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MEMORANDUM

August 25, 2005

TO: Corporate Compensation Plans, Inc.

FROM: Louis T. Mazawey
John F. McGuiness
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RE: 401(k) Disability Protection Plansm --
Principal Tax and ERISA Aspects

This memorandum summarizes the principal tax and ERISA issues associated with the 401(k) Disability Protection Plansm (the "Protection Plan") developed by Corporate Compensation Plans, Inc. ("CCP"). Our analysis is based on current laws, regulations and rulings of the Department of Labor ("DOL") and the Internal Revenue Service ("IRS") as we believe they would be applied to the Protection Plan.

I. Summary of the Protection Plan

If a 401(k) plan participant becomes disabled, typically all contributions on his behalf to his employer's 401(k) plan will cease. Thus, a disability could result in a significant reduction in the retirement benefits an employee will ultimately receive from his 401(k) plan. An employer can provide insurance for participants against this potential loss in retirement income by adding the Protection Plan to its 401(k) plan.

Our understanding of how the Protection Plan works is as follows:

- A group long-term disability ("LTD") policy is purchased by a 401(k) plan. Alternatively, a smaller plan could purchase individual LTD policies for its participants.
- The 401(k) plan document would be amended to add the Protection Plan. Appendix A contains a sample plan provision that could be used for this purpose.
- The 401(k) plan would provide that the LTD policy would cover one of the following groups:
 - (a) participants who made contributions or had contributions made on their behalf during the prior year;
 - (b) participants who made contributions or had contributions made on their behalf during the current year; or
 - (c) only those participants who elect coverage or are deemed to elect coverage under a "negative election" approach.
- Premiums for the LTD policy may be paid by the 401(k) plan out of the following potential sources:
 - (a) If participation is elective, from (a) the 401(k) accounts of participants who elect the coverage or are deemed to elect the coverage, or (b) from employer contributions that would otherwise be allocated to these participants' accounts;
 - (b) If participation is not elective, from either (1) employer contributions, (2) forfeitures, (3) so-called "12b-1 fees" or other fees received directly or indirectly from the mutual funds in which the plan invests,¹ (4) investment earnings

¹ Mutual funds or their affiliates may pay broker-dealers, banks, third party administrators or other plan service providers so-called "12b-1 fees" or similar fees for shareholder services, sub-transfer agency or other services in connection with investment in the mutual funds by the service providers' plan

(e.g. by a deduction from plan investment earnings before the earnings are allocated to participant accounts), or (5) a combination of these.

- If a participant covered by the LTD policy becomes disabled, the policy would (after a waiting period) pay into the participant's 401(k) plan account an amount equal to certain contributions (e.g., 401(k), employer match) made by or on behalf of the participant during a specified period. The specified period may be the prior calendar year, the prior 12-month period, the current plan year, or the current calendar year.
- A participant's vested status will not affect his eligibility for coverage or the amount of his coverage. Presumably, most 401(k) plans adding the Protection Plan would provide that participants become 100% vested in their account balance upon becoming disabled and entitled to benefits from the LTD policy.
- Benefits paid under the LTD policy to a participant's 401(k) plan account would continue until one of several events, described in the policy, occurs. These events may include the participant dying, recovering from the disability, or reaching a specified age.
- Benefits paid under the LTD policy to a participant's 401(k) plan account would be invested like regular contributions, i.e., according to the participant's most recent instructions for the investment of plan contributions until the participant modifies

clients. In some cases, mutual funds or the service providers may use such fees to offset plan costs for services, such as recordkeeping or trustee fees, participant education or other services or products that the plan may require. As explained below, such amounts, where available, also might be used to pay plan costs in connection with providing LTD coverage to participants.

the instructions in accordance with plan terms. Account balances attributable to benefits paid under the LTD policy would be distributable at the same time and manner as other amounts in the participant's account.

II. Favorable IRS Rulings on Similar Plans

The Protection Plan is similar to arrangements addressed in two recent IRS private letter rulings. In 1999, the IRS addressed a program whereby participants could elect LTD coverage and have part of their 401(k) contributions used to pay premiums for the group LTD policy owned by the plan. PLR 200031060 (Aug. 26, 1999). The LTD policy would pay into a disabled participant's plan account an amount equal to the 401(k) contributions, employer match and qualified nonelective contributions ("QNECs") made by or on behalf of the participant for the year immediately preceding the year in which the disability began. The benefits generally would be invested like regular contributions, but could not be withdrawn prior to normal retirement age as long as the LTD policy was in pay status.

In a 2002 letter ruling, the IRS addressed another similar arrangement. PLR 200235043 (June 6, 2002). The facts in the 2002 ruling were very similar to the facts in the earlier ruling, except for two significant differences. First, all participants who were making elective deferral contributions to the plan immediately before becoming disabled were covered by the LTD policy (i.e., no need for participants to elect coverage). Second, the LTD premiums could be funded with employer contributions, including matching and nonelective contributions (as well as elective deferrals).

In these two rulings, the IRS reached favorable conclusions on the basic plan qualification and income tax issues for plan sponsors and participants associated with the Protection Plan. We have indicated in the "Federal Income Tax Consequences" section below how the various issues we

discuss were addressed in the rulings. Although IRS private letter rulings are not legal precedents on which all taxpayers may rely (IRC § 6110(k)(3)), they do reflect current IRS thinking on the issues addressed. We believe that is particularly true for these rulings which we understand received the attention of senior IRS officials.

III. IRS Plan Qualification and Income Tax Issues

Our understanding of the basic consequences under the Internal Revenue Code of 1986, as amended (the “Code”), of a 401(k) plan adding the Protection Plan is summarized below.

1. Participants will not be currently taxed on premiums paid by the 401(k) plan for the LTD policy (although premiums must be tracked under the rules governing "incidental" insurance benefits).

The IRS ruled in PLR 200031060 and PLR 200235043 that participants would not be currently taxed on premiums paid by the plan for the LTD policy. The IRS rationale was that benefits under a qualified retirement plan are taxable to a participant when they are actually distributed to the participant. As the payment of LTD policy premiums did not amount to a distribution, participants were not taxable at this point. However, the IRS noted that under the “incidental benefit” rule, the total LTD policy premiums paid on behalf of a participant generally may not exceed 25% of the total contributions allocated to the participant under a plan, applied on a cumulative basis. Rev. Rul. 61-164; Rev. Rul. 76-353.

Under the reasoning in the IRS rulings, participants in a 401(k) plan adding the Protection Plan will not be currently taxed on premiums paid by the plan under the LTD policy. However, the administrator of the 401(k) plan would need to track the LTD premiums (plus any other insurance premiums paid under the plan, such as life insurance premiums) to ensure that they do not exceed the 25% limit. Because the LTD premiums are quite small, there is little or no likelihood that the limit could be exceeded in any event.

2. The purchase of the LTD policy by the 401(k) plan will not violate the “anti-conditioning” prohibition under Code § 401(k) or otherwise affect the qualification of the plan.

Code § 401(k)(4) generally provides that no employer-provided benefit (except matching contributions) may be conditioned directly or indirectly on whether 401(k) contributions are (or are not) made. The IRS ruled in PLR 200031060 and PLR 200235043 that the LTD arrangements would not violate this rule for the reasons described below.

The applicable regulations make it clear that life insurance and health benefits are "other benefits." Treas. Reg. § 1.401(k)-1(e)(6)(ii). However, Treas. Reg. § 1.401(k)-1(d)(6)(ii) makes it clear that a 401(k) plan may purchase life insurance with a participant’s contributions without violating the contingent benefit rule.² Since a 401(k) plan trustee may purchase life insurance, the trustee should also be permitted to purchase LTD coverage without violating the contingent benefit rule. The treatment of LTD coverage as an investment of the plan is consistent with the position that it does not involve an “additional” or “other” benefit for this purpose. Of course, if an additional matching contribution is used to pay the premium, it would be expressly exempted from the rule for that reason.

Under the reasoning in the IRS rulings, a 401(k) plan adding the Protection Plan will not violate the anti-conditioning rule of Code § 401(k)(4). Further, we do not believe the addition of the Protection Plan in and of itself would cause such a plan to violate any other qualification requirement under the Code.

3. Proportionate premiums may be paid by participants, including under a "negative election" approach.

² We note that the new final comprehensive 401(k) regulations, generally effective next year, reflect the same positions as the current regulations on these issues. Treas. Reg. § 1.401(k)-1(d)(5)(ii); -1(e)(6)(ii).

The IRS favorably ruled on an arrangement where employees affirmatively elected to use their 401(k) contributions to pay LTD policy premiums in PLR 200031060. The IRS has not addressed the use of a “negative election” approach to pay premiums for an LTD policy from employee contributions. However, the IRS has approved the use of a negative election approach in numerous similar contexts.

In three recent Revenue Rulings, the IRS held that retirement plan contributions could be deducted from participants’ wages on the basis of negative elections. See Rev. Rul. 2000-8 (involving a 401(k) plan); Rev. Rul. 2000-35 (involving a 403(b) plan); Rev. Rul. 2000-33 (involving a 457(b) plan). In these rulings, the IRS concluded that an employee essentially made an election to contribute if he did nothing after receiving a notice explaining the negative election and being given a reasonable period of time to make a contrary election. Under the facts of these rulings, plan participants were also provided an annual notice regarding their current contribution percentage and their right to change the percentage. Similarly, in Notice 2002-2, the IRS approved a negative election approach for the reinvestment of dividends under an ESOP, provided participants had a reasonable opportunity to make their initial election and change their elections annually.

We believe that a 401(k) plan adding the Protection Plan may deduct LTD policy premiums from employee contributions – whether employees affirmatively elect LTD coverage or are deemed to elect coverage under a negative election approach – without violating the Code. A negative election approach should be specifically set forth in the plan document and structured in a manner similar to the approach in the IRS rulings described above. Further, if premiums are paid with an employee's 401(k) contributions, the nondiscrimination testing issues described below should not be an issue as the 401(k) contributions will have already been subjected to the applicable nondiscrimination test. Code § 401(k)(3).

4. Brief analysis of issues associated with employer payment of premiums under Code § 401(a)(4) and § 415(c).

If LTD policy premiums are paid from additional employer contributions, forfeitures or earnings -- rather than from employee contributions -- the amounts paid may need to be treated as contributions and subject to certain Code limitations on contributions. Specifically, the amounts paid may be subject to the following Code limitations.

Code § 401(a)(4) - Nondiscriminatory Contributions

Code § 401(a)(4) provides that contributions under a qualified defined contribution plan may not discriminate in favor of highly compensated employees (generally those with annual compensation in excess of \$90,000, indexed). In other words, highly compensated participants can not receive disproportionately larger contributions under a plan than non-highly compensated participants. A 401(k) plan will meet this requirement if:

- (a) employee pre-tax contributions under the plan satisfy the actual deferral percentage test (“ADP Test”) under Code § 401(k)(3);
- (b) employer matching and employee after-tax contributions under the plan satisfy the actual contribution percentage test under Code § 401(m)(2) (“ACP Test”); and
- (c) other employer contributions can be shown to not disproportionately benefit highly compensated employees under one of several testing methods provided in the regulations under Code § 401(a)(4).³

³ For example, this requirement will be automatically met if each plan participant receives a contribution equal to the same specified percentage of his compensation for the year.

Code § 415(c) - Annual Limit on Contributions

Code § 415(c) provides that the total “annual additions” to a participant’s account under a qualified defined contribution plan for a year may not exceed the lesser of \$40,000 (indexed) or the participant’s compensation for the year. “Annual additions” are defined as the sum of employee contributions, employer contributions and forfeitures. Code § 415(c)(2).

In PLR 200235043, LTD policy premiums were funded with employer contributions, including elective deferrals. (The ruling request indicated that participant accounts could simply be charged with a pro rata share of the premium.) The IRS ruled that the LTD premiums would be subject to the Code § 401(a)(4) and § 415 limitations when paid. We analyze below how these Code limitations may be applied depending on the source used to pay the LTD policy premiums under the Protection Plan.

A. Additional Employer Matching Contribution

1. Code § 401(a)(4)

We expect that, in most 401(k) plans, additional employer contributions used to pay LTD premiums would be structured as additional matching contributions, and thus subject to the ACP Test under Code § 401(m)(2). If the amount of the potential LTD benefits and premiums for the current year are based on the amount of contributions made by or on behalf of participants in the prior year, the additional matching contributions normally would be allocated based on these prior year contributions. Contributions made at the beginning of a plan year and allocated in this manner should normally qualify, and be tested under § 401(m)(2), as matching contributions attributable to the prior plan year. We believe that, if structured in this manner, the additional

employer matching contributions would not significantly affect the plan's ability to pass the ACP Test for the prior year.

If the amount of the potential LTD benefits and premiums for the current year are based on the amount of contributions made by or on behalf of participants in the current year, the additional matching contribution would be allocated based on these current year contributions. For the same reasons described above, these contributions should be tested as matching contributions and not significantly affect the plan's ability to pass the ACP Test for the current year.

2. Code § 415(c)

We believe the payment of LTD premiums with an additional employer matching contribution would result in these contributions being treated as annual additions to participants' accounts under Code § 415(c). These contributions would normally count as annual additions for the limitation year in which contributed. See Treas. Reg. § 1.415-6(b)(7). In view of the modest LTD premiums and generous limits of § 415(c), situations where the LTD premiums may cause the limit to be exceeded should be rare.

B. Additional Nonelective Employer Contribution

1. Code § 401(a)(4)

We believe that payment of the LTD premiums with a nonelective employer contribution would result in the premiums paid being treated as contributions subject to the general nondiscrimination testing rules under Code § 401(a)(4). As described above, to meet these rules, the plan would need to demonstrate that the employer contributions do not disproportionately benefit highly compensated employees. This would be the case, for example, if (1) the contribution was the same amount for each employee, or (2) the contribution was the same percentage of each participant's compensation. The

regulations also provide other methods for establishing that contributions are not discriminatory. Treas. Reg. § 1.401(a)(4)-2.

2. Code § 415(c)

The analysis under Code § 415(c) would be the same as that described above for additional employer matching contributions.

C. Forfeitures or Earnings

1. Code § 401(a)(4)

Payment of the LTD policy premiums out of (i) any forfeitures or plan earnings, including a plan forfeiture account, (ii) from so-called 12b-1 or other fees received directly or indirectly from mutual funds in which the plan invests, or (iii) by deductions from plan investment earnings, should not result in the premiums paid being treated as contributions or allocations made to the accounts of participants for purposes of Code § 401(a)(4). Rather, it may be reasonable to treat the payment of the premiums in a manner similar to the payment of plan-wide expenses out of forfeitures or earnings. See, e.g., Rev. Rul. 86-142; Rev. Rul. 84-146.

As with payments of other plan expenses, payment of the LTD premiums out of plan forfeitures or earnings would reduce the amount of forfeitures or earnings potentially available for allocation to all participant accounts. Thus, some participants who do not benefit from LTD coverage in a given year (e.g., those who did not contribute to the plan in the prior plan year) may receive lesser allocations because LTD premiums are paid from these sources. However, this is also the case with payment of other plan expenses from such sources. Rarely does a direct correlation exist between the relative amount “charged” to a participant’s account to pay for plan expenses and the relative benefit the participant received based on the such expenses. We note, however, that IRS rules do prohibit the allocation of plan

earnings or expenses in a manner which would discriminate in favor of highly compensated employees. Treas. Reg. § 1.401(a)(4)-1(c)(8).

Although we believe the above analysis is reasonable, there is no authority directly on point. Thus, the IRS may take the position that LTD premiums paid out of forfeitures or earnings should be treated as contributions or allocations to participants' accounts, subject to the general nondiscrimination testing rules under Code § 401(a)(4) described above. One possible way to address this uncertainty is (1) to establish a portion of the premium for each participant that essentially reflects the insurer's administration charge and treat that portion as a plan expense, and (2) treat the remainder of each participant's premium as allocable to the participant's account in one of the other ways described above.

2. Code § 415(c)

The payment of LTD premiums out of plan forfeitures or earnings should not result in the premiums paid being treated as “annual additions” to a participant’s account under Code § 415(c) for the same reason they should not count as “contributions or allocations” for purposes of Code § 401(a)(4). Again, however, the IRS may disagree with this position and one approach is to bifurcate the premium as described in the preceding section.

5. Amounts paid to the 401(k) plan under the LTD policy will not be “annual additions” subject to the Code § 415(c) limit.

The IRS ruled in PLR 200031060 and PLR 200235043 that LTD proceeds received by a plan would not count as “annual additions” subject to the Code § 415(c) limits. The IRS' reasoning was that annual additions are defined under § 415(c)(2) to include only employee contributions, employer contributions and forfeitures, and LTD policy proceeds are none of these. Rather, the proceeds should be treated as plan earnings. See also PLR 8151001. We believe the same analysis should apply in the case of a 401(k) plan that adds the Protection Plan.

6. Participants will not be taxed when amounts are paid to the 401(k) plan under the LTD policy.

The IRS ruled in PLR 200031060 and PLR 200235043 that participants would not be taxed when amounts are paid to the 401(k) plan under the LTD policy. This reflects the principle that participants are only taxed on amounts actually received from qualified plans. Code § 402(a). We believe the same analysis should apply in the case of a 401(k) plan that adds the Protection Plan.

7. Distributions to a participant by the 401(k) plan of amounts received under the LTD policy (and earnings thereon) will be fully taxable to the participant.

The IRS ruled in PLR 200031060 and PLR 200235043 that distributions to a participant by the 401(k) plan of amounts received under the LTD policy (and earnings thereon) will be fully taxable to the participant. Code § 402(a). We believe the same analysis should apply in the case of a 401(k) plan that adds the Protection Plan.

8. Individual LTD policies could be purchased by the 401(k) plan instead of a group LTD policy.

While neither PLR addressed the issue,⁴ there is no reason under the IRS Code that individual LTD policies, rather than a group LTD policy, could not be purchased by a 401(k) plan adding the Protection Plan. In this regard, a small employer's 401(k) plan may not be able to purchase group coverage.

9. Benefits under the LTD policy may be based on contributions made during various periods prior to a participant's becoming disabled.

In both PLR 200031060 and PLR 200235043, the amount of LTD policy benefits paid to a participant's account was based on contributions made by or on behalf of the participant in the year prior to the year the

⁴ A group policy was clearly at issue in both PLR 200031060 and PLR 200235043.

participant became disabled. However, we do not believe any IRS Code requirements dictate that this contribution period be used to calculate the amount of LTD policy benefits. Thus, a 401(k) plan adding the Protection Plan should be able to calculate policy benefits based on contributions made during the prior calendar year, the prior 12-month period, the current plan year, or the current calendar year. Of course, an insurance company issuing an LTD policy may require that policy benefits be based on prior year contributions, or impose other underwriting limitations, to avoid adverse selection.

10. Disabled individuals may be required to refrain from withdrawing LTD policy proceeds from the 401(k) plan while benefits are still being paid to the plan on his behalf under the LTD policy.

The LTD policy described in PLR 200031060 provided that benefit payments to a plan ceased upon a participant's withdrawal of any policy proceeds. In PLR 200235043, the IRS states that the ruling is conditioned on LTD policy benefits not being distributed prior to normal retirement age while the policy is paying benefits.⁵ An insurance company issuing an LTD policy may require similar provisions in a LTD policy issued under the Protection Plan.

We are not aware of any specific IRS constraint on designing a plan to permit withdrawals of LTD policy proceeds on the same basis as other plan amounts (as long as the applicable Code rules otherwise limiting plan distributions are followed). In view of the wording in the IRS ruling, it is probably desirable not to vary significantly from the positions set forth therein. However, it should be permissible for a plan to permit a distribution that includes LTD policy proceeds to a disabled participant if the plan's requirements for hardship distributions would be met.

⁵ While it is unclear, presumably only the IRS ruling on an employee's taxation upon distribution is so conditioned.

IV. Principal ERISA Issues

Generally, Title I of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), imposes certain duties on plan "fiduciaries." These fiduciaries include the plan "administrator" named under the plan, the plan sponsor or other “named fiduciary” responsible for choosing plan investments and service providers, and other persons who have or exercise discretionary authority or discretionary control with respect to plan management or plan administration, exercise control with respect to the management or disposition of plan assets, or provide “investment advice” with respect to plan assets. See ERISA § 3(21).

ERISA generally requires all plan fiduciaries to act prudently, exclusively for the benefit of plan participants and beneficiaries, to use plan assets solely for purposes of paying plan benefits and defraying reasonable plan expenses, and to act in accordance with governing plan documents. ERISA § 404. In the case of participant-directed pension plans, the potential liability of fiduciaries for the investment of plan assets may be reduced under ERISA section 404(c), which relieves plan fiduciaries from liability for plan losses that result from a participant's exercise of control if certain conditions are met.

Plan fiduciaries must (among other things) avoid causing the plan to engage in certain "prohibited transactions." Prohibited transactions include certain transactions between plans and "parties in interest," and plan transactions that may involve a fiduciary conflict of interest. See ERISA §§ 3(14) and 406(a) and (b). ERISA also imposes on the plan administrators of all plans various disclosure and reporting requirements. See, e.g., ERISA §§ 101 to 104. In the case of participant-directed plans, regulations under ERISA section 404(c) impose additional disclosure requirements on plan fiduciaries who wish to obtain that relief.

Following is a general discussion of how these requirements would apply in the case of a 401(k) plan adding the Protection Plan.

1. Whether the Protection Plan is an "investment" or a "benefit."

As an initial matter, it is worth considering from an ERISA perspective whether the Protection Plan would be characterized as a "benefit" or an "investment" of a 401(k) plan that adds this feature. For example, a decision to provide a plan "benefit" is typically viewed as plan sponsor business decision (i.e., a "settlor" decision), which is not subject to ERISA fiduciary regulation, while plan "investment" decisions generally are subject to ERISA's fiduciary standards. In addition, ERISA section 404(c) may offer relief for participant decisions about "investments" but not for participant benefit elections. Finally, if the Protection Plan provides a "benefit," it may be a "welfare" benefit, subject to standards applicable to welfare plans, even though offered as part of a profit-sharing plan.

The IRS rulings discussed above describe the disability policy made available to participants as both an "investment" (because policy proceeds would be treated like the return on any other plan investment) and a "benefit" (because the policy provides protection to the participant from economic loss that would occur if he or she were unable to continue to make plan contributions). As discussed below, both characterizations may also apply under ERISA, depending on the particular legal issues to be addressed.

2. Amending a 401(k) plan to provide long-term disability protection should be a non-fiduciary "settlor" decision.

The Labor Department and courts generally agree that a plan sponsor does not act as a "fiduciary," and is not subject to ERISA's fiduciary regulation, when adopting a plan, determining the plan's design, modifying its terms, or terminating the plan. Lockheed Corp. v. Spink, 517 U.S. 882 (1996). In addition, specific plan terms that define, for example, how to allocate plan expenses, are in effect, part of the definition of the benefit provided by the plan, and also are not subject to review under ERISA's fiduciary standards. DOL Field Assistance Bulletin 2003-03 (May 19, 2003) ("FAB 2003-03"). Accordingly, where a plan sponsor amends a 401(k) plan to provide for a long-term disability benefit by adding the Protection Plan, the 401(k) plan sponsor's decision about whether or not to offer the benefit – and any conditions or terms that define the benefit (e.g., the covered groups of participants, source of premium payments, and investment of policy proceeds) – should be "settlor" decisions that are not subject to ERISA's fiduciary standards.

However, as explained below, the plan administrator of a 401(k) plan that provides for a long-term disability benefit will be governed by ERISA's fiduciary requirements in implementing that benefit, for example, in selecting an LTD policy or other method to fund the benefit, determining how to administer the benefit, and in paying policy premiums, to the extent that plan terms do not provide directions with respect to these matters. In addition, the Labor Department has stated (in its preamble to regulations under ERISA section 404(c)) that the selection of the plan "investment options" offered to participants under a participant-directed plan may be a "fiduciary" decision, even if the investment options are specifically identified by plan terms. 57 Fed. Reg. 46906, 46924 n.27 (Oct. 13, 1992) ("the act of limiting or designating plan investment options . . . , whether achieved through fiduciary

designation or express plan language, is not a direct and necessary result of any participant direction . . ."). Thus, to the extent that an elective long-term disability option provided to participants under a 401(k) plan is characterized as an "investment" option under a 404(c) plan, the decision to provide the option to participants may be subject to ERISA's fiduciary standards even if required by plan terms.

3. Plan fiduciaries must prudently select and monitor the LTD policy.

Although the decision to provide long-term disability protection under a plan should not be subject to ERISA's fiduciary regulation, the selection of the LTD policy probably will be. Thus, the plan administrator (or other responsible plan fiduciary) must prudently select and monitor the LTD policy that is used to fund the plan's long-term disability benefit.

Interpretative Bulletin 95-1 (29 C.F.R. § 2509.95-1) and Advisory Opinion 2002-14A (Dec. 18, 2002) apply ERISA's fiduciary standards to the selection of pension plan annuity providers. Generally, these authorities require plan fiduciaries selecting a plan's annuity policies to conduct an objective, thorough search to identify and select the annuity carrier, evaluating factors including claims paying ability and creditworthiness. If annuity premiums will be paid from the plan assets of a defined contribution plan, cost should also be considered if reduced cost may increase participant benefits. However, lower cost may not be used to justify a purchase of an unsafe annuity.

Similar standards would appear to apply to 401(k) plan fiduciaries in selecting an LTD policy. For example, a 401(k) plan's fiduciaries should conduct a search to identify those insurance carriers that will issue an LTD policy meeting the plan's needs, evaluating factors such as claims paying ability and creditworthiness, as well as premium costs. On an ongoing basis, the fiduciary should monitor whether the LTD policy continues to meet the

plan's requirements, considering premium cost as well as the carrier's claims paying ability and creditworthiness.

4. Considerations under ERISA's prohibited transaction rules.

The selection and continuation of the LTD policy must not involve a violation of the prohibited transaction rules under ERISA section 406(a) and (b).⁶ ERISA section 406(a) prohibits (among other things) a sale or exchange of "property" (such as an insurance contract) between a plan and "party in interest." For this purpose, parties in interest include plan fiduciaries and service providers and certain of their affiliates. To the extent that the LTD carrier is a party in interest to a plan (e.g., by virtue of already being a service provider), the plan's purchase of the LTD policy could be prohibited, unless an exemption is available.

ERISA section 406(b) prohibits plan fiduciaries from causing plans to engage in transactions that may involve fiduciary self-dealing or other conflicts of interest and also prohibits fiduciaries from receiving consideration from a person dealing with a plan in connection with a plan transaction. A plan's purchase of an LTD policy could involve a violation of ERISA section 406(b) if the LTD carrier (or its employee, agent or other affiliate) or plan consultant receives commissions or other consideration for selling the LTD policy and the carrier (or its employee, agent or other affiliate) or the plan consultant provides "investment advice" to a plan fiduciary (or a plan participant) of the type that makes that person a "fiduciary" under Labor Department regulations. Generally, an LTD policy carrier (or its employee, agent or other affiliate) or a plan consultant would provide "investment advice" only if that person provides advice or recommendations with respect

⁶ ERISA's prohibited transaction rules are also included in the Internal Revenue Code where they form the basis for excise taxes on prohibited transactions involving tax-qualified plans. See Code § 4975.

to plan investments on a regular basis, the advice is individualized, and there is mutual agreement that the plan fiduciary (or plan participant) may rely on the advice as a primary basis for making investment decisions. ERISA § 3(21)(B); 29 C.F.R. § 2510.3-21(c).

Both a plan's purchase of the LTD policy from a party-in-interest LTD carrier, and the provision of "investment advice" and receipt of commissions or other consideration by an LTD carrier (or its employee, agent or other affiliate) or a plan consultant, is allowed if the conditions under Labor Department Prohibited Transaction Class Exemption ("PTE") 84-24 are met. If the transaction does not involve a provision of investment advice, the conditions are satisfied so long as (1) the terms of the transaction are arms' length and the fees are reasonable, and (2) the LTD carrier (or any affiliate) is not a discretionary trustee, plan sponsor, or a fiduciary with discretion over the 401(k) plan's purchase of the LTD policy.

If the transaction involves a provision of investment advice by the LTD carrier (or its employee, agent or affiliate) or a plan consultant, PTE 84-24 imposes additional disclosure and acknowledgement conditions. Specifically, PTE 84-24 requires that, where an LTD carrier (or employee, agent or affiliate) or a consultant provides investment advice, an "independent plan fiduciary" must approve the transaction in writing after receiving written information about the fees and commissions paid in connection with the plan's purchase of the LTD policy and the affiliation of the LTD carrier and its employee, agent or affiliate or any plan consultant. This condition generally is satisfied where the plan administrator or other plan fiduciary with responsibility to select the LTD carrier and policy for the plan acts as the "independent plan fiduciary" to receive disclosure and approve the transaction.

Where participants elect LTD coverage under a participant-directed plan designed to meet conditions under ERISA section 404(c) and receive

investment advice, it is not entirely clear whether the disclosure and approval should be obtained from the participants or from a plan administrator or other plan fiduciary. Based on the plain language of PTE 84-24, it appears that the PTE 84-24 disclosure and approval condition could still be met by disclosure to and written approval by a plan administrator or other plan fiduciary responsible under a section 404(c) plan for determining whether the LTD policy will be available to plan participants, even if participants elect the coverage and could receive investment advice. However, DOL guidance would allow participants to act as the "independent plan fiduciary" to receive the disclosure and approve the transaction for their participant accounts for PTE 84-24 purposes. See DOL Adv. Op. 80-30A (May 21, 1980). Further, as discussed below, the plan administrator or other plan fiduciary may wish to ensure participants receive disclosure about commissions or other consideration to be received by a person providing investment advice to participants, even if conditions under PTE 84-24 may be satisfied by disclosure to and written approval by the plan fiduciary.

5. Considerations under ERISA section 404(c).

The requirements and impact of ERISA section 404(c) should be considered where a 401(k) plan's LTD policy will only cover those participants who elect coverage or who are deemed to elect coverage under a negative election approach. (Because section 404(c) only applies where participants may make investment choices, it will not be relevant if the plan's LTD policy covers all participants.) ERISA section 404(c) generally provides that a plan's fiduciaries (including a plan sponsor and plan administrator) are not liable for losses directly resulting from a participant's "exercise of control" over the investment of his or her individual account under the plan, as long as certain conditions described by Labor Department regulations are met. Among other things, these regulations require the plan to offer participants the opportunity to give instructions to invest among a "broad range" of investment options and that participants receive, automatically and on request, certain information about plan investment options. 29 C.F.R. § 2550.404c-1.

Importantly, with respect to any 401(k) plans using a "negative election" approach to participants' LTD policy coverage elections, the Labor Department's view is that section 404(c) is not available unless participants provide affirmative investment instructions.⁷ Accordingly, section 404(c) will not provide 401(k) plan fiduciaries any relief from responsibility for a participant's "deemed election" of LTD policy coverage. However, the Labor Department has further explained that a plan otherwise qualifying as a "404(c) plan" does not cease to be a 404(c) plan merely because one plan investment

⁷ 57 Fed. Regs. 46906, 46923 (Oct. 13, 1992) (Preamble to ERISA section 404(c) regulations). See also Rev. Rul. 2000-35 n.1 (July 17, 2000) (merely informing participants of investments that will be made on their behalf in the absence of affirmative instructions does not satisfy section 404(c)'s requirement that a participants exercise control over their account); Rev. Rul. 2000-8 n.1 (Jan. 27, 2000) (same).

alternative does not meet all requirements for section 404(c) relief. See 57 Fed. Reg. at 46928. Therefore, where a 401(k) plan otherwise meets the conditions under the section 404(c) regulations with respect to other participant investment elections, the fact that participants' deemed elections with respect to the LTD coverage do not meet conditions for relief under section 404(c) should not affect the plan's 404(c) status with respect to other participant elections under the plan.

If a 401(k) plan makes an LTD policy available to participants who may affirmatively elect coverage as a plan "investment option," section 404(c) may apply to relieve plan fiduciaries from responsibility for the participant's decision to elect the coverage, including payment of policy premiums from the participant's account balance. The relief would be available, however, only if the plan otherwise meets the requirements to be a "404(c) plan" described by the regulations. Among other things, these regulations would require that plan participants receive the same information about the LTD policy that is required for all other designated plan investment options, including –

- a general description of investment objectives and risk and return characteristics, the type and diversification of assets funding the policy, and identification of the investment manager (if any);
- an explanation of circumstances in which participants may give investment instructions with respect to the LTD policy, including any restrictions or limitations; and
- the fees or expenses that will affect the participant's account balance in connection with an election of coverage under the LTD policy, including transaction fees such as commissions, sales loads or charges, and redemption or exchange fees.

See 29 C.F.R. § 2550.404c-1(b)(2)(B)(1).

The section 404(c) regulations specifically provide that plan fiduciaries do not have any obligation to provide investment advice to participants under a section 404(c) plan. 29 C.F.R. § 2550.404c-1(c)(4). However, as a practical matter, plan administrators and plan sponsors may wish to provide investment education and advice to assist participants in making choices under 401(k) plans, and similarly may wish to provide assistance to participants eligible to elect LTD coverage. In this regard, DOL has explained that a plan fiduciary's designation of a person to provide investment education or advice to participants does not, by itself, give rise to fiduciary liability for losses that are otherwise a direct and necessary result of participants' investment decisions for purposes of ERISA section 404(c).⁸ However, any fiduciary "advisor" to participants (i.e., a service provider or other person providing investment advice of the type that results in fiduciary status) would be separately liable for any participant losses that are caused by the advisor's failure to provide

⁸ Interpretative Bulletin 96-1 ("IB 96-1"), 29 C.F.R. § 2509.96-1(e). IB 96-1 provides "safe harbors" under which plan fiduciaries and service providers may provide certain types of information to participants without being deemed to provide "investment advice" of the type that confers fiduciary status. Information permitted by these safe harbors includes: (a) objective descriptions of plan investment alternatives, plan terms and the benefits of plan participation (which are without reference to the appropriateness of any option for a particular participant or beneficiary); (b) general financial and investment information, including risk and return, diversification, and estimating future retirement income needs; and (c) asset allocation models that identify certain asset classes or types of investments as appropriate for hypothetical individuals with different time horizons and risk profiles. To the extent that similar objective information about LTD coverage available under a plan is presented to participants, whether by the plan fiduciary or by a plan service provider (including an LTD carrier, or its employee, agent or other affiliate, or another plan service provider), whether in written plan materials, on websites, or in person (in enrollment meetings or otherwise), such information similarly should not be treated as "investment advice" about the LTD coverage that could make the person providing this information a plan fiduciary for ERISA purposes.

prudent investment advice. See 29 C.F.R. §§ 2509.96-1(e) and 2550.404c-1(f)(8). In addition, if a plan administrator or other plan fiduciary selects a service provider to provide education or advice to participants, the selection and monitoring of this service provider by the plan fiduciary must be prudent. In this regard, while we are not aware of a DOL interpretation or court opinion in an ERISA case requiring that participants have notice of potential conflicts of interest that could impact a service provider's investment advice, such as the possible payment of commissions by an LTD carrier in connection with sales of LTD coverage, a plan fiduciary may believe that it is prudent to ensure that participants receive this type of information.

Finally, section 404(c) does not entirely relieve plan administrators or other plan fiduciaries from investment responsibility. The plan fiduciary still is responsible for matters under that fiduciary's control, including, for example, designating and monitoring the plan's investment options and service providers.⁹ Accordingly, the plan administrator (or other fiduciary) of a section 404(c) plan that makes an LTD policy available to participants may be liable for losses resulting from a failure to meet fiduciary standards by not prudently selecting and monitoring the LTD policy or a person who provides investment education or advice to participants with respect to the LTD policy.

6. Issues raised by the payment of LTD policy premiums from plan assets and allocation of premiums among participants.

If the LTD policy is viewed as providing a "benefit" to plan participants, premiums required to fund the LTD policy should be a plan "expense" that may be paid from plan assets, unless plan terms specifically provide otherwise. If the LTD policy is viewed as a plan "investment," plan assets could be invested in the policy, unless prohibited by plan terms.

⁹ 57 Fed. Reg. 46906, 46924 n.27 (Oct. 13, 1992) (Preamble to ERISA section 404(c) regulations); DOL Adv. Op. 98-04 (May 28, 1998).

An additional issue is the appropriate source of the plan assets used to pay the LTD premiums, i.e., employer contributions, forfeitures, 12b-1 or other fees received directly or indirectly from the mutual funds in which the plan invests, plan earnings, deductions from participant account balances under the plan, or a combination of these. In addition, if the premiums are allocated to and deducted from participant accounts, the plan's fiduciaries should consider how the premiums should be allocated among the participant accounts.

FAB 2003-03 provides general guidance on how plan expenses should be allocated to individual participant accounts under a plan. It explains that, as an initial matter, a plan administrator must follow any procedures for allocating plan expenses set forth in governing plan documents. Accordingly, if the terms of a 401(k) plan specify a source from which the LTD policy premiums should be paid and/or a method of allocating the premiums among participant accounts (including any plan provision that generally provides how plan expenses are allocated to participant accounts), the plan administrator (or other responsible plan fiduciary) must comply with the applicable plan provisions. (Indeed, as noted above, those plan provisions would, in effect, be part of the definition of the plan's long-term disability benefit.)

FAB 2003-03 further explains that, if plan terms are silent, the plan administrator (or other responsible plan fiduciary) must prudently select the method for allocating plan expenses among participants, taking into account the competing interests of various classes of participants and the effects of various allocation methods on those participant interests. Depending on the circumstances, it may be reasonable to select either a "pro rata" allocation method (under which allocations are based on participant account balances) or a "per capita" allocation method (under which expenses are charged equally to participant accounts, regardless of account balance). Importantly, FAB 2003-03 notes that an expense allocation method may even disfavor a class of

participants, so long as there is a rational basis for the method. An important factor in determining whether a method is "rational" is the basis on which the fees are paid by the plan – where the plan's fees are generally determined based on account balance, for example, a per capita method of charging the expense to participants would appear arbitrary.

Therefore, if a 401(k) plan's governing terms are silent on the question of how LTD policy premiums should be paid from the plan and allocated among participant accounts, the plan administrator (or other responsible plan fiduciary) should have considerable flexibility with respect to the methods for paying the LTD policy premiums so long as the methodology has a rational basis. For example, where LTD coverage is non-elective (e.g., coverage is provided to all participants based on participant contributions in the previous or current plan year),¹⁰ the plan administrator might pay the LTD premiums from forfeitures, or from 12b-1 or other fees the plan receives directly or indirectly from mutual funds, or from other plan investment earnings, unless plan documents specifically prohibit the use of these amounts to pay plan expenses. In this regard, we understand that many 401(k) plans pay for other plan services from forfeitures and 12b-1 or other fees received from mutual funds – the payment of LTD policy premiums for the benefit of all plan participants should be similarly appropriate. If the premiums are paid from the forfeitures, 12b-1 fees or other fees received directly or indirectly by the plan from mutual funds, or from plan earnings not yet allocated to participant

¹⁰ Where the coverage is elective with the participant, the use of forfeitures or fees received from mutual funds to pay LTD premiums might be challenged on the basis that it is not "rational" to use these amounts only for the benefit of those participants electing the long-term disability benefit. In this regard, our experience is that forfeitures and fees received from mutual funds are typically used to pay expenses incurred by the plan as a whole, such as recordkeeping or participant education costs, or are allocated among all participant accounts.

accounts, no specific charges would need be made to individual participant accounts.

Alternatively, whether the LTD coverage under the plan is elective or non-elective, plan administrators may determine that some or all of the premium expense should be allocated to and deducted from participants' account balances under the plan or from employer contributions that would otherwise be contributed to participant accounts (unless plan terms would specifically prohibit payment of the LTD policy premium from participant accounts or employer contributions). In addition, nothing in FAB 2003-03 would appear to prohibit a plan administrator from treating part of the premiums (e.g., the amount related to administration of the policy benefit) as a plan expense that is payable from forfeitures or 12b-1 or similar fees received by the plan, with the remainder allocated to (and on the basis of) individual participant account balances.

To the extent that the LTD policy premiums are allocated to and paid from participant account balances under a plan, FAB 2003-03 requires that the plan administrator adopt a reasonable methodology for allocating premiums to participants' account. In this regard, you asked whether LTD policy premiums may be allocated among participants by a per capita method (i.e., each participant pays the same fee) or pro rata based on the participant's contributions under the plan or, instead, must allocated by a method that takes into account the range of factors (e.g., participant age, amount of plan contributions, health history and other factors) that LTD policy carriers might apply in determining premiums under equivalent individual policies. We believe that guidelines provided by FAB 2003-03 do not require a plan administrator to make complicated premium allocation calculations, so long as the LTD policy premiums are in fact determined on a group basis and the allocation method adopted by the plan administrator has a rational basis. However, if the plan obtains individual LTD policies, or the LTD policy

carrier provides the plan administrator with specific information showing the portion of the group premium attributable to each individual participant, the plan administrator should consider allocating premiums to participant accounts based on the information provided by the LTD policy carrier.

7. ERISA disclosure, reporting and valuation issues.

In general, all employee benefit plans are subject to certain basic disclosure requirements. Among other things –

- Governing plan documents should specifically provide for each benefit offered under the plan (as also required by IRS plan qualification rules), including a long-term disability benefit, and all plan benefits (including a long-term disability benefit) also must be described in the summary plan description ("SPD") provided to plan participants.
- If an insurance policy, such as an LTD policy, is used to provide the plan benefit to employees, the insurance policy must be described in the SPD provided to plan participants.

In addition, every employee benefit plan generally must file an annual report on Form 5500, which includes information on the plan's assets, liabilities and expenses paid. Any insurance policies owned by a plan, including any LTD policies, would be reported on Schedule A of Form 5500. For purposes of this report, insurance carriers must supply certain information, including premiums paid under the policy by the plan, commissions, etc.

The proper reporting of premium payments generally would depend on their source. Proceeds received by the plan in the event of a participant's disability should be reported as "income" on Schedule H of the Form 5500 and generally would result in an increase in the value of plan assets reported on Schedule H as the LTD policy proceeds are invested.

Finally, all assets must be allocated to participant accounts at least annually. Rev. Rul. 80-155, 1980-1 CB 84. The LTD policy will be a plan asset. However, assuming the LTD policy will be non-participating and would not have any cash surrender value, it would not appear to have a “value” that can be allocated to participant accounts. Of course, any proceeds payable under the LTD policy as a result of a participant’s disability will be allocated to the participant's account (like a contribution) and invested as directed by the participant, and these proceeds will be reflected in both the participant's account value and in the plan’s total assets.

8. Possible "dual plan" issues.

A single plan may provide both pension and welfare benefits. See Rombach v. Nestle USA, 211 F.3d 190 (2d Cir. 2000) (plan may be amended to eliminate disability accruals without regard to anti-cutback rule for pension benefits). Thus, a 401(k) plan that provides a long-term disability benefit could be viewed as both a pension plan and a welfare plan. A plan providing both welfare and pension benefits presumably is not required to file separate Forms 5500. (Pension plans providing incidental life insurance do not.) However, under Labor Department regulations, disability benefit claims under a pension plan would be subject to the same regulations that govern all other disability claims. These regulations generally provide shorter claims processing times and include other requirements different from regulations governing pension plan claims. See 29 C.F.R. § 2560.503-1; 65 Fed. Reg. 70245, 70247 n. 4 (November 21, 2000). The insurer could be designated the claim fiduciary for this purpose.

* * *

This memorandum is intended as legal advice to CCP only and should not be construed as legal advice to any other individual or entity. The conclusions in this memorandum are based on applicable law as of the date of

this memorandum, and we do not make any representation as to any authority issued or made available subsequent to the date of this memorandum. Any variance from the facts stated herein may affect our analysis. Any individual or entity (other than CCP) that has questions as to the tax and other legal implications of the Protection Plan based on its particular circumstances should consult with its own legal counsel.

To comply with United States Treasury Regulations governing tax practice, unless expressly stated otherwise, any federal income tax advice contained in this memorandum cannot be used to or referred to to promote, market or recommend a tax arrangement, and is not intended or written to be used, and cannot be used, by a taxpayer to avoid penalties that may be imposed upon the taxpayer under the Code.

We hope this information is helpful. Please call if you have questions or we may be of further assistance.

Appendix A

Sample 401(k) Plan Provision For LTD Coverage

___. **Provision of Long-Term Disability Protection**

(a) The plan provides long-term disability coverage to eligible participants [who (affirmatively) elect the coverage in the form and manner approved by the Plan Administrator]. A participant is eligible for long-term disability coverage of [up to ___%, as elected by the participant] of his or her eligible Contributions for the [prior][current] plan year. **[Option:** All participants eligible for the coverage will be deemed to elect coverage of ___% of his or her eligible Contributions unless the participant designates a different percentage in accordance with procedures established by the Plan Administrator.] Eligible Contributions shall consist of **[Specify:** pre-tax, matching, nonelective, after-tax] contributions made to the Plan. Premiums for such coverage shall be paid by (or from) _____.¹¹

(b) Premiums paid for a participant's long-term disability coverage, together with premiums paid for life insurance and any other accident and health coverage for the participant under the Plan, at any and all times, may not exceed 25% of aggregate contributions to the Plan made on the participant's behalf.

(c) Benefits paid to the Plan under the policy providing for such long-term disability coverage shall be allocated to the participant's account and invested in accordance with the participant's most recent designation for the investment of contributions (unless and until modified in accordance with the procedures under the Plan).

¹¹ **Note:** In the case of a non-elective long-term disability benefit, the plan could specify, to the extent not paid by the employer, the premiums will be paid from forfeitures, employer contributions, earnings or other income received to the plan (including any so-called "12b-1 fees" or other amounts received directly or indirectly from mutual funds in which the plan invests) or from participant accounts, or any combination of these. If participants must elect the coverage (whether by affirmative or a deemed election), premiums should be paid from the assets of participant accounts or deducted from employer contributions that would otherwise be allocated to the participant accounts of the participants who elect the coverage.