Federal Legislative & Regulatory Report

September 2008

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I. Washington Update

Congress was in recess for the month of August and returned in early September. It is unclear what legislative initiatives, if any, will be concluded before Senators and Representatives return home to prepare for the November Presidential and Congressional elections.

Tax Policy Positions of the Presidential Candidates

There are some major differences between the retirement and benefits tax positions of the two Presidential candidates – Barack Obama and John McCain. In addition to what is discussed below, the Tax Policy Center offers information about each candidate's tax policies online at www.taxpolicycenter.org

> The Tax Policy Center is a non-partisan joint venture of The Urban Institute and The Brookings Institution.

Expiring "Bush tax cuts": McCain would make all but the estate tax repeal permanent. Obama would make certain provisions permanent, including the tax rates for those within 10% to 28% range, the child credit and the marriage tax penalty relief. Both say they want changes to the estate tax. McCain would set the exemption at $5 million with an estate tax rate at 15% while Obama proposes a $3.5 million exemption and 45% estate tax rate.

Health care tax policies: McCain would replace the current income tax exclusion for employer-sponsored insurance with a refundable credit of $2,500 for individuals and $5,000 for families, regardless of source. He would also establish a special high-risk pool for individuals with chronic health conditions.

Obama would keep the employer-based insurance exclusion intact while creating subsidies for low- and middle-income families to help them pay for health insurance purchased through a new, non-group purchasing pool. He would also expand public health insurance for the poor (children and families), provide subsidies for small employers that offer health insurance, and penalize employers that fail to provide employee health insurance benefits.

Alternative Minimum Tax (AMT): McCain would make permanent the 2007 AMT exemption and temporarily increase the exemption by an additional 5% a year after 2013. Obama wants to extend and index (permanently) the 2007 AMT patch.

Savings incentives: McCain has not yet identified specific retirement-related positions within his tax policy proposals. Obama has proposed several changes and improvements to the structure of tax-favored retirement accounts and incentives for Americans to contribute to them, which include:

- Mandating automatic 401(k) plans for employers offering retirement plans, which would require individuals to opt out of their employer's retirement plan rather than opt in.
- Requiring employers not sponsoring other retirement plans to offer access to automatic IRAs, which produces a payroll deduction savings option for all workers.
- Making the Saver's Credit fully refundable (meaning an individual would receive the credit whether federal taxes are owed or not), with certain modifications to the credit amounts, and indexing for inflation the income thresholds to qualify for the credit after 2009.

New GAO Report

The Government Accountability Office (GAO) issued a new report entitled "Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors." This report provides additional supporting rationale for previous recommendations from the GAO to Congress to amend the Employee Retirement Income Security Act (ERISA) in regard to fee and compensation disclosures. This report can be found at www.gao.gov/new.items/d08774.pdf

There were three main areas explored by the GAO as part of this examination, as follows:

1. common 401(k) plan features that typically have important fiduciary implications
2. challenges sponsors face in fulfilling fiduciary duties
3. actions DOL takes to ensure sponsors meet their fiduciary obligations and regulatory initiatives currently underway to monitor fiduciary compliance

To review these issues, GAO had a survey conducted that asked defined contribution retirement plan sponsors how plan features are selected and operations are monitored. GAO also reviewed industry research, conducted interviews and reviewed related documents. This effort determined that plan sponsors face challenges in fulfilling their fiduciary obligations, specifically gaps in their oversight responsibilities, when their roles have not been clearly defined or when there is a lack of knowledge about the arrangements between service providers.

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II. IRS Updates Retirement Plan Correction Programs

The Internal Revenue Service recently issued Revenue Procedure 2008-50 which supersedes and expands the current version of EPCRS (see June 2006 edition of this report). The general effective date for this updated version of EPCRS is January 1, 2009. Plan sponsors may begin using this new version of EPCRS on or after September 2, 2008. EPCRS is expected to be updated from time to time.

> The IRS Employee Plans Compliance Resolution System (EPCRS) consists of three correction programs that plan sponsors and employers can use to voluntarily correct a number of retirement plan errors.
>
> Plans that are voluntarily corrected under EPCRS can retain their tax-favored status allowing participants to continue earning tax-favored retirement benefits without suffering adverse tax consequences.
>
> EPCRS is available to qualified plans, including 401(k) plans, 403(b), SEP and SIMPLE plans. Eligible governmental 457 plans can submit plan failures to the IRS on a provision basis similar to EPCRS.

EPCRS Correction Programs

There are three correction programs under EPCRS:

1. *Self-Correction Program* (SCP) – A plan sponsor or employer must have established compliance practices and procedures in order to self correct qualified plan, 403(b) plan, SEP or SIMPLE IRA operational mistakes. Operational mistakes eligible for correction under SCP must be the result of an oversight or failure to follow established procedures. A plan document alone is not evidence of established procedures. All plans can correct insignificant operational errors at any time. Appendices A and B of this revenue procedure list pre-approved correction methods the IRS considers acceptable for self correction under EPCRS.

   Qualified plans with a favorable IRS determination letter and 403(b) plans can also self correct significant operational errors provided the significant failure has been substantially corrected by the *earlie*r of the last day of the second plan year after the year the failure occurred or the first date the plan the plan comes under IRS examination. Significant operational errors are defined, but not limited to, errors that occur repeatedly, involve a significant portion of the plan's assets or errors that affect a large percentage of plan participants. Self correction of significant or insignificant operational errors does not require the employer to report or pay fees or sanctions to the IRS.

2. *Voluntary Correction Program (VCP) with IRS Approval* – A plan sponsor or employer, at anytime before audit, may go to the IRS with a proposed correction for plan mistakes, pay a limited fee to the IRS and receive IRS approval for the correction. VCP has special procedures for anonymous and group submissions.

   Appendices C and D contain a checklist and sample VCP submission application forms. Appendix F, which can be used to correct more than one type of plan failure without paying an increased application fee, offers a streamlined application procedure for plan failures involving:

- Plan loans that exceed the loan limits under IRC §72(p) and loan repayment defaults. Plan loan failures resulting from employer errors can be resolved under VCP to avoid income and excise taxes only if the maximum loan repayment period, usually 5 years, has not expired;
- Required minimum distributions not distributed from the plan on time;
- Excess deferrals that have not been distributed from 401(k) and 403(b) plans;
- Failure to adopt interim plan amendments, both discretionary and mandatory or failure to restate plan documents as required;
- Compensation that was not limited to IRC §401(a)(17), $230,000 for 2008;
- Hardships and loans made without a plan provision permitting them;
- Employee participation in the plan prior to meeting plan's eligibility, requirements; and
- Employer eligibility failures under 401(k) and 403(b).

3. *Correction on Audit* (Audit CAP) – If a failure (other than a failure corrected through SCP or VCP) is found on audit, the plan sponsor may correct the failure and pay a sanction, a fee negotiated with the IRS, which usually higher than the VCP fee.

Corrections under EPCRS

The four basic categories of plan failures or defects that can be corrected under EPCRS are:

1. *Plan document failures* are any failures that are not an operational, demographic or employer eligibility failure. Qualified plan provisions (or absence of provisions) do not satisfy IRC §401(a).

   Section 403(b) plans, except for ERISA plans, are not required to have a written plan document or to follow a plan document until January 1, 2009. Revenue Procedure 2008-50 does not reflect the final 403(b) regulations which become effective on January 1, 2009.

2. *Operational failures* occur when the plan document complies with IRC §401(a) but the plan is not operated in accordance with its terms, including failures to:
   - Include eligible employees in the plan on a timely basis;
   - Permit eligible employees to make salary deferrals, designated Roth deferrals, catch-up or employee after-tax contributions for a full or partial plan year;
   - Satisfy the requirement for universal availability that requires that all 403(b) eligible employees be given the opportunity to make elective deferrals;
   - Limit elective deferrals and to provide for direct rollovers from 403(b) annuity contracts and custodial agreements;
   - Use the correct definition of compensation for determining plan benefits;
   - Limit contributions; or
   - Pay required minimum distributions from the plan on time;

A qualified plan may be amended to reflect certain corrections listed in Appendix B provided the amendment complies with §401(a). Plan sponsors may submit an amendment adopted to reflect corrective action under VCP.

3. *Employer Eligibility Failures* cover, as the terms suggests, employers that are not eligible to adopt a plan. Employer eligibility failures are corrected under VCP or audit CAP.

   - State or local government adopts a new 401(k) plan;
   - Employer that is not tax-exempt under 501(c)(3) or is not a public educational organization (such as a public school or university) adopts a 403(b) plan; or
   - 403(b) sponsor fails to establish or maintain a custodial account or purchase an annuity contract to hold 403(b) contributions.

4. *Demographic failures* are failures to comply with the coverage, participation and non discrimination requirements that are not operation, or employer eligibility failures.

   - Failure to satisfy minimum participation, coverage and non discrimination requirements under 401(a)(4), 401(a)(26) and 410(b) of the Code. These requirements do not apply to government plans.
   - Failure of a 403(b) plan to permit employees who would make more than $200 a year in deferrals to contribute to a 403(b) plan.

   Correction generally involves corrective amendments adding more benefits or increasing existing benefits.

What is new

EPCRS under Revenue Procedure 2008-50:

- Expands the definition of plan loan failure to include violations of IRC §72(p)(2) even if the plan does not contain language relating to §72(p)(2). IRC §72(p)(2)lists the requirements for non-taxable participant loans including maximum loan amounts, loan repayment period, and level amortization of principal and interest.
- Reduces VCP submission fee by 50% for participant loans that do no comply with §72(p)(2) if the failure does not affect more than 25% of the plan's participants in any year(s) the failure occurred, and the failure is the only failure of the VCP submission.
- Clarifies that in particular cases the IRS may decline to make available one or more correction programs under EPCRS in the interest of sound tax administration.
- Updates the definition of "excess amounts" to include overpayments that result from contributions, allocations or similar credit to a participant or beneficiary that is in excess of the amounts that are permitted under the terms of the plan. Excess amounts include elective deferrals and excess annual additions under a qualified or 403(b) plan. Corrective allocations are not required to be adjusted for losses.

- Clarifies that earnings adjustments for corrective contributions or distributions *are calculated from the date the failure occurred* without regard to any extensions under the tax code.
- Disregards corrective distributions of $75 or less. If the total corrective distribution to a participant or beneficiary is $75 or less the plan sponsor is not required to make the corrective distribution if the reasonable direct costs of processing and delivering the distribution would exceed the amount of the distribution.
- Clarifies that if the plan sponsor attempts to use the IRS Letter Forwarding Program to locate participants and the Service declines to implement the letter forwarding request, then the plan sponsor is expected to use alternative means to locate participants. The IRS Letter Forwarding Program cannot be used to locate participants who owe money to the plan for purposes of collecting amounts owed to the plan.

The following table summarizes the types of plan failures that may or may not be corrected under each of the EPCRS correction programs.

EPCRS Correction Programs

	SCP Insignificant and Significant Failures	Voluntary Correction Program	Audit closing agreement program (Audit CAP)
Eligible Plans	Qualified, 403(b) SEP & SIMPLE IRA plans	Qualified, 403(b), SEP & SIMPLE IRA plans	Qualified, 403(b), SEP &S SIMPLE IRA plans
Types of failures eligible for EPCRS	Operational	Operational, plan document demographic and employer eligibility	Operational, plan document, employer eligibility and demographic
Egregious or intentional failures (flagrant disregard of applicable requirements under the IRC)	No	Yes	Yes
Abusive Tax Avoidance Transactions [ATAT] (defined as any listed transaction under 1.6011-4(b)(2) and any other transaction identified on IRS website as EP Abusive Tax Transactions	No, if failure is directly or indirectly related to an ATAT.	Yes, if IRS determines failure is unrelated to an ATAT.	Yes if IRS determines failure is unrelated to an ATAT.
Failure involving misuse of plan assets	No	No	No
Plans under IRS Employee Plans (EP) exam, IRS	Available if under EP exam, but may be limited.	Not Eligible	Eligible

	SCP Insignificant and Significant Failures	Voluntary Correction Program	Audit closing agreement program (Audit CAP)
criminal investing-ation, 990 series exam or other types IRS of exam			
Correction for Terminated plans (whether or not trust still exists)	No	Yes	Yes
Correction of a terminating Orphan Plan (plan sponsor no longer exists, cannot be located, or unable to maintain the plan)	No	Yes-provided party acting on plan's behalf is an Eligible party such as a court-appointed representative with authority to terminate the plan.	Yes-provided party acting on plan's behalf is an Eligible party such as a court appointed representative with authority to terminate the plan.
Fee/sanction	None	Generally a fixed fee depending on number of plan participants.	Negotiated sanction based on a percentage of maximum payment amount that is approximately equal to the tax the IRS could collect as a result of the failure.
Written IRS approval of correction	No	Yes	Yes

Nationwide Comment

Plan sponsors and employer using any EPCRS correction program should keep:

- Detailed records about the plan and type of type of correction program used,
- A list of errors corrected, method of correction and any related calculations,
- Copies of any IRS submission applications, and
- Closing agreements and applicable compliance dates.

Reference material

Rev. Proc. 2008-50 www.irs.gov/pub/irs-irbs/irb08-35.pdf

Summary of Significant Changes www.irs.gov/pub/irs-tege/rp08_50_summary.pdf

Topical Index to EPCRS www.irs.gov/pub/irs-tege/rp08_50_topical_index.pdf

Employee Plans Newsletter www.irs.gov/pub/irs-tege/se_081408.pdf

June 2006 edition of the Nationwide Federal Legislative & Regulatory Report
https://www.nrsservicecenter.com/content/media/retail/pdfs/NRSFORU%20Employer/Jun06_Leg_Update.pdf

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III. IRS Formulates Back-to-School Math for Teachers

As discussed in the July 2008 edition of this report, IRS Notice 2008-62 describes a new rule that is expected to be included in proposed regulations to be issued under IRC §457(f) addressing recurring part-year compensation arrangements. These arrangements are common for public school employees who work during a 10-month school year but who are paid over 12 months.

> The Treasury Department and IRS released Notice 2008-62 in advance of the forthcoming Code §457(f) proposed regulations to provide relief to schools as they begin their 2008/2009 school year.

Typically school teachers are paid during a school year that begins in one calendar year and ends in another calendar year. The school system pays all of its teachers, or permits individual teachers to elect to paid, ratably over a 12 month schedule so that some of the compensation earned for working in one school year is paid in the next calendar year. This month's report explains how to do the math involved in determining if recurring part year compensation is subject to 457(f).

The Treasury and IRS anticipate that proposed 457(f) regulations will specify that an arrangement in which an employee or independent contractor receives recurring part-year compensation will **no**t be subject to 457(f) if the arrangement:

1) Does not defer payment of any of the recurring part-year compensation beyond the last day of the 13th month following the beginning of the work period, and
2) Does not defer from one taxable year to the next payment of more that $15, 500 (2008) as indexed for IRC 402(g)(1). None of the compensation that is **earned** during the first calendar year and **paid** in the second calendar year is subject to 457(f) if the compensation does not exceed the dollar limit under 402(g)(1) for the first calendar year.

Example

Mary, a school district employee works during a school year that begins August 1, 2008 and ends May 31, 2009 (10 month school year). She is paid over a 12 month period beginning August 1, 2008. Mary's compensation is $186,000 for the school year. Since five months of the school year are in 2008 and five months are in 2009, she earns $93,000 in 2008 and $93,000 in 2009. Under the 12 month payment schedule, Mary receives $77,500 in 2008 and $108,500 in 2009. Because the amount she earns in 2008 that is paid in 2009 does not exceed $15,500 ($93,000-$77,500), the arrangement is not considered deferred compensation for purposes of 457(f).

The calculation is detailed on the next page.

Doing the Math

To determine the amount of deferred compensation for Mary:

What to do	How to calculate it	Product of the calculation
Divide annual compensation by earnings months (10)	$186,000 / 10	$18,600
Divide annual compensation by annual payments (12)	$186,000 / 12	$15,500
Multiply monthly compensation by number of months the employee earns in 2008	$18,600 x 5	$93,000
Multiply monthly compensation by number of months employee is actually paid in 2008	$15,500 x 5	$77,500
Compare amount of compensation earned during the 10 earning months to the amount of compensation paid in 2008	$93,000 - $77,500	$15,500

CONCLUSION: This amount does not exceed $15,500 for 2008 and is not subject to IRC §457(f).

Effective Date and Reliance

Until further guidance is issued, Notice 2008-62 may be relied upon for purposes of IRC §§457(f) and 409A, beginning with the first taxable year that includes July 1, 2008.

Reference Material

IRS Notice 2008-62 www.irs.gov/pub/irs-drop/n-08-62.pdf

Internal Revenue Bulletin, July 21, 2008 www.irs.gov/pub/irs-irbs/irb08-29.pdf

IRS Retirement News for Employers, Aug. 29, 2008 www.irs.gov/pub/irs-tege/rne_se082908.pdf

July 2008 edition of the Nationwide Federal Legislative & Regulatory Report
https://www.nrsservicecenter.com/content/media/retail/pdfs/NRSFORU%20Employer/LegReports/Jul08_Leg_Update.pdf

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IV. DOL Investment Advice Guidance for 401(k) plans and IRAs

The Department of Labor (DOL) has published two proposed regulations as directed under the Pension Protection Act of 2006 (PPA) to make investment advice more accessible for participants in ERISA 401(k)-type plans and individual retirement accounts (IRAs). Along with the two proposed rules, the DOL issued a report to Congress, as required under the PPA, examining the feasibility of using computer models to provide investment advice to IRA owners and beneficiaries. The report notes that some computer models currently available meet the requirements outlined in the PPA.

The PPA amended the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code by adding a new prohibited transaction exemption (PTE) that allows greater flexibility for participants of 401(k) plans and IRAs to obtain investment advice. These ERISA prohibited transaction rules are designed to prevent plan fiduciaries and others associated with them from using plan assets for their own benefit (self dealing).

> A *prohibited transaction exemption* allows plan fiduciaries to engage in transactions that would otherwise be prohibited under ERISA such as providing investment advice for a fee. PTEs may be statutory under the Code and ERISA, or granted by the DOL as class or individual exemptions.

Two ways investment advice may be given under a statutory exemption is through the use of a computer model that is certified as unbiased, and through an adviser who is compensated on a "level-fee" basis. Advice arrangements that use fee leveling are required to based advice on generally accepted investment theories that take into account historic investment performance of various asset classes through time. Investment advice must also take into account the participant or beneficiary's age, life expectancy, risk tolerance, other sources of income and investment preferences. Additional factors may also be considered. Other requirements also must be satisfied, including disclosure of fees the adviser is to receive and independent certification of the computer model.

The proposed regulation also includes a non-mandatory model form that advisers may use to satisfy the exemption's fee-disclosure requirement. In addition, to further the availability of quality, professional investment advice, the DOL has proposed a class exemption that permits advisers to provide individualized advice to a worker after giving advice generated by use of a computer model.

Feasibility of computer models

The PPA directed the DOL has examined the feasibility of using computer models for providing investment advice to IRA owners and beneficiaries. Based on the criteria required in the PPA, the DOL has identified computer models that:

1. Utilize relevant information about the owner or beneficiary;
2. Take into account the full range of investments, including equities and bonds, in determining the options for the investment portfolio of the account holder; and
3. Allow the account holder sufficient flexibility in obtaining advice to evaluate and select investment options.

Computer investment advice models that are not covered under the new statutory exemption, may, according to the DOL, be beneficial to participants and beneficiaries of individual account plans and IRAs. To assure that plan participants and IRA beneficiaries may have access to these investment advice programs, the DOL has proposed an administrative class exemption from the prohibited transaction provisions of ERISA and the Code for certain additional investment advice arrangements.

How to comment

The DOL is accepting written comments on the investment advice proposals which should be submitted by October 6, 2008 to:

> The Office of Regulations and Interpretation, Employee Benefits Security Administration
> Room N-5665
> U.S. Department of Labor,
> 200 Constitution Avenue, NW
> Washington, D.C. 20210
> Attn: Investment Advice Regulations

Comments may also be submitted electronically by email to e-ori@dol.gov, or through the federal e-rulemaking portal at www.regulations.gov.

Nationwide Comment

Presumably, any DOL class exemption for IRAs could extend to deemed IRAs that are part of a governmental employer's retirement plan.

The regulation and the PTE have already stirred up controversy in Congress. House Republican Minority Leader John Boenher, (R-OH) praised them in a recent press release while House Education and Labor Chairman George Miller (D-CA) called for the DOL to withdraw them.

Could more investment advice legislation be on the way?

Reference Material

Proposed Regulation
    www.dol.gov/federalregister/HtmlDisplay.aspx?DocId=21243&AgencyId=8&DocumentType=1

Proposed Class Exemption
    www.dol.gov/federalregister/HtmlDisplay.aspx?DocId=21242&AgencyId=8&DocumentType=3

Report to Congress   www.dol.gov/ebsa/publications/reporttocongress.html

News Release   www.dol.gov/ebsa/newsroom/08-1195-NAT.html

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V. 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:

- *Plan Sponsor Voice* newsletter, available online on the Hot Topics / News page of NRSforu.com.
- *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 member of the ASPPA Education and Examinations Committee. She is a member of the National Association of Governmental Defined Contribution Administrators. Albrecht is a current contributor to Aspen Publisher's "457 Answer Book."

BOB BEASLEY, CRC, CIC, Communications Consultant, edits it. Beasley brings 18 years of financial services communications experience to your plan. He helped prepare the *457 Guidebook* and *Fiduciary Fundamentals,* edited 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 Governmental Defined Contribution Administrators.

NRM-5306AO (09/2008)

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.