Pension ANALYST

Important Information Plan Administration September 2005

IRS and DOL Provide Guidance Affecting Qualified Plans

WHO'S AFFECTED These developments affect qualified defined benefit and defined contribution plans, including multiemployer plans and ERISA 403(b) plans. The guidance does not apply to governmental and non-electing church plans, or to non-ERISA 403(b) programs and section 457 plans.

BACKGROUND AND SUMMARY In late 2004 and early 2005, the IRS issued several pieces of guidance relating to the operation of qualified plans, including:

- Guidance regarding abusive plan designs (IRS Memorandum dated October 22, 2004);
- Transition guidance relating to the actuarial assumptions used to determine maximum benefit amounts payable under certain forms of payment from defined benefit plans (Notice 2004-78); and
- Proposed rules that officially delay the effective date of the "relative value" rules.

In addition, the Department of Labor (DOL) released Field Assistance Bulletin (FAB) 2004-03 which provides clarification of the DOL's position on the duties of directed trustees. Finally, the DOL and the Securities and Exchange Commission (SEC) jointly released tips to help ERISA plan fiduciaries in selecting and monitoring pension consultants.

ACTION AND NEXT STEPS None of this guidance requires plans to be amended at this time, but some of the guidance may influence decisions regarding future plan amendments. Plan sponsors should review the information in this publication to determine which items apply to their plans. Questions regarding the application of any of these items to a specific plan may be directed to your Prudential Retirement representative.

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Items Applicable to Both Defined Benefit and Defined Contribution Plans

Abusive Plan Designs

Qualified plans must comply with IRS rules to ensure that the number of employees benefiting under the plan, as well as the amount of the benefit provided, does not discriminate in favor of highly compensated employees (HCEs). A plan must be nondiscriminatory both in form (i.e., the plan document and required testing) and operation. In an October 22, 2004 memorandum, IRS agents were directed to issue adverse determination letters to plans that satisfy the numerical nondiscrimination tests but do not comply with the spirit of the nondiscrimination rules.

Of particular concern to the IRS are plan designs that use formulas and/or hiring practices to provide a substantial benefit to HCEs while providing a minimal benefit to nonhighly compensated employees (NHCEs).

For example, a defined contribution plan would be considered discriminatory even if it is able to pass the nondiscrimination in amounts test (typically, on a cross-tested basis), if it:

- Excludes most or all permanent NHCEs;
- Covers a group of NHCEs who were hired temporarily for short periods of time;
- Allocates a higher percentage of compensation to the HCE accounts; and
- The compensation of the NHCEs covered by the plan is significantly less than the compensation of the excluded NHCEs.

According to the IRS directive, this plan design distorts the nondiscrimination test. While the contribution made to any one NHCE may be significant in comparison to the employee's compensation, the amount of the contribution is small since it is made to short-term employees with low compensation. On its face, the plan satisfies the nondiscrimination requirement but it does not provide a meaningful benefit to the NHCEs.

Delayed Effective Date for "Relative Value" Rules

On January 28, 2005, the IRS published proposed regulations to formalize the delayed effective date for the "relative value" disclosure rules for qualified joint and survivor annuities (QJSAs) provided in an earlier Announcement. As discussed in our July 2004 *Pension Analyst*, all defined contribution plans that are subject to spousal consent requirements can continue to provide their existing QJSA notices until November 2005. However, qualified pre-retirement survivor annuity (QPSA) notices had to comply with the new rules effective July 1, 2004.

Defined benefit plans are eligible for similar treatment, unless they provide certain forms of payment (e.g., single sum, years of certain installment payments) that have lower values than the QJSA. Plans that offer these forms of benefit had to comply with the new disclosure rules for payments with annuity starting dates of October 1, 2004, or later. Notably, these rules clarify that a social security level income form of payment is not eligible for the delayed effective date.

The proposed regulations also confirm that estimates and charts may be used in certain situations to provide relative value information. In addition, they clarify that a single sum payment that has a greater value than the QJSA solely because it is required to use a specific interest rate in its calculation will not violate the rule that the QJSA be the most valuable form of benefit.

These regulations are only proposed, but plan sponsors may comply with them until the IRS publishes final regulations.

Directed Trustee Duties Concerning Employer Securities

On December 17, 2004, the Department of Labor (DOL) issued a Field Assistance Bulletin (FAB) 2004-03 providing guidance on the DOL's views of the nature and scope of a directed trustee's fiduciary duties with respect to transactions involving employer securities. These responsibilities have received particular scrutiny in recent years as a result of the Enron and WorldCom litigation.

A plan trustee is always a fiduciary under ERISA. However, this guidance recognizes that not all trustees have the same authority. If a plan expressly provides that a trustee is subject to the direction of a named fiduciary who is not a trustee and that fiduciary provides "proper" direction to the trustee, the directed trustee's responsibilities as a plan fiduciary are limited. As a result, a directed trustee's duties are significantly narrower than a discretionary trustee's duties.

According to the DOL, direction is "proper" only if it is made in accordance with the terms of the plan and does not conflict with ERISA rules. If a directed trustee knows or should know that a direction is inconsistent with the terms of the plan or is contrary to ERISA, the directed trustee may not follow the direction. As a result, a directed trustee should review documents and instruments governing the plan that are relevant to its duties.

Since a directed trustee may not follow a direction that the trustee knows or should know is contrary to ERISA, the trustee must follow procedures that are designed to avoid prohibited transactions. For example, a directed trustee could seek written representations from the directing plan fiduciary (e.g., the plan administrative committee) that the plan maintains and follows procedures for avoiding prohibited transactions or identifying an exemption that would allow the transaction.

The DOL guidance emphasized that a plan's named fiduciary has primary responsibility for determining the prudence of a particular transaction. A directed trustee has no independent obligation to determine the prudence of every transaction or to duplicate or second-guess the work of the plan fiduciaries. Accordingly, a directed trustee rarely has an obligation to question the prudence of purchasing publicly traded securities at the market price solely on the basis of publicly available information. However, in limited extraordinary circumstances where certain public indicators call into question a company's ability to be an ongoing concern, the directed trustee may have a duty not to follow the named fiduciary's instruction without further inquiry.

Following the publication of these guidelines, plan sponsors may find directed trustees requesting more plan documentation than they had in the past in an effort to properly carry out their limited fiduciary responsibilities.

Guidance for Evaluating Pension Consultants

On June 1, 2005, the DOL and the Securities and Exchange Commission (SEC) jointly published tips to help plan fiduciaries identify potential areas of conflicts of interest by pension consultants. These tips consist of ten questions that are designed to help plan fiduciaries evaluate the objectivity of the recommendations provided by a pension consultant.

Items Applicable to Defined Benefit Plans Only

Temporary Benefit Limit Guidance

IRS Notice 2004-78 provides a special transition rule for calculating the maximum allowable benefit that can be paid from a defined benefit plan under certain forms of payment that were affected by the provisions of the Pension Funding Equity Act of 2004 (PFEA), which we discussed in a May 2004 *Pension Analyst.*

Payment forms that are affected by this rule include:

- Single lump sum payments,
- Certain installment type payments, and
- Other decreasing annuities, such as certain level income options.

In general, the interest rate that must be used to determine the maximum allowable benefit payable under one of these forms of payment may not be less than the greater of the "applicable interest rate" or the rate specified in the plan document. The "applicable interest rate" is the "417(e)(3) interest rate" which is currently the 30 year Treasury rate. For 2004 and 2005, PFEA requires plans to use a fixed rate of 5.50% instead of the "applicable interest rate" although the plan rate must still be used if it is greater than 5.50%.

If the PFEA fixed rate is greater than both the plan rate and the applicable interest rate, the resulting lump sum benefit will be lower than it would have been under the pre-PFEA rules.

A special transition rule has been provided for payments with annuity starting dates (ASDs) occurring on or after the first day of a plan's 2004 plan year but before January 1, 2005. Rather than using the fixed rate of 5.50%, the plan can use the "applicable interest rate" in effect as of the end of the 2003 plan year. However, in no event can the transition amount be greater than the amount that would have been determined in 2004 under the old rules. While this transition rule does not apply to benefits with ASDs occurring after December 31, 2004, plans that permit retroactive ASDs may apply this rule for any benefit that is calculated in 2005 or later, retroactive to the 2004 transition period, under the affected forms of payment.

In general, benefits already accrued cannot be reduced by a plan amendment. This is commonly referred to as the "anti-cutback rule." However, as long as a plan is properly amended for PFEA by the end of the 2006 plan year and has been operating in accordance with PFEA since 2004, it will not violate the anti-cutback rule. In addition, a plan that followed a reasonable interpretation of the transition rule prior to the release of this guidance will not violate the anti-cutback rule if payments are lower than the amount allowed under the transition rule.

Unless a new law is enacted, the rules in effect before the enactment of PFEA will apply after 2005.

The rules regarding the calculation of maximum benefits under a defined benefit plan can be complicated. As a result, you should discuss the impact of PFEA and this notice on your plan with your plan's Enrolled Actuary.

Next Steps

None of the guidance described above necessarily requires changes to be made to either the plan documents or plan administration. However, some guidance may clarify the application of certain rules in specific situations or result in changes in plan design. Plan sponsors should direct questions regarding the applicability of any of these items to their plans to their Prudential Retirement representative.

Pension Analyst by Prudential Retirement
The Pension Analyst is published by Prudential Retirement, a Prudential Financial business, to provide clients with up-to-date information on current legislation and regulatory developments affecting qualified retirement plans.

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