Employment and Labor Law

ALERT

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Common Employee Benefit Plan Compliance Problems

Employee benefits plans and compensation arrangements are subject to an array of technical requirements under ERISA and/or the Internal Revenue Code. These rules apply not only to tax qualified retirement plans such as "40l(k) plans," but also may apply to nonqualified retirement plans, employee welfare plans (*i.e.*, group health, life and disability plans), certain bonus and long term incentive plans, severance plans, equity based compensation plans and even unwritten compensation arrangements. This Client Alert seeks to outline a number of common employee benefit plans compliance problems, which, although typically correctible, could result in serious adverse consequences if discovered as part of a U.S. Department of Labor or Internal Revenue Service audit.

1. **Invalid Summary Plan Descriptions** — ERISA requires sponsors of employee benefit plans to distribute to eligible employees an up-to-date (every 5 years), easily-understandable written summary of the plan's terms, conditions and requirements, known as a "Summary Plan Description" or "SPD." To qualify as a valid SPD under ERISA, certain information regarding the plan and the plan sponsor must be provided and an "ERISA Statement of Rights" must be included. Further, the often critical reservation of the plan sponsor's right to amend or terminate the plan (*e.g.*, to require retirees to begin to contribute to the cost of their post-employment medical coverage) should be set forth prominently in the SPD for the plan.

   Form SPDs sometimes provided by insurance companies, brokerage houses, banks, mutual fund companies and third party administrators may be inadequate and should be enhanced (if not rewritten) for the protection of the plan sponsor. The booklets provided by insurance companies to their customers with respect to insured group welfare plans (*i.e.*, insured group medical, life and disability plans) often do not constitute valid SPDs under the applicable ERISA requirements (*e.g.*, missing required information such as the plan sponsor's Employer Identification Number or the identity and address of the party on which to serve legal process in connection with a claim against the plan). Many employers have SPDs (or SPD-like noncompliant booklets) sitting in a file in the HR Department; however, the SPD requirements are not satisfied unless and until valid SPDs are in fact distributed to the eligible employees. Existing SPDs should be reviewed and revised as necessary, and compliant SPDs should be prepared and disseminated where required SPDs do not currently exist.

2 **Annual Returns Not Filed** — With exceptions for certain smaller plans, an "Annual Return" must be filed each year with the Internal Revenue Service, utilizing IRS Form 5500, for each employee benefit plan subject to ERISA. An important exception is that no Annual Return is required for a fully-insured welfare plan with fewer than 100 participants. ERISA specifically authorizes the U.S. Department of Labor to assess a penalty of up to $1,100 per day for failing to file a required Annual Return - when

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multiple plans and multiple years are involved the maximum penalty amount can be severe. Further, the statute of limitations does not begin to run unless a "substantially complete" Annual Return is filed.

Amnesty programs are available pursuant to which a plan sponsor can voluntarily file missing Annual Returns, and under which the plan sponsor will typically be required to pay significantly lesser penalties. Conversely, should the failure(s) to file be uncovered as part of a regulatory audit, the plan sponsor will have no leverage. Plan sponsors seeking exemptive relief should review and consider the applicability of the numerous Annual Report exceptions for smaller plans, although even the 100-participant test mentioned above has certain intricacies which must be addressed to qualify for the exception.

3. **Existence of Severance Plan** — An employer's severance plan is likely to be deemed an employee benefit plan subject to ERISA and many of its requirements, including the SPD and Annual Return requirements discussed above. The U.S. Department of Labor has historically taken the position that a severance plan which provides for a discretionary severance benefit is nonetheless an ERISA plan (*i.e.*, a severance plan with a discretionary benefit). Under current law, an unwritten but historical practice of having provided severance "in the past" may well rise to the level of an ERISA plan. Were the U.S. Department of Labor to conclude on audit that a company's historical practice of paying severance did constitute an ERISA plan, it could be expected to take action to enforce the above-described SPD and Annual Report requirements with respect to that plan.

Employers who have routinely provided severance benefits should determine whether or not they need to address the ERISA requirements applicable to severance plans.

4. **No "Top-Hat" Filing** — A non-tax-qualified employee pension plan which otherwise would be subject to most of ERISA's requirements will be exempted from those requirements provided that it satisfies the standards for status as a "top-hat" plan. In general, a "top-hat" plan is a plan which is unfunded (*i.e.*, no trust) and is maintained by an employer "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." (Although there is no applicable "bright line" test, most employee benefits practitioners feel comfortable that 15% or less (10% or less is even better) of the employer's employees constitutes a "select group" for top-hat plan purposes.) "Top-hat plan" status exempts most nonqualified retirement plans (*e.g.*, supplemental executive retirement plans or "SERPs") from ERISA's reporting and disclosure, funding, trust and fiduciary requirements. Filing with the U.S. Department of Labor is required for "top-hat plan" status. Although it is a very simple one-page filing, plan sponsors often omit this required step.

"Top hat plan" status should be secured by employers for their SERPs and other nonqualified retirement plans by preparing the necessary DOL filing.

5. **Failure to Comply with New Tax Rules for Deferred Compensation** — New Internal Revenue Code Section 409A impacts nearly every type of deferred compensation arrangement and agreement, including annual bonuses, long term incentive plans, equity based compensation plans, severance plans and various provisions typically found in employment agreements. Failure to comply with these new requirements can result in additional taxes to the participating employees, including but not limited to a 20% penalty and in certain cases, acceleration of the tax liability itself. Often compliance is easily achieved, for example, by requiring that an employee's entitlement to the payment of a bonus for year 1 does not become vested until the date of payment, or alternatively, that the bonus does not vest until December 31 of year 1 (*i.e.*, the employee must be in the employer's employment on December 31 of year 1) and is fully paid by March 15 of year 2. Another simple fix can be simply defining a payment date. Under the transition relief provided, employers and other plan sponsors have until December 31, 2007, to amend their plans, agreements and arrangements for compliance with Internal Revenue Code Section 409A.

All potentially applicable documents and unwritten arrangements which provide for deferred compensation should be reviewed for Internal Revenue Code Section 409A compliance at the earliest possible time.

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