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For Your Benefit

A newsletter on current legal issues impacting employee benefits and executive compensation

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DOL Proposes Expanded Definition of "Fiduciary" and Releases Other New Rules, Increasing Exposure of Financial Advisers

By Daniel N. Kuperstein

The Employee Benefits Security Administration (EBSA) of the Department of Labor (DOL) has proposed dramatic changes to the rules that govern the relationship between employee benefit plans and those who provide investment advice and other financial services to plans and plan participants. As a result, brokers and brokerage houses, appraisers and valuation firms, and various types of financial advisers face a changing regulatory landscape and may soon become exposed to new liabilities.

Specifically, the DOL recently: (1) proposed rules that would more broadly define the circumstances under which a person is considered a "fiduciary" by reason of giving investment advice to an employee benefit plan or to a plan's participants; (2) published rules for greater disclosure of service provider fees and other plan expenses and fees; and (3) clarified rules pertaining to specific types of asset managers.

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DOL Proposes (and Re-examines) Rules Expanding Definition of "Fiduciary"

In October 2010, the DOL proposed a regulation to expand the definition of "fiduciary," set forth in ERISA § 3(21)(A), to include any individual who provides advice regarding the value, management or purchasing or selling of securities or other property to an ERISA plan, even if that advice was not delivered on a regular basis or was not the primary reason for the plan's investment decision, as the rules currently require.

In March and April of this year, the EBSA held hearings and collected comments from stakeholders on the roles and duties of fiduciaries in order to better understand the implications of their proposed changes to the definition. A final "fiduciary definition" regulation is expected to be issued by the end of the year.

Impact of the Definition Expansion

As a result of the expansion of what constitutes "investment advice" in the new rules, brokers, appraisers, financial advisers and others who service employee benefit plans will likely find that they are in a fiduciary relationship with the benefit plans they are servicing and therefore are exposed to additional liability.

With regard to the definition of "investment advice," the new regulation:

- Eliminates the requirement (for fiduciary status) that the investment advice be rendered on a regular basis;
- Provides that any advice that may be considered in connection with investment or management decisions is now covered;
- Provides that the advice no longer needs to be provided pursuant to a mutual agreement; and
- Provides that fairness opinions and appraisals are specifically included as covered types of investment advice.

It is important to note that an individual or entity can become a fiduciary based on actions alone. Under ERISA's functional definition of "fiduciary," a person or entity may be deemed a fiduciary of a plan solely as a result of the functions the person performs with respect to the plan, regardless of whether the person is a "named fiduciary" on plan documents.

Impact on Valuation Firms/Appraisers

Although the specific implications of the expanded "fiduciary" definition are not entirely clear for all financial advisers, firms and individuals providing valuation and appraisal services are likely to suffer economically from the proposed regulatory modification.

In a 1976 Advisory Opinion, the DOL found that a valuation of closely held employer securities on which an employee stock ownership plan (ESOP) would rely in determining the adequate consideration for purchase of the securities did not

constitute investment advice, and therefore, fiduciary status did not attach to the valuation firm. The Opinion clarified that when valuation firms provided advice to sponsors of ESOPs or ESOPs themselves, such advice would not serve as the primary basis for investment decisions with respect to plan assets; nor would it constitute advice as to the value of securities within the meaning of the regulation. The proposed regulation explicitly overturns the DOL's 1976 Advisory Opinion.

As a result, valuation firms, such as those that provide fairness opinions to ESOPs, may soon acquire the status of "fiduciary." This new status will, among other things, compel them to procure fiduciary liability insurance, expose them to litigation for potential breach of fiduciary duties and require greater disclosure. These new costs may drive many of these firms out of the marketplace.

DOL Releases Regulations on Fee Disclosure

Adding to the regulatory burden on financial advisers, the DOL has released two new rules on fee disclosures for retirement plans—the "Section 408(b)(2)" regulations and the "Participant-Directed" regulations.

408(b)(2) Regulations

Last year, the DOL released interim final rules concerning required disclosures in connection with services rendered to ERISA plans or Keogh plans. Although the rules initially were set to take effect in July 2011, a DOL Notice published on June 1, 2011, proposes to extend the effective date of the rules until January 1, 2012.

Section 408(b)(2) of ERISA requires that certain service provider arrangements involving ERISA plans be "reasonable" in order to qualify for exemption from the prohibited transaction rules. Generally, a "prohibited transaction" is one between a plan and an interested or related party that may result in liability for those involved due to self-dealing or conflict of interest.

The rules provide that an arrangement will not be considered "reasonable" unless the service provider discloses its fees and other financial terms to the plan. The goal of the regulation is to ensure that all service provider expenses, including hidden and indirect fees, are provided to plans.

Participant-Directed Fee Disclosure Regulations

New "participant-directed" plan fee disclosure regulations were released by the DOL in October 2010. The new rules were initially applicable for the first plan year beginning on or after November 1, 2011. However, the DOL effectively extended the applicability date of the rules to January 1, 2012 (or beyond, depending on the start of the plan year) by extending (from 60 to 120 days) the date by which initial disclosures must be provided.

These rules require fiduciaries of participant-directed individual account plans, such as 401(k) plans, to disclose to plan participants and beneficiaries certain plan and investment-related fee and expense information.

Changing Regulatory Landscape

There is no question that financial advisers in the retirement plan industry must now operate under new rules. Advisers have a lot at stake if they fail to make appropriate disclosures and meet their new obligations. Failure to comply with these new requirements could result in penalties, monetary damages and the inability to continue providing advice and other financial services to benefit plans.

For more information regarding this topic, please contact Daniel N. Kuperstein at 973.994.7579 or dkuperstein@foxrothschild.com or any member of the firm's Employee Benefits & Compensation Planning Practice Group.

ESOPs – The Ideal Vehicle for Buying Out a Minority Shareholder

By Harvey M. Katz

Traditionally, employee stock ownership plans (ESOPs) are used as a vehicle to facilitate the retirement of the sole (or majority) shareholder of a closely held corporation and to finance business acquisitions. However, ESOPs are sometimes the perfect (and often overlooked) financing vehicle for many other corporate transactions. For example, when structured properly, ESOPs can be the ideal vehicle to purchase the interest of a minority shareholder/investor.

ESOPs as a financing tool work particularly well if the company is a Subchapter C corporation, as the selling shareholder can take advantage of the tax deferral for ESOP rollovers under the Internal Revenue Code. In those cases, there are two principle reasons for the ESOP's advantage over a simple buyout: (1) **both** principal and interest are fully deductable to the corporation; and (2) the selling shareholders pay **zero** tax on their gain if they engage in an ESOP rollover transaction. In such situations, there can be a 50 percent savings realized in the total cost of the transaction. These savings are best illustrated by the example set forth below.

Consider the following differences between a majority shareholder's direct purchase of minority held corporation shares and his/her same purchase of shares through an

ESOP, where the objective is to provide the selling shareholder with $10 million after taxes. In both cases, the corporation is the ultimate source of the funds. In the first instance, the investor/sellers pay no capital gains tax in a properly structured ESOP transaction. Assuming a combined 20 percent state and federal capital gains rate, in a private transaction, the selling shareholder/investor would need to receive $12.5 million to put him or her in the same after-tax financial position.

Further, assume that both the shareholder/purchaser and the ESOP will finance the transaction through an outside lender over a five-year period. Whereas the ESOP would need to repay $12 million (arbitrarily assuming $10 million principal and $2 million interest), the majority shareholder would repay $15 million ($12.5 million principal and $2.5 million interest) using the same assumptions. In the ESOP transaction, the net cost of the repayment to the sponsoring corporation is approximately $7.2 million over five years (assuming a 40 percent marginal corporate tax rate). By comparison, in a private sale, the corporation would have to pay a purchasing majority shareholder almost $21 million over five years in order to provide sufficient after-tax funds for him/her to repay the loan's $12.5 million principal, plus $2.5 million to pay the loan's interest (which is deductible and need not be "grossed up"). Thus, to equal the corporation's expenses under an ESOP equity sale, it would have to provide the purchasing majority shareholder approximately $23.5 million at an after-tax cost of almost $14.1 million - almost twice as much as would be required using an ESOP transaction! The ability to achieve such extraordinary savings warrants commensurate efforts to structure the ESOP transaction as to allow it and its shareholders the advantages of these tax savings.

These savings are shown in the following table:

	Shareholder Purchase	ESOP
Cost of Shares:	$10,000,000	$10,000,000
Amount of proceeds necessary to provide same after tax value to selling shareholder/investor:	$12,500,000	$10,000,000
Amount of proceeds required including financing costs:	$15,000,000	$12,000,000
Bonus to majority shareholder to fund transaction including interest (over 5 years):	$23,500,000	N/A
Contribution to ESOP including interest (over 5 years):	N/A	$12,000,000
After tax cost to the corporation:	$14,100,000	$7,200,000

In order to realize the full benefits of the ESOP rollover, the selling shareholder must invest in "qualified replacement property" **and** sell at least 30 percent of the company to the ESOP while meeting several other technical requirements. However, in most cases, the ESOP is economically superior to other financing arrangements, leaving these requirements palatable to the selling shareholder.

Undoubtedly, not every corporation or transaction is suited to be structured as an ESOP transaction. Generally, the ideal private company candidate for an ESOP will meet most of the following criteria: (1) strong cash flow; (2) history of increasing sales and profits; (3) consistently been in a high federal income tax bracket; and (4) substantial stockholder equity. The other attribute - that the company have strong management - is always satisfied in the case of a minority buyout.

Whether an ESOP is ultimately the right tool for a transaction largely depends on the specifics of the company and the contemplated transaction. However, the ESOP alternative always merits serious consideration based on the potential cost savings and tax advantages it presents.

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Benefits of Self-Funded Health Plans

By Michelle M. Stimson

Due to the economic recession and the potential for increased health insurance costs brought about by health care reform, many employers are beginning to view self-funded health care plans as a more attractive option than fully insured plans. These employers recognize the advantages of self-funding, which include cost savings, increased cash flow and more flexibility in benefit decisions, administration and funding. Moreover, it appears that self-funded plans will be favored under health care reform because, while many provisions of health care reform apply both to fully insured and self-funded plans, there are many provisions of health care reform from which only self-funded plans are exempt. For example, self-funded plans will not have to comply with the new marketing, internet portal, enrollment and provider network and quality accreditation rules. This will mean direct cost savings to the plan, which will pass through to the employer. Furthermore, there are many state mandates from which self-funded plans are still exempt.

Flexibility of Plan Design

One major advantage of self-funding is the control and flexibility of plan design.

Under a self-funded health plan, the employer has the option of either duplicating its current fully insured plan design or redesigning and tailoring the benefits to meet the specific needs of the employer. Of course, as mentioned, health care reform has put some limitations on the extent to which an employer can influence the plan design, but for the most part, the employer has the freedom to eliminate benefits that result in plan abuses or high utilization.

Exemption From State-Mandated Benefits

As previously noted, another benefit of opting for a self-funded arrangement is an employer's ability to opt out of state mandated benefits, although this benefit has been somewhat limited by health care reform. Since self-funded health care plans are governed by ERISA, they follow federal law and are not required to provide state-mandated benefits, which can be both expensive and unnecessary. Likewise, these employers can set their own limits on benefits where states would otherwise set the limits.

Control of Reserves

Employers sponsoring self-funded plans also enjoy the advantages of controlling reserves. In a fully insured plan, a substantial portion of the premium is held by the carrier as a state-required reserve for claims and inflation. Under a self-funded arrangement, the employer maintains and controls the reserves and has the ability to invest these funds. Moreover, there are no restrictions on reserves, and the employer retains them when claims do not materialize. Under a fully insured arrangement, if an employer's claims experience is better than expected, only the insurer benefits financially.

Claims Experience

Even where an individual employer has a history of good claims experience, the insurance companies pass on a renewal based upon the entire pool of insureds. Thus, an employer is rated, not based upon its individual claims experience but upon those of other companies that have no relationship to that employer's company or industry. A self-funded arrangement eliminates this component of maintaining a plan.

Premium Tax

In most states, there is no premium tax for self-funded plans. This results in an immediate savings because approximately two to four percent of an employer's fully insured health care costs fund this premium tax.

Advantages of Advanced Preparation

It seems clear that health care reform will increase the already high cost of health insurance. With greater flexibility, fewer mandated benefits and potentially lower costs, now is the time for both large and small employers to consider shifting their fully insured plans to self-funded plans. Through innovative ideas and strategic planning, employers can examine their workforce and prepare for the changes coming in 2014.

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Health Care Reform Update: Form W-2 Reporting

By Theresa Borzelli and Mary Andersen

In this article, we continue summarizing recent government guidance/announcements with respect to the Patient Protection and Affordable Care Act of 2010 (Affordable Care Act).

The Affordable Care Act requires informational reporting of the aggregate cost of employer-sponsored group health plan coverage, which is to be included on Form W-2 and which was originally scheduled to take effect in 2011. IRS Notice 2010-69 provided transition relief until 2012 (for Forms W-2 issued by January 31, 2013) although employers could voluntarily elect to include the information in 2011. The IRS recently issued Notice 2011-28, which provides further relief as follows:

- W-2 reporting of the aggregate cost of employer-provided health plan coverage is not required until 2012 for employers that issue 250 or more Forms W-2.
- Employers issuing fewer than 250 Forms W-2 do not have to report the aggregate cost of employer-provided health care until further guidance is issued.
- Aggregate reportable cost generally includes the portion of cost borne by the employer and by the employee, regardless of whether it is on a pre-tax or post-tax basis (exclusions for Flexible Spending Accounts), as well as cost for any person covered under the plan because of a relationship to the employee including any portion includible in the employee's gross income.
- Reportable cost must be determined on a calendar year basis and reported as Code DD in Box 12 of Form W-2.
- Plan sponsors must use a reasonable method for reporting aggregate cost for terminated employees. Aggregate cost is not required for employees who request a Form W-2 before the end of the calendar year in which they terminate.
- Total aggregate cost is not required to be reported on Form W-2.

Unlike IRS Notice 2010-69, Notice 2011-28 does not provide relief from any reporting penalties.

What Is Not Included in Reportable Cost:

- Amounts contributed to an Archer MSA;
- Amounts contributed to an HSA;
- Amounts contributed to HRA;
- Salary reduction contributions to an FSA, subject to certain rules;
- Coverage for a dental or vision plan that is not integrated into a group health plan;
- Coverage only for accident or disability income insurance, or any combination thereof;
- Coverage issued as a supplement to liability insurance;
- Liability insurance, including general liability insurance and automobile liability insurance;
- Workers' compensation or similar insurance;
- Automobile medical payment insurance;
- Credit-only insurance; and
- Other similar insurance coverage under which benefits for medical care are secondary or incidental to other insurance benefits.

Also excluded from reportable cost are coverage only for a specified disease or illness and hospital indemnity or other fixed indemnity insurance, provided that such coverage is offered as independent, noncoordinated benefits.

Calculating the Cost of Coverage

Notice 2011-28 describes four methods for calculating cost of coverage: (1) COBRA premium, (2) premium charged method, (3) modified COBRA premium, and (4) composite rate; and provides several examples.

The Q&A section of Notice 2011-28 also provides guidance where the employee commences, changes or terminates during the year and when excess reimbursements under Internal Revenue Code § 105(h) are included in the gross income of a highly compensated individual.

What Should Plan Sponsors Do Now?

Plan sponsors need to be aware of the changes that may be required in W-2 reporting. This may be as simple as capturing the necessary data elements and transmitting the information to an outside party, if Form W-2 preparation is outsourced. Additionally, plan sponsors must decide how they calculate cost. It is not too early to begin this discussion with your attorney, consultant and/or management.

For more information regarding this topic, please contact Theresa Borzelli at 973.992.4800 or tborzelli@foxrothschild.com, Mary Andersen of ERISA Diagnostics, Inc. at 610.524.5351 or www.erisadignostics.com or any member of the firm's Employee Benefits & Compensation Planning Practice Group.

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