Federal Legislative & Regulatory Report

Nationwide® Retirement Solutions
On Your Side®

August 2009

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I. Washington Update

Congress is adjourned for the month of August. Since Congress did not pass a health care reform bill before its summer recess, reform is expected to continue to be a top domestic policy initiative for the Administration and legislators when they return on September 8.

National Save for Retirement Week Resolution

By passing identical resolutions, Congress established October 18 – 24, 2009 as *National Save for Retirement Week*. Senate Resolution 234 was co-sponsored by Senators Kent Conrad (D-ND) and Michael Enzi (R-WY) and passed by unanimous consent on August 3. Representatives

Allyson Schwartz (D-PA) and Sam Johnson (R-TX) co-sponsored House Resolution 662, which unanimously passed on July 31.

This is the fourth year that a National Save for Retirement Week has been established to raise public awareness of the various tax-favored opportunities that are available to help them save for retirement. Nationwide Retirement Solutions is a participating sponsor of National Save for Retirement Week.

CBO Budget Options, Volume II

On August 6, 2009, the Congressional Budget Office (CBO) released "Budget Options, Volume II." This report provides the CBO analyses and projections of the potential impact on federal tax revenues considering 59 different policy options. The options examined include: (1) eliminating the tax exclusion for employment-based life insurance, (2) including the investment income from life insurance and annuities in taxable income, and (3) consolidating and simplifying different types of defined contribution retirement plans.

The CBO provides regular reports to the House and Senate on various policy initiatives. These projections have been included in previous iterations of their reports and are not necessarily related to legislation currently pending or being considered at this time.

The 284-page "Budget Options, Volume II" document may be downloaded from www.cbo.gov/ftpdocs/102xx/doc10294/08-06-BudgetOptions.pdf.

Fee Disclosure Proposals

Although the future of fee disclosure legislation is uncertain at this time, there have been three proposals introduced this year that could impact defined contribution retirement plans.

1. *The 401(k) Fair Disclosure and Pension Security Act of 2009* (H.R. 2989) – This bill was approved by the House Education and Labor Committee on June 24, 2009 and combines two earlier proposals: (1) The 401(k) Fair Disclosure for Retirement Security Act of 2009 (H.R. 1984) and (2) The Conflicted Investment Advice Prohibition Act of 2009 (H.R. 1988). This bill was discussed extensively in our July 2009 report.
2. *The Defined Contribution Plan Fee Transparency Act of 2009* (H.R. 2779) generally covers both ERISA and non-ERISA plans, including 403(b) plans and governmental 457(b) plans and would mandate certain disclosures from service providers to plan sponsors and from plans to participants. This bill was discussed extensively in our July 2009 report.
3. *The Defined Contribution Fee Disclosure Act of 2009* (S. 401) would generally apply to 401(k) and 403(b) plans subject to ERISA, and mandate that certain disclosures regarding fees be made by providers to plan sponsors and also from the plan to participants. This bill was discussed extensively in our March 2009 report.

Previous issues of our Federal Legislative and Regulatory Report may be, found here.

SEC Proposes Measures to Curtail 'Pay to Play' Practices

At the beginning of August, the Securities and Exchange Commission (SEC) released a new proposed rule under the Investment Advisers Act of 1940. The 32-page proposed rule may be downloaded from http://edocket.access.gpo.gov/2009/pdf/E9-18807.pdf.

The SEC says the proposed rules are designed to:

- Prevent an adviser from using hidden payments, such as through placement agents, to influence the government officials' decisions regarding investments.
- Restrict political contributions to officials by limiting or restricting donations.
- Curtail "pay to play" practices by investment advisers that seek to manage money for state and local governments.

Concept Paper: Regulating Derivatives

On July 30, 2009, Representatives Barney Frank (D-Massachusetts), Chairman of the House Financial Services Committee and Collin C. Peterson (D-Minnesota), Chairman of the House Agriculture Committee released a concept paper that will guide the two committees as they develop legislation to regulate derivatives. The concept paper can be found at www.house.gov/apps/list/press/financialsvcs_dem/otc_principles_final_7-30.pdf.

Two New Reports from The Retirement Security Project

The Retirement Security Project, which includes a variety of think tanks such as the Brookings Institute and the Heritage Foundation, recently released two reports:

- *The Automatic Annuitization: New Behavioral Strategies for Expanding Lifetime Income in 401(k)s* – This report discusses the increased reliance on 401(k) plans and the challenge they present for retirees in managing the risk of outliving their assets. Suggested strategies are offered based on concepts using behavioral economics to replicate guaranteed lifetime income features of traditional defined benefit pension plans. The 24-page report may be downloaded from www.retirementsecurityproject.org/pubs/File/RSP_IwryTurnerPolicyBriefFinal.pdf.
- *National Retirement Savings Systems in Australia, Chile, New Zealand, and the United Kingdom and Lessons for the United States* – This report reviews the retirement systems of four other countries and the insights they provide for American retirement proposals. The discussion focuses on concepts such as mandatory savings versus automatic enrollment, default investment choices, administrative costs and how they can be lowered through simple savings platforms, and more. This 36-page report may be downloaded from www.retirementsecurityproject.org/pubs/File/RSP_InternationalPapervFinal7.14.pdf.

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II. Public Colleges and Universities Lax in Tax Compliance

In its July newsletter, the IRS Office of Federal, State and Local Governments (FSLG) reports its findings on a project to:

- Assess the level employment tax compliance among governmental community colleges, and
- Identify the types of noncompliance found in public community colleges.

FSLG conducted employment tax examinations on randomly selected group of 88 community colleges (out of 983 community colleges currently operating in the United States). The primary measure of compliance for closed examinations is the “change rate”, a measure that indicates how many cases resulted in either an assessment of additional tax or an advisory related to changes needed to avoid assessment of additional tax in the future. Of the cases sampled:

- 76% resulted in a change, and
- 50 % resulted in a tax assessment.

What is the FSLG?

The IRS Office of Federal, State and Local Governments (FSLG) is responsible for ensuring that federal, quasi-governmental and state agencies, city, county and other units of local government comply with federal tax laws.

Noncompliance Issues

The secondary goal of this project was to identify the common categories of noncompliance ranked from the highest rate to the lowest rate of noncompliance.

Information Reporting for Education

This category includes failure to issue Forms W-2 and 1099, as well as failure to properly collect Forms W-4, and W-9, for recipients of educational benefits. Form W-9, *Request for Taxpayer Identification Number and Certification,* or its equivalent must be furnished to each person, including recipients of educational benefits and scholarships, who receives reportable payments or benefits from a government entity.

Benefits Provided to Employee

This category includes failures to properly include in employee income different types of benefits provided, including:

- Meals provided without qualifying travel.
- Expense allowances not meeting accountable plan requirements, and not included in income.
- Use of employer-provided cell phones not meeting accountable plan requirements.
- Other benefits, including taxable clothing and uniforms provided

Worker and Payment Reclassification

In this category, workers who should be considered employees are treated as independent contractors, or payments that should be treated as wages are treated as non-employee compensation.

Section 218 Coverage

This category covers failure to properly apply Social Security coverage rules to workers covered by a Section 218 Agreement.

FSLG to plans to conduct a series of phone forums with community colleges to provide more specific information to help them with the most common compliance issues cited in the report.

Reference Material

July 2009 issue of the FSLG Newsletter: www.irs.gov/pub/irs-tege/p4090_0709.pdf.

Employment Tax and Social Security Coverage Information

The 91-page Taxable Fringe Benefit Guide and the 33-page IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits,* contain information about:

Publication 15, *Employer's Tax Guide (Circular E)* and Publication 15-A, *Employer's Supplemental Tax Guide*.

Publication 963, *Federal State Reference Guide*, contains information on Social Security and Medicare coverage, and § 218 agreements.

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III. ERISA 403(b) Community Applauds FAB 2009-2

While 403(b) plans that are subject to Title I of ERISA have always been required to file informational Form 5500 annually, beginning with the 2009 plan year, these plans will also be subject to the full financial reporting requirements that apply to ERISA 401(k) plans, including the independent audit requirement. Prior to the 2009 plan year, ERISA 403(b) plans filed simplified 5500s and were exempt from the independent audit requirement for large plans – plans with 100 or more participants.

The Department of Labor (DOL) recently issued Field Assistance Bulletin (FAB) 2009-2 which has been hailed as a common-sense solution to the potentially difficult and costly burden of tracking down information about individual annuity and custodial accounts that the employer had no knowledge of or control over, for purposes of meeting the new 5500 reporting requirements.

According to the FAB, plan administrators who make good faith efforts to transition for the 2009 plan year to the new ERISA reporting requirements can avoid the administrative burden and expense of having to collect and include in their 2009 Form 5500 financial report information on certain individual annuity contracts and mutual fund custodial accounts of current and former employees which were established before 2009 and to which the employer is no longer is making ongoing contributions.

What is a 403(b) plan?

A 403(b) plan is a retirement plan for employees of public schools, 501(c) tax-exempt organizations and self-employed ministers that are funded with annuity contracts or custodial accounts purchased by an employer.

A 403(b) plan may be either an ERISA or non-ERISA plan. Government, non-electing church plan and plans with no active employer involvement are not subject to Title I of ERISA.

For purposes of 5500 annual reporting, a 403(b) administrator does not need to treat annuity contracts and custodial accounts as part of the employer's 403(b) plan or as plan assets provided:

1. The contract or account was issued to a current or former employee before January 1, 2009;
2. The employer ceased to have any obligation to make contributions (including employee salary reduction contributions), and had ceased making contributions to the contract or account before January 1, 2009;
3. All of the rights and benefits under the contract or account are legally enforceable against the insurer or custodian by the individual owner of the contract or account without any involvement by the employer; **and**
4. The individual owner of the contract is fully vested in the contract or account.

Furthermore, current or former employees with only contracts or accounts that are excludable from the plan's Form 5500 under this transition relief do not need to be counted as participants covered under the plan for Form 5500 annual reporting purposes.

For large plans subject to an independent audit, the DOL will not reject a Form 5500 on the basis of a "qualified," "adverse" or disclaimed opinion if the accountant expressly states that the sole reason for such an opinion was because such pre-2009 contracts were not covered by the audit or included in the plan's financial statements.

Note: On July 30, 2009, the DOL told BNA (Bureau of National Affairs) tax service that relief allowing 403(b) administrators to ignore pre-2009 contracts applies to future years beyond the 2009 plan year.

Nationwide Comment: 403(b) administrators still need to exercise caution counting "participants" for 5550 purposes because of the *universal availability* rule which requires the plan treat all employees as participants eligible to make elective deferrals unless they can be statutorily excluded from the plan.

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IV. Bad Professional Advice Proves Costly

This month, we present two case examples that illustrate the ramifications of acting on bad professional advice.

CASE #1: Loan Re-Fi Lands Participant in Tax Court (below)

CASE #2: IRS Rejects Do-Over to Escape 10% Distribution Tax – page 8

CASE #1: Loan Re-Fi Lands Participant in Tax Court

The United States Tax Court found that a retirement plan participant who had refinanced his existing retirement plan loan exceed the limits for a non-taxable participant loan. The excess loan amount was subject to income taxes on the excess as well as the 10% additional distribution tax.

Generally, loans from an employer retirement plans are not treated as plan distributions if the loan when added to all the other loans from the plan does not exceed the lesser of:

1) $50,000 reduced by the excess, if any, of the outstanding balance of loans from the plan during the one-year period ending on the day before the date on which the loan was made and the outstanding balance of loans on the date the loan is to be made,
   or
2) The greater of one-half the vested account balance or $10,000.

A non-residential loan, by its terms, is required to be repaid within 5 years in substantially and level payments of principal and interest that are made at least quarterly over the period of the loan.

Background

Michael K. Billups, a New York City transit worker, participated in a qualified plan with the New York City Employees' Retirement System (NYCERS). He took frequent plan loans from 1993 through 2005. In 2005, he asked NYCERS to replace an existing loan of $27,012.73 with a new loan and took the new loan proceeds of $12,630 in cash. The replacement loan of $39,642.73 ($27,012.73 + $12,630) was amortized over 5 years payable in bi-weekly installments. At the time of his new loan, his vested account balance was $52,863.38.

When Billups replaced his prior loan from NYCERS in 2005, he chose the refinancing option which extended the prior loan's repayment terms causing the current and prior loan to be treated as outstanding on the date of the refinancing. Both loans collectively exceeded the non taxable loan limits resulting in a deemed taxable distribution of the excess amount above the loan limit. The deemed distribution triggered the 10% additional tax since Billups was under age 59½ at the time. NYCERS advised him when he signed the loan agreement that all or part of the outstanding loan could be taxable.

On the advice of his accountant, Billups reported the distribution of $29,467 as a rollover on his 2005 Form 1040. He also failed to include the 10% additional distribution tax on his 1040.

The Decision

The Tax Court concluded that any amount of the loan in excess of one half of his vested account balance of $26,431.69 was taxable. After reviewing the evidence, the Court concluded that:

- The new loan and the loan it replaced ($39,642.73 + $27,012.73) totaled $66,655.46 which exceeded one-half his vested account balance of $26,431.69 by $39,748.06.
- Since he had already paid some of the taxes due
  - He had a taxable distribution of $29,467.46, and
  - He did not meet any exception to the 10% early distribution tax.

Additional Taxes and Penalties

The IRS also sought a 20% accuracy related penalty on the portion of the underpayment of taxes attributable to negligence or disregard of the rules or regulations. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the IRC. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis taking into account all the pertinent facts and circumstances. The most important factor is the extent of the taxpayer's effort to assess his proper tax liability. A taxpayer who makes full disclosure to any accountant or other qualified expert and reasonably relies on the expert advice in good faith is not negligent. The Court ruled that Billups was not subject to the IRS' additional accuracy related penalty.

Nationwide Comment: Like home mortgage re-fi's, extra cash in the pocket may prove quite costly later. Retirement plan loan refinancing rules are complex and can increase tax liability if misapplied.

NOTE: U.S. Tax Court rulings are binding only on the petitioner and cannot be cited as precedent.

Reference Materials

Tax Court Summary Opinion 2009-86: www.ustaxcourt.gov/InOpHistoric/Billups.SUM.WPD.pdf.

Case #2: IRS Rejects Do-Over to Escape 10% Distribution Tax

Distributions prior to age 59½ from retirement plans and IRAs are generally subject to income taxes and may be subject to a 10% additional tax, unless an exception to the additional tax applies.

One of the exceptions to this tax is for substantially equal payments made at least annually based on the life of the participant or the joint life expectancy of the participant and a designated beneficiary for five years or until the IRA owner reaches age 59½, which ever period is longer. Payments based on this exception that are modified prior to age 59½ for reasons other than death or disability will trigger the 10% early distribution tax on all prior payments.

Background

Wanda, age 56, had two IRAs, X and Y at the same company. She took substantially equal periodic payments from IRA X for 6 years, but not from IRA Y. A market downturn prompted her to ask her tax advisor if she could convert a portion of her investments in IRA X to cash. Her tax advisor instead suggested that she transfer a portion of IRA X to another company offering certificates of deposit. Following his advice, she made a partial trustee-to-trustee transfer from IRA X as well as the entire amount of IRA Y to IRA Z at another company.

When Wanda asked a third company about transferring the rest of IRA X to an IRA at the third company, she was told that the partial transfer from IRA X to IRA Z caused a modification in the substantial and equal periodic payment exception that would trigger the 10% additional tax plus interest on all amounts that had been distributed from IRA X. Her accountant confirmed that she would be subject to the additional tax because she had modified the payment scheduled from IRA X.

To correct her mistake, Wanda sought an IRS private letter ruling (200925004) asking the Service:

1. Not to consider the partial transfer from IRA X, combined with IRA Y, to IRA Z, as a modification to the series of substantially equal periodic payments subject to the 10% early distribution tax, and
2. Approve her proposed correction to transfer the partial transfer from IRA X and related earnings held in IRA Z back to IRA X.

The IRS rejected both requests noting that any modification to the series of payment will occur, if after the first valuation date selected there are:

- Any additions to the account balance except for gains and losses,
- Any non-taxable transfers of a portion of the account balance to another retirement plan,

  or

- Any non-taxable rollover of these payment amounts.

Note: Although this PLR applies only to the taxpayer who requested it and may not be cited as precedent, it provides insight on the IRS' view of such tax matters.

Reference Material

IRS private letter ruling: www.irs.gov/pub/irs-wd/0925044.pdf.

Revenue Ruling 2002-62: http://ustreas.gov/press/releases/reports/rr200262.pdf.

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V. How Red Flags Rule Applies to Employee Benefit Plans, Governments and Nonprofits

The Red Flags Rule, a federal anti-fraud regulation effective since January 1, 2008, requires many businesses and organizations – including governments and nonprofits – to implement a written Identity Theft Program designed to:

- Detect the warning signs – "red flags" – of identity theft in their day-to-day operations,
- Identify the steps that will be taken to prevent the crime, and
- Mitigate the damage resulting from identity theft.

The Red Flags Rule applies to financial institutions and creditors with covered accounts.

A *creditor* is defined broadly to include any organization that regularly extends or renews credit or arranges for others and includes all entities that regularly permit deferred payments for goods or services.

Financial institutions include entities that offer accounts that enable consumers to write checks or make payments to third parties through other means, such as other negotiable instruments or telephone transfers.

Identity Theft Fact

As many as 9 million American have their identities stolen each year resulting staggering economic damages to individuals and businesses.

A *covered account* includes credit card accounts, cell phone accounts, mortgage and automobile loans, utility accounts, checking and savings accounts, as well as other types of accounts with foreseeable risk for identity theft.

The Federal Trade Commission (FTC), one of the federal agencies responsible for enforcing the Red Flags Rule, has delayed enforcement of the Red Flags Rule until November 1, 2009 to give businesses and organizations under its enforcement jurisdiction more time to develop and implement their written Identity Theft Prevention Programs. To help business understand the Red Flags Rule, the FTC has created Red Flags Guide and a list of Frequently Asked Questions (Red Flags Rule FAQs) addressing the application of the Red Flags Rule.

The following summary – based on the FAQs – addresses the effect of the Red Flags Rule on employee benefit plans and on governments, non profits and schools.

Participant loans from retirement plans

When participants in a 401(k) plan take out loans, they're generally borrowing from their own funds. Allowing participants to borrow from their funds would not, by itself, make the plan sponsor or the plan a "creditor" under the Red Flags Rule. Q/A B12

IRAs and 401(k) accounts

Individual retirement accounts, IRAs, generally qualify as covered accounts under the Red Flags rule.

However, 401(k) plan participant accounts are established by the participants with the 401(k) plan itself, not with the employer or plan sponsor. Since the 401(k) plan is a separate legal entity, the employer would not need to include the retirement plan accounts in a written Identity Theft Prevention Program. Q/A B13

Health Flexible Spending Accounts

Healthcare flexible spending accounts (FSAs) operate like insurance plans. Employers must make the entire amount elected by participants available to them from the beginning of the plan year. If participants leave their employer before the end of the plan year, they aren't required to make up any difference between the amount they contributed and the benefits they received. Neither offering employees healthcare flexible spending accounts nor maintaining those accounts for other companies makes a business a "creditor" under the Rule. Q/A 14

Government agencies, nonprofits and schools

The Red Flags Rule applies to government agencies and nonprofits if their activities fall within the statutory definitions of "financial institution" or "creditor". For example, cities which operate utilities that regularly bill customers after they've received services, or colleges that regularly provide student loans or process student loan applications, are creditors under the Rule. Q/A C1

Municipalities, cities, or counties, tax bills, parking tickets, or fines

Financial obligations like taxes, fines, fees etc. are not considered "credit" for purposes of the Red Flags Rule. In this context, "credit" assumes an underlying transaction that a customer enters into voluntarily, Q/A C2 & C3

Mandatory municipal services

Generally, there are two types of billing arrangements for mandatory services. If mandatory municipal services are billed to customers as a flat fee, the municipality is not a creditor under the Red Flags Rule. If the municipality charges customers based on how much they use and then send them a bill, the municipality would be considered a creditor. Q/A C4

Schools regularly offering tuition payment plans

Schools that bill for tuition after students attend class are creditors for purposes of the Red Flags Rule. Schools that require payment upfront or "pay as you go" – so that students could be barred from class if they don't pay are not creditors. Q/A C5

Penalties for non-compliance

The Federal Trade Commission can seek both monetary civil penalties and injunctive relief for violations of the Red Flags Rule. Where the complaint seeks civil penalties, the U.S. Department of Justice typically files the lawsuit in federal court, on behalf of the FTC. Currently, the law sets $3,500 as the maximum civil penalty per violation. Each instance in which the company has violated the Rule is a separate violation. Injunctive relief in cases like this often requires the parties being sued to comply with the law in the future, as well as provide reports, retain documents, and take other steps to ensure compliance with both the Rule and the court order. Failure to comply with the court order could subject the parties to further penalties and injunctive relief. Q/A E4

Reference Material

Red Flags Rule: www.ftc.gov/redflagsrule.

Red Flags FAQs: www.ftc.gov/bcp/edu/microsites/redflagsrule/faqs.shtm.

Red Flags Guide: www.ftc.gov/bcp/edu/microsites/redflagsrule/more-about-red-flags.shtm.

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VI. Keeping watch

You can find the most recent information on issues affecting governmental defined contribution plans, plan sponsors and plan participants on the Employer page of our plan Web site, NRSforu.com. In addition, we report guidance on legislative and regulatory activity relevant to government sector defined contribution plans through:

- *Federal Legislative and Regulatory Report* — distributed monthly and posted on the Legislative / Regulatory tab on the Employer section of NRSforu.com. It's available online and for download.
- *Plan Sponsor Alerts* — published as needed to announce breaking news, and distributed by e-mail and posted in the Plan Sponsor Corner of NRSforu.com.

About this report

JoAnn Albrecht, CPC, QPA, Plan Technical Consultant, our resident expert on legislative and regulatory issues, prepares this report. As a leading member of the Nationwide Legislative Task Force, she identifies how federal actions may affect your plan and its participants.

Albrecht is a member of American Society of Pension Professionals and Actuaries (ASPPA), currently serving on its Government Affairs Committee, is immediate past chair of the ASPPA Tax Exempt and Government Plans Subcommittee and is a subject matter expert (SME) for the ASPPA Education and Examinations Committee. She is a current contributor to Aspen Publisher's "457 Answer Book."

Bob Beasley, CRC, CIC, Communications Consultant, edits it. Beasley brings 20 years of financial services communications experience to your plan. He helped prepare the two most recent editions of the *457 Guidebook* as well as *Fiduciary Fundamentals;* he edits countless newsletters and plan sponsor communications, and in 2001 authored "What you should know about the Economic Growth and Tax Relief Reconciliation Act of 2001."

Beasley serves on the Education and Communication Committee for the Profit Sharing / 401k Council of America and is a member of the National Association of Government Defined Contribution Administrators.

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Information presented in this newsletter was current and accurate as of the date of publication. This information is of a general and informational nature and is NOT INTENDED TO CONSTITUTE LEGAL OR INVESTMENT ADVICE. Rather, it is provided as a means to inform you of current information about legislative, regulatory changes and other information of interest. Plan Sponsors are urged to consult their own counsel regarding this information.