plan (such as a 401(k) plan);

   - **Share (or Stock) Appreciation Right Plans ("SARs")** that allow the participant to receive the difference in the value of a specified number of shares between the date the SAR rights were granted and the date they were exercised;

   - **"Phantom" Stock Plans** (also known as "Shadow" Stock Plans or Stock Participation Plans) that provide a "select group of management or other highly compensated employees" with the economic benefits of ownership without giving up actual ownership;

   - **Code § 457(f) Plans** (also known as "ineligible deferred compensation plans") that are offered by tax-exempt and governmental entities, including deferral arrangements in individual contracts (but <u>not</u> 457(b) plans);

   - **Certain retention plans** that provide for bonuses if employees or executives remain employed for a number of years;

   - **Long-term or annual incentive plans** that provide for bonuses if an employee or executive meets certain performance standards during a year, a period of years, or a partial year;

   - **Severance pay policies or agreements** that provide severance payments to departing employees or executives; and

   - **Individual contracts of employment** that provide for the payment of compensation after an individual's employment has been terminated, such as those that might be found in the contract of a company officer or executive or in a non-compete agreement.

2. **Amend Documents.** Formally amend plans, contracts, and arrangements to comply with Code § 409A and the final Treasury Regulations. If the plan, contract, or arrangement has never formally been set forth in writing, that is now required. Please note that even if a plan, contract, or arrangement has previously been amended to comply with Code § 409A, it should be reviewed to make sure that the final Treasury Regulations do not require further revisions. The last day to make formal amendments is December 31, 2008. If a plan, contract, or arrangement fails to comply with Code § 409A, even by mistake, three things will happen:

   - *Inclusion in Income.* Amounts that have been deferred under that plan, contract, or arrangement will become includible in the employee's taxable income for the year in which amounts vest;

- *20% Penalty Tax.* Those amounts includible in current taxable income will be subject to a 20% penalty tax, payable by the employee, that is over and above any other taxes the employee owes; and

- *Interest*. Interest will be assessed at the IRS underpayment rate plus one additional percent based on the underpayments that would have existed had the income been included in the taxpayer's taxable income in the year in which the income was first deferred.

Please be aware that the final Treasury Regulations number almost 400 pages and cover a number of different areas, many of which are filled with potential traps for the unwary. The issues covered include:

- **Initial Deferral Elections.** In general, and subject to some exceptions, an employee or the employer must make the initial election to defer compensation before the year in which the services upon which the compensation is based begin to be performed.

- **Timing of Payments.** In general, payments may only be made at a fixed date, under a fixed schedule, or upon any of the following events: separation from service, death, disability, change in control of the employer, or unforeseeable emergency.

- **Anti-Acceleration Rules.** In general, payments of deferred compensation cannot be paid sooner than the time the payment is supposed to be made.

- **Change in Payment Elections.** In general, the time and form of a payment must be elected by the employee or the employer before the year in which services are performed. The time and/or form of payment can be changed later, but the following conditions must be satisfied:

    - The election may not take effect for at least 12 months;

    - The payment must be deferred for at least an additional 5 years, unless the payment is on account of death, disability, or unforeseeable emergency; and

    - Any election related to a payment at a specified time or under a fixed schedule must be made at least 12 months before the date of the first scheduled payment.

This Memorandum provides only a brief overview of the Code § 409A requirements, the types of documents that should be reviewed for compliance with Code § 409A, and the consequences of violating Code § 409A. If you have additional questions or would like us to evaluate and/or amend any plans, contracts, or other arrangements for compliance with Code § 409A, we encourage you to call Eric Namee or Jim Spencer at (316) 267-2000.

II. QUALIFIED PLAN PROTOTYPE RESTATEMENTS

The IRS has adopted new rules regarding the restatement of qualified retirement plans. Under the new rules, plans utilizing pre-approved prototype documents (as most sponsoring employers do) must now restate those documents every six years; plans utilizing non-prototype documents must restate their documents every five years on cycles determined by the last digit of their employer identification numbers.

To put these rules into context, recall that a plan document is required to reflect the rules in the Code and Treasury Regulations as those rules apply to the plan. The problem is that these rules are almost always changing. Nearly every year, Congress has made amendments, both large and small, to the qualification requirements in the Code, and the IRS has issued new regulations. As a result, a document that is up-to-date when adopted will quickly become out-of-date. Congress and the IRS have dealt with this problem, broadly speaking, in two different ways:

- *Remedial Amendment Periods*. First, when Congress changes the rules by amending the Code, it generally (but not always) authorizes a "grace period" of sorts for updating plan documents. This "grace period" is known as a "remedial amendment period." Although an employer is required to follow the new rules as of their effective date in administering its plan, it may generally wait until the end of the current "remedial amendment period" to update its plan documents. By having a remedial amendment period, the IRS has time to fill in gaps in the law by writing new regulations. It also keeps employers from having to amend their plan documents every time Congress passes a new law. The downside is that it can become difficult to keep track of all the instances in which the rules the plan is required to follow are different from the rules that are written in the plan document.

- *"Good Faith" Amendments*. After the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the IRS tried to close the gap between what the law requires and what plan documents say by introducing the concept of "good faith" amendments. A "good faith" amendment represents a sort of "interim" amendment that reflects the broad strokes of a legislative change while leaving the details to be addressed in a more comprehensive amendment that is prepared and adopted after the IRS has issued additional guidance. This more comprehensive amendment usually involves the complete updating and "restating" of the plan document.

In the past, the "remedial amendment period" (*i.e.*, the deadline for restating a qualified plan) was the same for all qualified plans. In an effort to even out its workload and provide some predictability on when plans must be restated, however, the IRS adopted a "staggered restatement" approach.

After spending over two years reviewing the master plan language in defined contribution prototype retirement plan documents that were submitted for review by prototype sponsors across the country, the IRS finally granted its formal approval of those documents last month. All employers sponsoring defined contributions plans (such as 401(k) plans, profit sharing plans and money purchase pension plans) that utilize prototype documents now <u>must restate</u> their plans or risk losing the plan's qualified status. The good news is that the IRS has given employers who sponsor plans plenty of time to restate their documents. The deadline is April 30, 2010. Because it is always a good idea to keep your plan documents as current as possible, we recommend that you not wait until the last minute to restate your plan. Our advice to our clients is that this should be done sooner, rather than later. If your company utilized the prototype document sponsored by Hinkle Elkouri, you should have already received an update on this topic in the mail. If for some reason you did not, please contact us as soon as possible.

III. DEPOSIT TIMING RULES FOR EMPLOYEE CONTRIBUTIONS TO 401(K) PLANS

Recently, the Department of Labor issued proposed regulations establishing a safe harbor time period for employers operating "small" (*i.e.*, less than 100 participants) retirement plans to deposit their employees' contributions into qualified retirement and welfare plans. These regulations resolve an issue of uncertainty that has plagued many employers for years, namely how soon salary deferrals (*i.e.*, money withheld from an employee's paycheck to be contributed to the plan) or plan loan repayments must be transmitted by the employer to the plan. As proposed, the regulations provide that an employer will be deemed to have timely transferred employee contributions into the plan if the contributions are deposited within seven days of the date of withholding (in the case of salary deferrals), or within seven days of the date money is received (in the case of plan loan repayments).

By way of background, the DOL issued "plan asset" regulations in 1988 that established a deadline for employers to deposit employee contributions – usually salary deferrals, but also plan loan repayments – to the employer's qualified retirement plan. After the deadline, the employee contributions are considered plan assets, and the employer's failure to transmit those contributions into the plan is treated as a violation of ERISA's trust requirement, a breach of fiduciary duty, and potentially a prohibited transaction.

The general rule for how quickly the employer must deposit the salary deferrals/employee contributions into the plan is "the earliest date on which such contributions may be reasonably segregated from the employer's general assets." Naturally, what is reasonable for one employer is not necessarily reasonable for another. One way in which the DOL has attempted to address this situation over the years is by adopting various outer limits on the timeliness of employer deposits of employee contributions into the plan. In the 1988 regulations, for example, the DOL provided that in no event could the employer's deposit of the employee contributions occur more than 90 days from the date the amounts are withheld (in the case of salary deferrals) or received (in the case of plan loan repayments) by the employer. In 1996, the DOL amended the outer limit to the 15^{th} business day of the month following the month in which the employee contributions are withheld or received by the employer.

Unfortunately, many employers have focused not on the DOL's *general rule*, but only on its *outer limit*, when depositing employee salary deferrals or loan repayments into the plan. The DOL has repeatedly reminded employers that if they are able to segregate employee contributions from employer assets prior to the outer limit for depositing such funds into the plan, the deposits must be made well before the outer limit has been reached.

With the adoption of the recent proposed regulations, the DOL has entered the fray once again and, at least with respect to "small" plans, offered employers some genuine certainty as to when their deposits of employee contributions will be considered timely. Now, regardless of "the earliest date on which such contributions may be reasonably segregated from the employer's general assets," an employer who deposits the amounts withheld or received into the plan within seven days will be automatically deemed to be in compliance with the regulations. An employer that fails to meet this seven-day time period does not automatically violate the regulations, but that employer will have the burden of demonstrating that it deposited the contributions as soon as reasonably possible, and not later than the outer limit (i.e., the 15^{th} business day of the month following the month in which the employee contributions are withheld or received by the employer).

As noted above, the proposed regulations apply only to "small plans," which the DOL has defined as plans with fewer than 100 participants. Please remember that in calculating the number of "participants" in a 401(k) plan, a "participant" includes any employee who is eligible to make or receive contributions under the plan, even if the employee elects not to participate.

CONCLUSION

The world of employee benefits is constantly in a state of flux. The purpose of this Memorandum is to provide you with a very brief synopsis of some of the more important changes to employee benefit rules that may be of interest to you. It is not a comprehensive analysis or a list of every change that has taken place. Of course, you are always welcome to contact us at any time to discuss the design of your plan and whether any changes are appropriate in order to take advantage of new rules.

If you have any questions about anything discussed in this Memorandum, please feel free to call Eric Namee or Steven Smith at (316) 267-2000.