II. QUALIFIED PLANS

A. Overview of Present Law Relating to Qualified Retirement Plans

1. In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code[1187] ("a qualified retirement plan") is accorded special tax treatment under present law. Employees do not include qualified retirement plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified retirement plan even though the contributions are not currently included in an employee's income. Contributions to a qualified retirement plan are held in a tax-exempt trust.

Employees, as well as employers, may make contributions to a qualified retirement plan. Employees may, subject to certain restrictions, make both pre-tax and after-tax contributions to a qualified retirement plan. Pre-tax employee contributions may be made to a qualified cash or deferred arrangement, i.e., a 401(k) plan. Such contributions are referred to in the Code as "elective deferrals" and are generally treated the same as employer contributions for Federal tax purposes.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to obtain tax-favored status.[1188] One of these requirements is that a qualified retirement plan must be maintained for the exclusive benefit of employees. In particular, a qualified retirement plan must prohibit the diversion of assets for purposes other than the exclusive benefit of employees and their beneficiaries (the "exclusive benefit rule").

In addition, minimum participation and coverage rules and nondiscrimination rules are designed to ensure that qualified retirement plans benefit an employer's rank-and-file employees as well as highly compensated employees. Under the minimum coverage rules, a plan must satisfy one of the following requirements: (1) the plan benefits at least 70 percent of employees who are nonhighly compensated employees;[1189] (2) the plan benefits a percentage of nonhighly

---

[1187] Except as otherwise indicated, this discussion refers to rules in the Internal Revenue Code. The Employee Retirement Income Security Act of 1974 ("ERISA") also contains rules relating to qualified plans. In some cases the ERISA requirements are identical or substantially similar to Code requirements. ERISA's requirements generally may be enforced through administrative actions by the Department of Labor or by lawsuits brought by plan participants, the Department of Labor, or plan fiduciaries.

[1188] In some cases, special provisions apply to certain types of plans, such as qualified retirement plans maintained by State and local governments and churches. This document discusses the rules applicable to qualified retirement plans without regard to such special provisions, except as specifically mentioned.

[1189] Under present law, an employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of $90,000 (for 2002) or (b) at

AUTHENTICATED U.S. GOVERNMENT INFORMATION GPO

compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or (3) the plan satisfies an average benefits test which compares the benefits received by highly compensated employees and nonhighly compensated employees.[1190] Present law also contains a general nondiscrimination requirement which provides that a qualified retirement plan may not discriminate in favor of highly compensated employees. This requirement generally applies to all benefits, rights, and features under the plan, not just to contributions and benefits.[1191] Special rules apply to plans that primarily benefit key employees (called "top-heavy plans").[1192]

The plan qualification standards also define certain rights of plan participants and beneficiaries and provide some limits on the tax benefits for qualified retirement plans. A limit of $200,000 (for 2003) applies to the amount of a participant's compensation that may be taken into account for qualified retirement plan purposes.[1193] Limits apply also to the benefits or contributions provided to a participant and to the amount an employer may deduct for contributions to a qualified retirement plan, based on the type of plan.[1194]

Certain rules that apply to qualified retirement plans are designed to ensure that the amounts contributed to such plans are used for retirement purposes. Thus, for example, an early withdrawal tax applies to premature distributions from qualified retirement plans,[1195] and the ability to obtain distributions prior to termination of employment from certain types of qualified retirement plans, including defined benefit plans, is restricted.[1196]

Enforcement of the requirements that apply to qualified retirement plans depends on the source of the requirements. The qualification requirements under the Internal Revenue Code are

---

the election of the employer had compensation for the preceding year in excess of $90,000 (for 2002) and was in the top 20 percent of employees by compensation for such year. A nonhighly compensated employee is an employee other than a highly compensated employee. Sec. 414(q).

[1190] Sec. 410(b).

[1191] Sec. 401(a)(4).

[1192] Sec. 416.

[1193] Sec. 401(a)(17).

[1194] *See* secs. 404 and 415. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased many of the limits that apply to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[1195] Sec. 72(t).

[1196] *See, e.g.*, sec. 401(k)(2).

enforced by the IRS.[1197] If a plan fails to meet the Code's qualification requirements, then the favorable tax treatment for such plans may be denied; that is, the employer may lose tax deductions and employees may have current income taxation. As a practical matter, the IRS rarely disqualifies a plan. Instead, the IRS may impose sanctions short of disqualification and require the employer to correct any violation of the qualification rules.

Certain of the Internal Revenue Code rules relating to qualified plans are enforced through an excise tax rather than through disqualification. For example, a failure to satisfy the minimum funding requirements for defined benefit plans, discussed below, does not result in disqualification of the plan. Instead, an excise tax is imposed on the employer.

After a plan's initial establishment, the employer may find it necessary or desirable to change its terms and provisions by amending it. Amendment of a plan may be necessary to ensure the plan's continued qualification, or may be discretionary, implementing design changes desired by the plan sponsor. Additionally, a plan, including amendments, may be restated from time to time, that is, a new version of a plan document incorporating legal and design changes will be produced to reflect all current provisions.

2. Types of qualified retirement plans

In general

Overview

Qualified retirement plans are broadly classified into two categories, defined benefit plans and defined contributions plans, based on the nature of the benefits provided. A defined benefit plan promises to provide a specific benefit specified in the plan. Defined contribution plan benefits are based on the contributions to and investment returns on individual accounts. Certain types of qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan. For example, a cash balance plan is a hybrid plan. Legally, a cash balance plan is a defined benefit plan; however, plan benefits are defined by reference to a hypothetical account balance. Floor offset arrangements are another type of hybrid plan. These arrangements consist of a defined benefit plan, which provides a floor benefit, and a defined contribution plan, which offsets the benefit under the floor plan. Cash balance plans and floor-offset arrangements are discussed below.

Defined benefit plans

Under a defined benefit plan, benefits are determined under a plan formula, typically based on compensation and years of service. For example, a defined benefit plan might provide an annual retirement benefit of two percent of final average compensation multiplied by total years of service completed by an employee. Benefits under a defined benefit plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.

[1197] Employees do not have a right to sue to enforce the qualified retirement plan requirements under the Internal Revenue Code.

Employer contributions to a defined benefit plan are subject to minimum funding requirements to ensure that plan assets are sufficient to pay the benefits under the plan.[1198] An employer is generally subject to an excise tax for a failure to make required contributions.[1199] Benefits under a defined benefit plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation ("PBGC").

Defined contribution plans

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Defined contribution plans fall into three general types: profit-sharing plans, stock bonus plans, and money purchase pension plans. A plan must designate the type of plan it is intended to be.[1200]

Different types of contributions may be made to a defined contribution plan. The type of contributions made to a defined contribution plan depends on the design of the plan. Many plans provide for different types of contributions. Contributions fall into two general types: employee contributions and employer contributions. Further distinctions apply within each type.

Employee contributions can be made on a pre-tax or an after-tax basis. Employee elective deferrals under a 401(k) plan are pre-tax employee contributions. Elective deferral contributions are generally treated the same as employer contributions for income tax purposes and are not subject to tax until distributed from the plan.

Employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes elective deferrals or after-tax contributions. Depending on the type of defined contribution plan and the plan terms, employer nonelective contributions may be required or may be discretionary. Matching contributions are employer contributions that are made only if the employee makes contributions.

Within the three general types of defined contribution plans are plan designs that contain special features, such as qualified cash or deferred arrangements (or 401(k) plans) and employee stock ownership plans ("ESOPs"), discussed below.

Cash balance plans

A cash balance plan is a type of defined benefit plan with benefits resembling the benefits usually associated with defined contribution plans. Under a "cash balance" formula, the benefit

---

[1198] Sec. 412.

[1199] Sec. 4971.

[1200] While certain rules apply only to certain types of plans, the differences between these types of plans have been blurred over time and are largely historical with respect to some plan characteristics. For example, contributions under a profit-sharing plan are no longer required to depend on the employer's profits.

is typically defined by a hypothetical account balance, which is periodically credited with an amount based on the participant's compensation (a "pay credit") and interest thereon (an "interest credit").

Benefits paid to the participant are based on the value of the hypothetical account even though the plan does not allocate assets to individual accounts to participants. The hypothetical account is only a method of computing participants' promised benefits. A participant's hypothetical account balance is typically credited with hypothetical contributions and hypothetical earnings designed to mimic the allocations of actual contributions and actual earnings to a participant's account that would occur under a defined contribution plan.

Qualified cash or deferred arrangements ("401(k) plans")

A 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan that contains a "qualified cash or deferred arrangement."[1201] Thus, such arrangements are subject to the rules generally applicable to qualified retirement plans. In addition, special rules apply to such arrangements.[1202]

Under a 401(k) plan, an employee may elect to have the employer pay compensation as contributions to a qualified retirement plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $12,000 for 2003.[1203] Starting in 2002, an individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a 401(k) plan. The limit on elective deferrals is increased for an individual who has attained age 50 by $2,000 for 2003.[1204] An employee's elective deferrals must be fully vested.

A special nondiscrimination test applies to elective deferrals under a 401(k) plan, which compares the elective deferrals of highly compensated employees with elective deferrals of

---

[1201] Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement.

[1202] Other arrangements are similar to 401(k) plans, but are not subject to all the same rules, such as section 457 plans of State and local governments, and tax-sheltered annuity plans (sec. 403(b)).

[1203] Sec. 402(g). The dollar limit on elective deferrals increases to $13,000 for 2004, $14,000 for 2005, and $15,000 for 2006. After 2006, the limit is adjusted for inflation in $500 increments. The increases in the limit are subject to the general sunset provision of EGTRRA.

[1204] Sec. 414(v). The additional amount permitted for catch-up contributions increases to $3,000 for 2004, $4,000 for 2005, and $5,000 for 2006. After 2006, the limit is adjusted for inflation in $500 increments. The increases in the limit are subject to the general sunset provision of EGTRRA.

nonhighly compensated employees.[1205] Employer matching contributions and after-tax employee contributions under a defined contribution plan are also subject to a special nondiscrimination test.[1206]

Employers are not required to offer matching contributions based on employee elective deferrals. Many employers provide a match because doing so makes it easier for the plan to satisfy applicable nondiscrimination rules by encouraging employees to make elective deferrals. For example, a plan could provide that the employer will make matching contributions equal to 50 percent of an employee's elective deferrals, up to a maximum of three percent of compensation.

In addition to or in lieu of matching contributions, some employers make "qualified nonelective contributions" for employees participating in a 401(k) plan, which may be taken into in account applying the special nondiscrimination test for elective deferrals test. Like matching contributions, qualified nonelective contributions may make it easier for plans to satisfy the applicable nondiscrimination rules. "Qualified nonelective contributions" are contributions that are made by the employer without regard to whether the employee makes elective deferrals, that are 100 percent vested, and that meet certain other requirements.

Under a safe harbor,[1207] a 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule if the employer either: (1) satisfies a matching contribution requirement; or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules. A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to three percent of compensation and (b) 50 percent of the employee's elective deferrals from three to five percent of compensation; and (2) the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that satisfy the design-based safe harbor for 401(k) plans are deemed to satisfy the special nondiscrimination test for such contributions-test. Certain alternative matching arrangements also can be used to satisfy the safe harbor.

[1205] Sec. 401(k)(3). (This test is called the actual deferral percentage test or the "ADP" test).

[1206] Sec. 401(m). (This test is called the actual contribution percentage test or the "ACP" test.)

[1207] Sec. 401(k)(12).

Employee stock ownership plans ("ESOPs")

An ESOP is a defined contribution plan that is designated as an ESOP, is designed to invest primarily in securities of the employer, and meets certain other requirements.[1208] An ESOP can be an entire plan or it can be a component of a larger defined contribution plan.[1209] ESOPs are subject to additional requirements that do not apply to other plans that hold employer securities. For example, voting rights must generally be passed through to ESOP participants, employees must generally have the right to receive benefits in the form of employer securities, and certain ESOP participants must be given the right to diversify a portion of their account into investments other than employer securities.[1210]

In addition, certain benefits are available to ESOPs that are not available to other types of qualified retirement plans that hold employer securities. For example, an ESOP may be "leveraged," i.e., employer securities held in an ESOP may be purchased with loan proceeds. In a leveraged ESOP, the ESOP typically borrows from a financial institution. The loan is typically guaranteed by the employer and the employer securities are pledged as security for the loan. Alternatively, the loan can be made directly by the employer to the ESOP, or the employer may borrow from a financial institution, and then make a loan to the ESOP. Contributions to the plan are used to repay the loan. Dividends on employer securities may also be used to repay the loan. The employer securities are held in a suspense account and released to participants' accounts as the loan is repaid.

Special tax benefits also apply to ESOPs. For example, the employer may deduct dividends paid on employer stock held by an ESOP if the dividends are used to repay a loan, if they are distributed to plan participants, or if the plan gives participants the opportunity to elect either to receive the dividends or have them reinvested in employer stock under the ESOP and the dividends are reinvested at the participant's election.[1211] In addition, special deduction rules apply to ESOPs that do not apply to other types of plans.[1212]

Prior law also provided additional tax benefits for ESOPs that were in effect during the period covered by the Joint Committee staff review of Enron. Prior law provided that banks and

---

[1208] Sec. 4975(e)(7); Treas. Reg. sec. 54.4975-11. The plan must be either a stock bonus plan or a stock bonus and money purchase pension plan.

[1209] An ESOP may provide for different types of contributions, including employer nonelective contributions and others. For example, an ESOP may include a 401(k) feature that permits employees to make elective deferrals. Such an ESOP design is sometimes referred to as a "KSOP."

[1210] *See* secs. 401(a)(28), 409(e), and 409(h).

[1211] Sec. 404(k). The ability to deduct dividends reinvested at the election of the participant is effective for taxable years beginning after December 31, 2001.

[1212] Sec. 404(a)(9). Additional special rules also apply to ESOPs that hold employer securities that are not publicly traded.

other financial institutions could exclude from income 50 percent of the interest received with respect to a loan used to acquire employer securities for an ESOP.[1213]

In addition, prior law allowed for the transfer of defined benefit plan assets to an ESOP without imposition of the excise tax on reversions.[1214] Under present and prior law, an excise tax is imposed on employer reversions from a qualified plan equal to 20 percent of the reversion (50 percent if the employer does not establish a replacement plan or provide certain benefit increases). [1215] Prior law provided that, if certain requirements are satisfied, the reversion tax did not apply to the extent a reversion upon plan termination was transferred to an ESOP.

In order for the exception for transfers to an ESOP to apply, the following requirements had to be satisfied: (1) within 90 days, or such longer period as the IRS allowed, after the transfer, the amount transferred had to be invested in employer securities or used to repay loans used to purchase employer securities; (2) certain allocation requirements had to be met which generally required that the employer securities be allocated ratably over no more than seven years;[1216] (3) at least half of the participants in the qualified plan had to be participants in the ESOP as of the close of the first plan year for which an allocation of the securities was required; (4) under the plan, employer securities, the acquisition of which satisfied the first condition, had to, except to the extent necessary to meet plan qualification requirements relating to diversification of assets, remain in the plan until distributed to participants in accordance with the provisions of the plan; and (5) the amount had to be transferred after March 31, 1985, and before January 1, 1989, or after December 31, 1988, pursuant to a termination which occurred after March 31, 1985, and before January 1, 1989.

3. General rules relating to investment of qualified retirement plan assets

Risk of investment loss

The person who bears the risk of investment loss with respect to qualified retirement plan assets depends on whether the plan is a defined benefit plan or a defined contribution plan.

[1213] The exclusion was added in section 133 of the Code by the Deficit Reduction Act of 1984, Pub. L. No. 98-369 (1984), generally effective for loans used to acquire employer securities after July 18, 1984. Significant changes were made to the interest exclusion by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 (1989), including a provision generally limiting the exclusion to cases in which the ESOP owned more than 50 percent of the stock of the corporation. The exclusion was subsequently repealed, generally effective for loans made after August 20, 1996. Pub. L. No. 104-188, sec. 1602(a) (1996).

[1214] Sec. 4980(c)(3). This provision was utilized by Enron to provide funding for the Enron ESOP. A "reversion" is any amount of cash or the fair market value of property received by an employer from a qualified plan. A reversion can occur, for example, if a defined benefit plan is terminated and plan assets are greater than plan liabilities.

[1215] Sec. 4980.

[1216] Sec. 4980(c)(3)(C).

In a defined benefit plan, investment risk is generally on the employer as a result of the minimum funding requirements, under which the employer must make contributions in the amount necessary to fund promised benefits, as discussed above. The minimum funding rules also require periodic valuation of defined benefit plan assets. If the plan suffers investment losses, the employer may be required to increase plan contributions to maintain the funded status of the plan.

Benefits under most defined benefit plans are guaranteed (within limits) by the PBGC.[1217] In the event a plan terminates with assets insufficient to pay promised benefits, the PBGC will pay benefits up to the maximum guaranteed amount.[1218] For 2003, the maximum guaranteed benefit for an individual retiring at age 65 is $3,664.77 per month, or $43,977.24 per year.

In a defined contribution plan, the benefit to which the participant is entitled is the account balance. Thus, the plan participant bears the risk of investment losses, regardless of whether investment decisions are made by the participant or a plan fiduciary. Defined contribution plans are not insured by the PBGC.

General fiduciary rules and investment responsibility

Overview

Except with respect to certain investments in employer securities, discussed below, generally neither the Internal Revenue Code nor ERISA imposes restrictions on the specific investments that can be made with qualified retirement plan assets. Rather, ERISA imposes general standards applicable to the conduct of plan fiduciaries. In addition, except with respect to investment in employer securities and the ability of plan participants to direct investments, discussed below, defined benefit plans and defined contribution plans are generally subject to the same rules regarding the investment of plan assets.

Definition of fiduciary

ERISA provides, in relevant part, that a person is a fiduciary with respect to a plan to the extent he or she exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of plan assets or has any discretionary authority or discretionary responsibility in the administration of the plan.[1219] Fiduciary status extends to those aspects of the plan over which the fiduciary exercises authority or control. The determination of whether an individual is a plan fiduciary often involves significant factual inquiry. Corporate officers and directors are not considered plan fiduciaries merely because of their corporate position--whether they are fiduciaries is determined by reference to whether they have or exercise the requisite authority

---

[1217] ERISA sec. 4021.

[1218] *See* ERISA sec. 4022.

[1219] ERISA sec. 3(21)(A)(i) and (ii).

and control over the plan. Under ERISA, a person who makes investment decisions with respect to a qualified retirement plan is generally a plan fiduciary.

ERISA also provides that every plan must have one or more named fiduciaries.[1220] Named fiduciaries must be named in the plan document (or by the employer, employee organization, or the two acting jointly, pursuant to a procedure specified in the plan). The named fiduciary must have authority to control and manage the operation and administration of the plan. In practice, a committee is often identified as the named fiduciary and has employer officers as its members.

Generally, the plan trustee has exclusive authority and responsibility for managing and controlling plan assets and is thus responsible for investing plan assets. However, the plan may make the trustee subject to the direction of the named fiduciary, or the authority for managing plan assets may be delegated to an investment manager.[1221] An investment manager is a registered investment advisor, bank, trust company, or insurance company that is appointed by a named fiduciary of the plan with the power to manage, acquire, or dispose of plan assets. The investment manager must acknowledge in writing its status as a fiduciary.[1222]

General standard of conduct for plan fiduciaries

ERISA contains general fiduciary standards that apply to all fiduciary actions,[1223] including investment decisions made by fiduciaries. ERISA requires that a plan fiduciary generally must discharge its duties solely in the interests of participants and beneficiaries and:

- for the exclusive purpose of providing benefits to plan participants and beneficiaries and defraying reasonable expenses of plan administration;
- with the care, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
- by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
- in accordance with plan documents insofar as they are consistent with ERISA.[1224]

[1220] ERISA sec. 402(a).

[1221] In such case, ERISA provides that the trustee is obligated to follow the instructions of the named fiduciary unless the directions are contrary to the provisions of ERISA or the plan or trust. *See* ERISA sec. 403(a)(1) and (2).

[1222] ERISA sec. 3(38).

[1223] Although the focus of this discussion is plan investments, fiduciary actions and liability are not limited to issues regarding investment of plan assets.

[1224] ERISA sec. 404(a)(1).

In the case of a defined contribution plan, the diversification requirement and the prudence requirement (only to the extent it requires diversification) are not violated by the acquisition or holding of employer securities.[1225] The application of the fiduciary rules to plans holding employer securities is discussed in more detail in Part II.C.3, below.

The fiduciary rules under ERISA are subject to enforcement through administrative actions by the Department of Labor or by lawsuits brought by plan participants, the Department of Labor, or plan fiduciaries. Plan fiduciaries may be held personally liable for losses resulting from a breach of fiduciary duty.[1226]

In some circumstances, a plan fiduciary may be liable for a breach of fiduciary duty by another fiduciary of the plan.[1227] A fiduciary may be liable for a breach of duty by another fiduciary if the fiduciary: (1) knowingly participates in, or undertakes to conceal, an act or mission of the other, knowing that the act or omission constitutes a breach of duty; (2) enables another fiduciary to commit a breach by failing to comply with their own duty; or (3) knows of a breach by another fiduciary and fails to make reasonable efforts[1228] under the circumstances to remedy it. For purposes of these provisions, constructive knowledge, rather than actual knowledge is sufficient to establish cofiduciary liability. For example, a fiduciary may be liable for the actions of another if the fiduciary knew or should have known of the breach and failed to make reasonable efforts to correct the breach.

Plan investment decisions made by plan fiduciaries may in some cases violate the exclusive benefit rule under the Internal Revenue Code. However, not all fiduciary violations relating to plan investments are violations of the exclusive benefit rule.

Special fiduciary rules for participant-directed investments in defined contribution plans

A defined contribution plan may permit participants or beneficiaries to make investment decisions with respect to their individual accounts. For example, it is common for 401(k) plans to provide participants with investment authority with respect to their own elective deferrals.

Under a so-called safe harbor rule, ERISA fiduciary liability does not apply to investment decisions made by plan participants in deferred contribution plans if plan participants control the investment of their individual accounts.[1229] Many employers design plans so that they can take advantage of this rule in order to minimize fiduciary responsibilities. If the safe harbor applies, a

---

[1225] ERISA sec. 404(a)(2).

[1226] ERISA sec. 409.

[1227] ERISA sec. 405. Such liability is often referred to as cofiduciary liability.

[1228] Department of Labor regulations clarify that if a fiduciary takes reasonable steps to remedy a breach by another, the fiduciary generally is not liable under cofiduciary liability merely because the remedial efforts fail. 29 C.F.R. sec. 2509.75-7, at FR-10.

[1229] ERISA sec. 404(c).

plan fiduciary may be liable for the investment alternatives made available, but not for the specific investment decisions made by participants. This includes investments in employer securities made at the direction of the participant. Failure to satisfy the safe harbor rule means that plan fiduciaries may be held liable for the investment decisions of participants. The safe harbor rule is discussed in detail below.[1230]

4. Rules relating to investments of qualified retirement plan assets in employer securities

In general

In addition to the general ERISA rules relating to the investment of qualified retirement plan assets, special rules apply to the investment of plan assets in stock or other securities issued by the employer or an affiliate of the employer.[1231] The assets of either a defined contribution plan or a defined benefit plan may be invested in employer securities. However, the rules relating to such investments differ for defined benefit plans and defined contribution plans, as discussed below.

Application of fiduciary rules to plans holding employer securities

As mentioned above, the general diversification standard applicable to plan fiduciaries (and the general prudence requirement to the extent it requires diversification) generally are not violated by the acquisition or holding of employer securities by a defined contribution plan.[1232] However, under case law, this does not mean that the holding of such securities by such plans never involves a breach of fiduciary duty. This issue, and applicable cases, is discussed in detail below.[1233]

Limits on investments in employer securities

ERISA imposes restrictions on the investment of qualified retirement plan assets in employer securities. ERISA prohibits defined benefit plans (and money purchase pension plans other than certain pre-ERISA plans) from acquiring employer securities if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer securities.[1234] Most defined contribution plans, such as profit-sharing plans, stock bonus plans, and certain pre-ERISA money purchase pension plans are not subject to any limit on the amount of employer contributions that can be invested (or required to be invested) in employer securities.[1235]

[1230] *See* Part II.C.5.

[1231] Special rules apply also to the investment of plan assets in employer real property.

[1232] ERISA sec. 404(a)(2).

[1233] *See* Part II.C.3.

[1234] *See* ERISA sec. 407.

[1235] ERISA sec. 407(b)(1).

In the case of a 401(k) plan, no more than 10 percent of elective deferrals can be required to be invested in employer securities. However, this restriction does not apply if: (1) the amount of elective deferrals required to be invested in employer securities does not exceed more than one percent of any employee's compensation; (2) the fair market value of all individual account plans maintained by the employer is no more than 10 percent of the fair market value of all retirement plans of the employer; or (3) the plan is an ESOP. In addition, there is no limit on the amount of elective deferrals that an employee can choose voluntarily to invest in employer securities.[1236]

The Code requires that ESOP plan participants who are age 55 and have 10 years of plan participation must be permitted to diversify the investment of the participant's account (i.e., to invest the account in assets other than employer securities).[1237] The participant must be given a period each year for six years in which to diversify up to 25 percent (or 50 percent in the last year) of the participant's account, reduced by the portion of the account diversified in prior years. As an alternative to providing diversified investment options in the plan, the plan can provide that the portion of the participant's account that is subject to the diversification requirement is distributed to the participant.

Definition of employer securities

Under ERISA, a qualified retirement plan may hold only a "qualifying employer security."[1238] Any stock issued by the employer or an affiliate of the employer is a qualifying employer security.[1239] In the case of a defined benefit plan (and money purchase pension plans other than certain pre-ERISA plans), in order for stock to be a qualifying employer security, the plan cannot hold more than 25 percent of the aggregate amount of the issued and outstanding stock of the same class, and at least 50 percent of the aggregate amount of that stock must be held by persons independent of the issuer.[1240]

For purposes of ESOP investments, employer securities (or "qualifying employer securities") are defined in the Code to mean only:

(1) publicly traded common stock of the employer or a member of the same controlled group;

[1236] ERISA sec. 407(b)(2).

[1237] Sec. 401(a)(28).

[1238] ERISA sec. 407(a)(1)(A).

[1239] ERISA sec. 407(d)(5). Qualifying employer securities also include certain publicly traded partnership interests and certain marketable obligations (i.e., a bond, debenture, note, certificate or other evidence of indebtedness). *Id.*

[1240] ERISA sec. 407(f).

(2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or

(3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.[1241]

5. Other rules

Prohibited transaction rules[1242]

Both the Internal Revenue Code and ERISA contain prohibited transaction rules that prohibit the employer, plan fiduciaries, and other persons with a close relationship to a qualified retirement plan from engaging in particular transactions with the plan. These rules are not targeted toward particular types of investments, but rather seek to prevent self-dealing transactions.

Prohibited transactions include (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, (3) the furnishing of goods, services or facilities, (4) the transfer to, or use by or for the benefit of, the income or assets of the plan, (5) in the case of a fiduciary, any act that deals with the plan's income or assets for the fiduciary's own interest or account, and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Certain transactions are exempt from prohibited transaction treatment. In addition, the Department of Labor may grant administrative exemptions in particular circumstances.

If a prohibited transaction occurs, the disqualified person who participates in the transaction is subject to a two-tier excise tax under the Code. The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved.

Limitations on contributions and benefits

Limits apply to the contributions or benefits provided to a participant under a qualified retirement plan, based on the type of plan.[1243]

[1241] Secs. 4975(c)(7) and 409(l). This document uses the term "employer securities" to refer generally to qualifying employer securities as defined under ERISA and the Code.

[1242] *See* sec. 4975 and ERISA secs. 407 and 408.

Under a defined contribution plan, the annual additions to the plan with respect to each plan participant cannot exceed the lesser of (1) 100 percent of the participant's compensation or (2) a dollar amount, indexed for inflation ($40,000 for 2003). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer.

Under a defined benefit plan, the maximum annual benefit payable to a participant at retirement cannot exceed the lesser of (1) 100 percent of the participant's average compensation, or (2) a dollar amount, indexed for inflation ($160,000 for 2003). The dollar limit is reduced for benefit commencement before age 62 and increased for benefit commencement after age 65.

Deductions for plan contributions

Employer contributions to qualified retirement plans are deductible subject to certain limits.[1244] In general, the deduction limit depends on the kind of plan. Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.[1245]

In the case of a defined contribution plan, the amount of deductible contributions is generally limited by compensation. In general, the annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is 25 percent of compensation of the employees covered by the plan for the year.[1246]

In the case of a defined benefit plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. In order to encourage plan sponsors to fully fund defined benefit plans, the maximum amount otherwise deductible generally is not less than the plan's unfunded current liability. In the case of a plan that terminates during the year, the maximum deductible is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program.

If an employer sponsors both a defined benefit plan and a defined contribution plan that covers some of the same employees, the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet

---

[1243] Sec. 415. EGTRRA increased many of the limits that apply to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[1244] Sec. 404. EGTRRA increased many of the limits relating to qualified retirement plans. These limit increases are generally effective for years beginning after December 31, 2001. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[1245] Sec. 4972.

[1246] Additional amounts may be deductible in the case of an ESOP as described in the discussion of ESOPs in Part II.A.2.

the minimum funding requirements of the defined benefit plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

Taxation of qualified retirement plan contributions and distributions

Employer contributions and employee elective deferrals (and earnings) to a qualified retirement plan generally are not includible in an employee's income until distributed.

A distribution of benefits from a qualified retirement plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents a return of the employee's after-tax contributions (i.e., basis). Special rules apply to lump-sum distributions, distributions rolled over to another employer-sponsored retirement plan or IRA, and distribution of employer securities.[1247]

Early distributions from qualified retirement plans generally are subject to an additional 10-percent early withdrawal tax. That is, includible amounts distributed prior to attainment of age 59-1/2 are subject to an additional 10-percent tax, unless the distribution is due to death or disability, is made in the form of certain periodic payments, is made to an employee after separation from service after attainment of age 55, or is used to pay medical expenses in excess of 7.5 percent of adjusted gross income.[1248]

Distributions from a qualified retirement plan are required to begin no later than the participant's required beginning date. The required beginning date is April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70-1/2, or (2) the calendar year in which the employee retires. In the case of an employee who is a five-percent owner, the required beginning date is April 1 of the calendar year following the calendar year the employee attains age 70-1/2. Distributions after the participant's death also must meet certain minimum distribution requirements.[1249]

The sanction for failure to make a minimum required distribution to an employee (or other payee) under a qualified retirement plan is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount required to have been distributed under the minimum distribution rules, over the amount that actually was distributed. The tax is imposed on the individual required to take the distribution. However, in order to satisfy the qualification requirements, a plan must expressly provide that, in all events, distributions under the plan are to satisfy the minimum distribution requirements.[1250]

[1247] Sec. 402.

[1248] Sec. 72(t). Certain other exceptions to the tax may also apply.

[1249] Sec. 401(a)(9).

[1250] Sec. 4974.

Qualified retirement plan reporting and disclosure requirements

A qualified retirement plan is subject to annual reporting and disclosure requirements under both the Internal Revenue Code and ERISA.

The plan administrator of a qualified retirement plan generally must submit an annual report of certain information with respect to the qualification, financial condition, and operation of the plan to the Department of Labor.[1251] The plan administrator must also to file an annual registration statement with the IRS with respect to certain participants who separate from service during the year.[1252] The plan administrator must also furnish an individual statement to each participant who separates from service and is listed in the annual registration statement described above.[1253]

The plan administrator must automatically provide participants with a summary of the annual report.[1254] A plan administrator is also required to furnish participants with a summary plan description that includes certain information, including administrative information about the plan, the plan's requirements as to eligibility for participation and benefits, the plan's vesting provisions, and the procedures for claiming benefits under the plan.[1255] The plan administrator must also furnish participants with a summary of any material modification in the terms of the plan and any change in the information required in the summary plan description within 210 days after the end of the plan year in which the modification or change occurs.[1256] Under ERISA, a plan administrator must also furnish a benefit statement to any participant or beneficiary who makes a written request for such a statement.[1257] This requirement applies in the case of any plan that is subject to ERISA, including defined contribution and defined benefit plans.

[1251] ERISA secs. 103 and 104. Defined benefit plans must also provide certain reports or notices if the plan is underfunded (ERISA secs. 4010 and 4011), if a plan amendment significantly reduces the rate of future benefit accrual (sec. 4980F and ERISA sec. 204(h)), or if plan assets are transferred to health benefit accounts pursuant to sec. 420 (sec. 101(e) of ERISA).

[1252] Sec. 6057.

[1253] ERISA secs. 101(a)(2) and 105(c).

[1254] ERISA secs. 101(a) and 104(b)(3).

[1255] ERISA secs. 101(a), 103, and 104(3). The summary plan description must also be furnished to the Department of Labor on request. ERISA sec. 104(a)(6).

[1256] ERISA secs. 102 and 104(b).

[1257] ERISA sec. 105.

IRS compliance

The IRS has three programs to ensure that plans comply with the numerous requirements under the Code for a retirement plan to receive the tax benefits of qualified plan status: (1) the determination letter program; (2) the examination program; and (3) the Employee Plans Compliance Resolution System ("EPCRS").

The IRS permits plan sponsors to voluntarily submit plans for review to ensure that plans comply with tax law requirements for retirement plans. The IRS reviews the plan design reflected in the plan documents and certain operational requirements. The determination letter program involves the issuance of determination letters to requesting plan sponsors, which are a statement of the IRS' determination that a plan meets the qualification requirements of the Code.

The examination program involves the IRS' examination of plans to determine whether the qualification requirements are met in operation. The qualified plan examination program reviews issues of plan design as well as those arising in plan operation. For example, a plan that, by its terms, provides for contributions in a manner satisfying tax law requirements may in operation result in contribution levels that impermissibly favor highly compensated employees.

Additionally, the IRS has established EPCRS, which is a comprehensive system of correction programs for sponsors of retirement plans and annuities that are intended, but have failed, to satisfy the requirements of section 401(a), section 403(a), or section 403(b), as applicable.[1258] EPCRS permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.

The basic elements of the programs that comprise EPCRS are self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program generally permits a plan sponsor that has established compliance practices to correct certain insignificant failures at any time (including during an audit), and certain significant failures within a 2-year period, without payment of any fee or sanction. The Voluntary Correction Program permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

[1258] Rev. Proc. 2002-47, 2002-29 I.R.B. 1.