

Employee Benefits Law

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Qualification and ERISA Requirements

THIRD EDITION

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For my father, Mark J. Jennings, whose passion for integrity and justice propelled me into the pursuit of law and to my mother, Doris M. Jennings, whose passion for education propelled me into teaching, and

For my husband, Brian A. Kennedy, whose insights and constant support allowed me to pursue my dreams.

K.J.K.

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Preface

This publication differs from most existing employee benefits casebooks in the following ways:

- The book makes a clear delineation of the qualification requirements of the Internal Revenue Code applicable to employee benefit plans versus the ERISA requirements. As such, most of the materials focus upon pension and profit sharing plans. However, the tax rules applicable to welfare benefit plans are also discussed. Since ERISA's civil enforcement requirements are applicable to both retirement and welfare plans, these requirements are addressed for employee benefit plans in general.
- The book places a strong emphasis on planning and policy, focusing on the adoption, maintenance and correction of such plans.
- The substantive qualifications of the Code are discussed in full: minimum participation standards; overall coverage tests; minimum vesting standards; accrued benefit requirements; maximum limitations on benefits and allocations; nondiscrimination requirements; minimum funding standards; employer deductibility limits; related employer rules; distribution rules; plan termination standards; disqualification results; and benefit restrictions. ERISA's fiduciary, enforcement, reporting and disclosure standards are set forth, which are applicable to all covered employee benefit plans, retirement and welfare plans.

The text of *Employee Benefits Law: Qualification and ERISA Requirements* is divided into twenty-one chapters, each containing all of the types of problems discussed above and concluding with in-depth, take-home problems that may be used as the basis for in-class discussion or as a graded written assignment. The book is accompanied by a comprehensive teacher's manual that contains detailed answers for every question posed in the text, together with suggestions for discussion and debate topics.

The federal tax consequences of employee benefit plans have become part of the tax and labor practices of virtually every large law firm, and most (25 or more) of the graduate tax programs offer a course in employee benefits law. Indeed, some programs offer more than one course, led by the John Marshall Law School in Chicago which offers a graduate degree in employee benefit law and Georgetown University School of Law which offers an employee benefits certificate under its graduate tax and labor law programs. There is a dearth of published employee benefits course materials suitable for use in graduate programs because of both the complexity of the subject matter and the difficulty in using case law as a method for understanding the

area. Federal courts, including the Supreme Court, often confront ERISA tax and labor issues from purely a trust or labor or contractual analysis. Such perspective makes it difficult to reconcile the various aspects of employee benefits law and thus case law often adds to the confusion instead of providing clarity. Often times, the only way to reconcile case law with the realities of employee benefits law is to further legislate this area, leading to additional complexities.

Since the 1920s, the federal tax code has extended valuable tax subsidies to encourage employers to voluntarily adopt and maintain employee benefit plans, both retirement type plans and welfare type plans (*e.g.*, medical, dental, death). By the 1940s, pensions were regarded by the courts as remuneration and thus a mandatory subject of collective bargaining for employers with union employees. Hence, such plans became subject to the requirements of the Labor Management Relations Act of 1947, a federal nonrevenue regulation regarding the negotiation of employee's remuneration. It was not until 1974 that Congress passed ERISA, setting forth substantive requirements for employee retirement plans, civil procedure rules and causes of action for employee benefits plans, and reporting and disclosure requirements for employee benefit plans as a whole, as well as amending the qualification rules of the federal tax code applicable to employee retirement plans. ERISA's most onerous set of requirements are found in the qualification rules of the federal tax code.

This book is directed to the adoption and maintenance of an employee benefit plan that satisfies the qualification requirements of the federal tax code, as well as the applicable requirements of ERISA. Since employee benefits law also involves welfare plans, the tax requirements for those types of plans are discussed at the end of the book. Although such benefits are substantially as valuable as retirement plans for employees and employers alike, the tax and labor rules applicable to such plans are not as developed as those that exist for retirement plans.

The chapters of Section I of the book will examine the specific qualification requirements of the tax code applicable to employee retirement plans, from both the employer and employee perspective. The initial chapters of Section II discuss the tax rules applicable to welfare benefit plans and cash and deferred arrangements. Thereafter, the ERISA rules applicable to employee retirement plans and welfare plans will be covered. The book will take a planning perspective for the tax attorney with clients maintaining these types of plans, as well as a correction perspective if one or more of these federal requirements are not satisfied. Each chapter will include a set of problems designed to analyze the applicable tax and ERISA authority and to aid in understanding the practical difficulties in satisfying such requirements. Visual aids (*e.g.*, flow charts) will be used to assist in the understanding of the legislative requirements.

The materials covered in this book are suitable for a single 2-hour course, a single 3-hour course, or two 3-hour courses. A teacher's manual will accompany the book, along with PowerPoint presentations, answers to problems and additional problems the instructor may wish to use for examination purposes. The teacher's manual will explain how the material is to be divided for its use in a single or multiple courses. It also provides midterm and final exam questions, along with answer keys.

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—K.J.K.

Structure of the Book

Part I—Qualification Rules Generally Applicable to Employee Retirement Plans

Chapter 1—An introduction to the field of employee benefits law. This chapter begins with an overview of employee benefits law, discussing the Internal Revenue Code and ERISA. A distinction between welfare and retirement plan benefits will be made. While ERISA is regarded as a labor statute, it also amended the qualification requirements of the Internal Revenue Code applicable to employee retirement plans. The variety of subsequent legislative changes made to both the tax code and ERISA will be summarized and listed. The scope of ERISA's preemption clause will also be introduced as it is relevant to states' ability to regulate employee benefits plans. Commonly used terms found in the Code's qualification requirements and in ERISA will be delineated for the students. Finally, the regulatory administration of such employee benefits plans through the Internal Revenue Service, the Department of Labor and the Pension Benefit Guaranty Corporation will be discussed.

Chapter 2—An overview of the Code's qualification requirements applicable to employee retirement plans. This chapter provides an overview of the list of qualification requirements applicable to employee retirement plans under Section 401(a) of the Internal Revenue Code. Such requirements may be formal or substitutive, fully contained within Section 401(a) or explained under another Section in the 400 series of the Internal Revenue Code, and may be cross-referenced or fully explained under the formal plan provisions. This overview serves as the basis for 15 of the chapters, which will examine each one of these substantive qualification requirements in more detail. As these substantive requirements may be contained in both the Internal Revenue Code and ERISA, jurisdictional division among the Internal Revenue Service, the Department of Labor and the Pension Benefit Guaranty Corporation will be discussed.

Chapter 3—Minimum participation requirements for eligibility under employee retirement plans. This chapter examines the applicable participation requirements that may be set forth in an employee retirement plan for eligibility purposes (*e.g.*, age, service, geographical location). Since virtually all employee retirement plans have an age and service eligibility component, these rules must be learned. A series of problems is used to help the student understand the technicalities of these rules.

Chapter 4—Overall coverage tests that must be utilized annually for employee retirement plans. For plans that impose eligibility requirements in addition to age and

service components, the plan administrator must test annually to ensure that such requirements do not result in discriminatory coverage of a highly compensated group. These annual tests are discussed and students work through various problems to understand when and how such tests are triggered. As failing to satisfy these tests would potentially disqualify the plan, the student is instructed how to draft the plan terms to avoid such unintended consequence.

Chapter 5—Vesting standards applicable to employee retirement plans. While pension benefits may accrue while an employee participates in a retirement plan, such benefits may be forfeited pursuant to a plan's vesting schedule if the employee prematurely terminates employment. The Code's and ERISA's vesting rules will be discussed, along with a series of problems that will illustrate how such rules apply.

Chapter 6—Accrued benefit requirements applicable to employee retirement plans. Generally employee retirement plans are designed to provide a normal retirement benefit for employees who retire from the employer; however, eligible employees who terminate employment prior to retirement must accrue a portion of the normal retirement benefit while a participant. The Code imposes minimum accrued benefit tests to assure that the accrual of the normal retirement benefit is not disproportionately earned in the later years of coverage rather than the earlier years of coverage. In addition, both the Code and ERISA impose prohibitions on the reduction of a participant's accrued benefit, the elimination or reduction of an early retirement benefit or retirement-type subsidy, and the elimination of an optional form of benefit payment. These limitations will be discussed and case law surrounding the cash balance design controversy will be examined.

Chapter 7—Maximum limitations on the level of benefits or contributions under employee retirement plans. In order to reduce the tax subsidy that employee retirement plans may offer to the highly paid employees, the Code imposes dollar and percent of compensation limitations on the benefits or contributions allocated under employee retirement plans. As these limitations have been reduced, altered and redefined several times since 1974, students will examine the tax opportunities afforded by these limits, especially for small employers who adopt such plans solely for the tax advantages.

Chapter 8—Nondiscrimination requirements on benefits or contributions under employee retirement plans. While the Code's nondiscrimination rules in Section 401(a)(4) contain only 42 words, the Internal Revenue Service has hundreds of pages of regulations implementing these rules in the defined benefit and defined contribution contexts. Uses of the regulations' safe harbors will be discussed, as well as the general test for plans not relying upon the safe harbors. Students will learn these rules through the use of problems and visual aids.

Chapter 9—Minimum funding standards. The Code imposes minimum funding standards on pension plans, but not profit sharing plans. These requirements are actuarial in nature and must be adhered to annually. Since the actuary has some discretion in applying these standards, the choices available will be examined and

compared. Students will be exposed to a typical actuarial valuation of a retirement plan in order to ascertain the plan's financial health.

Chapter 10—Employer deductibility limitations. Beyond the ordinary reasonable and necessary business criteria requirement for an employer deduction, employer contributions to an employee retirement plan are limited by the Code on an annual basis. Such limitations will be discussed for defined benefit and defined contribution plans. And since some of the limitations may be permanently lost if not utilized by the employers, a series of problems will illustrate the extent of the tax subsidy available to a typical employer.

Chapter 11—Controlled group rules, affiliated service group rules, and the leasing rules. An employer, regardless of its legal entity, may establish an employee retirement plan for its employees. However, if that employer is “related” to another employer through the controlled group rules, the affiliated service group rules or the leasing rules, then many of the qualification requirements are applied as if the employee were employed by any member of the “business family.” These related employer rules are discussed and problems are utilized.

Chapter 12—Distribution rules applicable to employee retirement plans. Whether distributions may be made to a covered employee varies depending on whether the applicable plan is a pension plan or profit sharing plan. These differences are examined. Also the Code's and ERISA's anti-assignment clause prohibits the attachment of benefits under employee retirement plans except in limited situations involving qualified domestic relations orders (*i.e.*, QDROs). However, since many family domestic relations orders are not made “qualified” at the time of the divorce or separation, case law has had to determine whether such order could be made qualified retroactively. Such cases will be discussed, as well as ways to avoid such litigation.

Chapter 13—Plan termination rules for defined benefit plans. ERISA sets forth rules as to how and when a single employer may terminate its defined benefit plan. Such rules will be discussed, as well as ERISA's insurance provisions to guarantee the payment of benefits from insolvent plans. Problems plaguing this insurance model will be examined, as well as suggested legislative initiatives to curb the abuse.

Chapter 14—Taxation of distribution rules applicable to employee retirement plans under the Internal Revenue Code. There are applicable excise taxes imposed by the Internal Revenue Code on premature and late distributions. These rules will be discussed.

Chapter 15—Plan disqualification and the Internal Revenue Service correction methods. As the courts and the Internal Revenue Service have found that a single violation of the Code's qualification rules could render the plan disqualified, the Service has devised a correction program for plan sponsors and plan administrators to utilize to “undo” and correct potentially disqualifying defects. The evolution of this correction program will be discussed along with sample case studies.

**Part II—Tax Rules Applicable to Specialized Employee
Benefit Plans and ERISA Rules Applicable
Generally to All Employee Benefits Plans**

Chapter 16—Tax rules applicable to welfare benefit plans. The tax rules applicable to qualified retirement plans are far more complex than the tax rules applicable to welfare benefit plans. In contrast, there are a variety of Code provisions relating to specific welfare benefits that must be satisfied in order to exempt such benefits from an employee’s income. Those requirements relating to life insurance and death benefits, severance benefits, medical, accident and health benefits, disability benefits, dependent care assistance benefits, and miscellaneous fringe benefits will be examined. The applicable rules relating to cafeteria plans, which permit employers to offer employees’ the choice between various welfare benefits and deferred compensation under a Code § 401(k) plan, will also be covered.

Chapter 17—Cash or deferred arrangements under Code § 401(k). Salary deferrals may be made on a pre-tax basis pursuant to a cash or deferred arrangement, a feature of a qualified profit sharing or stock bonus plan. Beginning in 2006, participants may also be offered the ability to made deferrals as “designated Roth contributions” to a cash or deferred arrangements. Often employers will match employees’ elective deferrals in order to encourage participation in the cash or deferred feature. Other times the employer will simply make non-elective and non-matching employer contributions to the plan for all eligible employees. There are special nondiscrimination rules applicable to elective salary deferrals as well as employer matching contributions and employee after-tax contributions set forth in Code § 401(k) and (m). Cash or deferred arrangements must impose more restrictive distributions regarding employee salary deferrals and employer contributions if used for testing of the salary deferral amounts.

Chapter 18—ERISA’s fiduciary rules and prohibited transaction provisions. Plan fiduciaries are held to higher standards of care in their role as trustee, plan administrator, or plan sponsor of an employee benefits plan. ERISA also sets forth a set of prohibited transactions involving the use of plan assets, which require an exemption (statutory or administrative) in order to effectuate. These transactions and their exemptions will be examined. The final DOL fiduciary regulations will also be addressed.

Chapter 19—ERISA’s procedural rules and causes of action. ERISA sets forth the exclusive set of employees’ causes of action relating to an employee benefit plans, as well as a preemption clause to eliminate some, but not all, state regulation of employee benefits plans. Case law will be discussed to enumerate these various causes of actions and the resulting remedies. Also, as ERISA sets forth its own set of procedural rules, these too will be discussed and contrasted with normal federal civil procedure rules.

Chapter 20—ERISA’s reporting and disclosure requirements. ERISA creates stringent reporting and disclosure requirements, including plan audits and actuarial valuations of a pension plan’s assets and liabilities. For covered participants and

beneficiaries, ERISA sets forth disclosure requirements which are designed to explain benefits under a plan and the procedures to be utilized to obtain these benefits. As the courts generally require exhaustion of the plan's internal administrative procedures before litigation, such claims procedures are important plan features. Regulations directed at a plan's claims procedures will be discussed.

Chapter 21 — ERISA's and the Code's benefit restrictions. PPA '06 imposed stricter funding requirements for sponsors of single-employer defined benefit plans, effective for 2008 and later plan years. To avoid further leakage of assets from an existing underfunded plan and to prevent greater underfunding through the expansion of benefit increases, PPA '06 created new benefit restrictions, with parallel provisions in Title I of ERISA.

About the Author

Kathryn J. Kennedy is a Full Professor of Law and Director of the Graduate Program in Taxation, the Graduate Program in Employee Benefits Law, and the Graduate Program in Estate Planning at The John Marshall Law School. She received a B.S. from Drake University (with honors) and a J.D. from Northwestern University School of Law (*summa cum laude*). She practiced with the law firm of McDermott, Will & Emery in Chicago, IL. She is also a Fellow of the Society of Actuaries (FSA) and was a practicing actuary for CNA Insurance Company and Towers Perrin. She joined the faculty of The John Marshall Law School full-time in 1996. Since that time, she developed the nation's only graduate program in employee benefits law, now with a total of 20 different courses in employee benefits. Professor Kennedy writes and lectures on matters relating to tax and employee benefits law. She is a vice chair of the Employee Benefits Committee of the American Bar Association's Section of Taxation, was Chair of the Illinois State Bar Association Employee Benefits Section Council, and was Chair of the Chicago Bar Association Employee Benefits Committee. She has been member of the Employee Plans (EP) subcommittee of the IRS' Advisory Council for Tax Exempt/Government Entities Division (known as the ACT), as well as the Department of Labor's ERISA Advisory Council. She serves on the Board of Governors of the American College of Employee Benefits Counsel.

