

At Last! Proposed 204(h) Regulations

BY BRUCE GAFFNEY

THE IRS HAS FINALLY RELEASED PROPOSED regulations governing the manner in which plan sponsors must communicate certain benefit reductions to plan participants.

When EGTRRA was enacted last year, it modified ERISA Section 204(h) and created parallel provisions under Internal Revenue Code Section 4980F. Both sections require participants be notified when a DB or money purchase plan is amended to significantly reduce the future rate of benefit accrual, or is amended to eliminate or reduce an early retirement benefit or retirement-type subsidy. Under EGTRRA, the scope of the notice requirement was broadened, and excise taxes and other fees were added to penalize plan sponsors who fail to comply with the rules. The proposed regulations provide specific instructions on how the new law should be applied.

The regulations are, for the most part, more liberal than might have been expected (see the box on Page 8 for a summary of the major provisions). In areas where the IRS could have specified rigid rules or strict requirements, the regulations actually provide more general guidance and leave much to the discretion of

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Speaking at a session on professionalism at the EA meeting are, from left, Academy President Dan McCarthy and Phillip Romello, a member of the ASB's Pension Committee. For coverage of this year's meeting turn to Page 3.

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Guidance on SFAS 87

LAST DECEMBER, the Academy's Pension Accounting Committee sent a letter to the Financial Accounting Standards Board (FASB) requesting guidance on the appropriate interpretation of the EGTRRA sunset provision when stating pension benefit obligations under Statement of Financial Accounting Standards (SFAS) No. 87.

In its letter, the committee suggested at least three alternative interpretations:

- Estimate the benefits payable in years after 2010 as if EGTRRA had never increased the Section 415(b) limits (in other words, treat the sunset provision as having full impact).
- Treat the sunset provision as being subject to the anti-cutback provisions of Internal Revenue

Code Section 411(d)(6).

► Assume that the sunset provision will be repealed prior to its effective date (or treat the sunset provision as having no impact).

In an April statement responding to the Academy's letter, the FASB indicated that "...possible amendments of the law should not be considered in determining...pension measurements." As a result, the FASB stated, the third interpretation provided in the Academy's letter would be unacceptable since it anticipates changes to EGTRRA.

Whether the remaining alternative interpretations are appropriate should be based on individual determination as to whether the anti-cutback provisions apply. The FASB statement

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Joint Board Seeks Actuaries for Advisory Committee

THE JOINT BOARD FOR THE ENROLLMENT OF ACTUARIES is looking for actuaries interested in serving on its Advisory Committee on Actuarial Examinations. The term of the current committee expires Nov. 1.

The committee meets about four times a year, and committee work, including meeting time, runs from 125 to 175 hours over the course of a year. Actuaries who are interested in serving should send a letter, stating their qualifications, to the Joint Board for the Enrollment of Actuaries, Internal Revenue Service, Attn: Executive Director N:C:SC:DOP, 1111 Constitution Avenue, N.W., Washington, DC 20224. The deadline for applications is Aug. 19. Questions? Call the Joint Board at 202-694-1891.

REQUEST FOR PROPOSAL

Defined Benefit Floor Offset Pension Plan Administrator

The American Academy of Actuaries is accepting proposals for the annual actuarial and administrative work associated with our defined benefit floor offset pension plan. For a complete description of the RFP, go to the Academy's website at www.actuary.org/pdf/pension/academy_rfp.pdf. Closing date for proposals: July 31, 2002.

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suggests that consultation with legal counsel may be necessary to make that determination.

In its December letter, the Academy noted that the IRS in Revenue Ruling 2001-51 stated that the sunset provision of EGTRRA should be disregarded for the purposes of calculating the required minimum calculations for each year as well as the maximum tax deductions.

Members of the FASB staff wrote the statement about SFAS 87. As such, the statement should be considered the opinion of the authors and not necessarily the official position of the FASB.

To read a copy of the FASB statement, go to www.fasb.org/q&a87.pdf. ▲



VOLUME 27 ■ NUMBER 2 ■ SUMMER 2002 ■ PUBLISHED BY THE AMERICAN ACADEMY OF ACTUARIES

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Debating Pension Professionalism

THERE WAS AMPLE OPPORTUNITY AT THIS YEAR'S EA meeting for pension actuaries to wrestle with knotty questions about ethics and professionalism. Five of the meeting's sessions were devoted to different aspects of professionalism.

In his welcoming remarks at the first general session, Academy President Dan McCarthy reminded attendees that their commitment to professionalism is key to maintaining the high regard in which the profession is held.

By taking their initial and continuing education seriously, McCarthy said, actuaries acknowledge the importance the Joint Board for the Enrollment of Actuaries places on mastering the complex web of law, regulation, and practice in which an enrolled actuary works.

McCarthy also served as a panelist at a session on professional standards affecting pension actuaries. The session featured case studies of actual requests for guidance received by the Actuarial Board for Counseling and Discipline (ABCD), as well as a discussion of the revised Code of Professional Conduct, the Actuarial Standards of Practice, and qualification standards.

The revised code applies to all actuaries practicing in North America but is an international document, said Lauren Bloom, the Academy's legal counsel and director of professionalism. "If you are a member of any actuarial organization in North America, you are bound to follow the code. This applies regardless of where you practice."

Actuarial Standards of Practice, on the other hand, are nation-specific and task-specific. "They are the documents

that give you guidance as you do your work," said panelist Phillip Romello, senior vice president and actuary for The Segal Co. and a member of the Pension Committee of the Actuarial standards board. Similarly, Qualification Standards apply to actuaries issuing a prescribed statement of actuarial opinion.

Case studies from ABCD files also figured in another EA meeting session that focused on the difficulties inherent in balancing client demands and professional responsibilities.

When the consultant/vendor is wearing two hats, often the only answer is to take off one of the hats.

One of the cases was based on a letter seeking guidance from the ABCD on the implications of precepts 6 and 7 when a consultant gets fees or commissions from a third party.

"There are three requirements," said panelist Ed Burrows, a member of the ABCD. "You must be able to act fairly, you must disclose, and your client must acknowledge the conflict and consent to your performing the services."

The hardest of those to satisfy, said Burrows, is the first. "When the consultant/vendor is wearing two hats, often the only answer is to take off one of the hats," Burrows said.

The exchange of letters was published in the May *Actuarial Update* and is also available online at www.actuary.org/pdf/prof/abcd_rfg2_jan02.pdf. ▲



About 1,100 pension actuaries attended the 2002 Enrolled Actuaries meeting in Washington, March 11-13. The meeting was co-sponsored by the Academy and the Conference of Consulting Actuaries. Left: Conferring after the EA meeting's opening session are, from left, panelists Randall Johnson and Larry Sher. Right: Panelist Karen Friedman, left, answers questions after the same session. Read further coverage of the opening session in the online edition of the May *Actuarial Update* at www.actuary.org/update/index.htm.

2002 Gray Book

BY BRUCE GAFFNEY

ANNUALLY IN CONJUNCTION WITH THE EA MEETING, a committee of actuaries solicits questions from pension practitioners regarding unusual situations or areas in which the Internal Revenue Code and regulations are unclear, insufficiently specific, contradictory, or silent.

The questions are submitted to representatives of the IRS and the Treasury Department, who respond to some and decline to answer others. The responses are summarized by the committee and published in what has come to be known as the Gray Book.

In a session at the 2002 EA meeting, Donald Segal, senior vice president and actuary for The Segal Co. and chairperson of the Academy's Pension Committee, and Lawrence Sher, a principal with Buck Consultants and a member of the Academy's Pension Practice Council, led an in-depth discussion of the details and ramifications of a number of Gray Book questions, especially those which are surprising or confusing.

The 2002 Gray Book contains 44 questions and answers, covering a range of topics from deductibility of cash deposits under a DB plan to "catch-up contributions" pursuant to Section 414(v). The Gray Book also contains useful information regarding various changes enacted last year as part of EGTRRA.

In the session, there was a particularly interesting discussion, taken from question 5, on the relationship between quarterly contribution requirements and deductibility rules applicable to DB plans. The rules regarding the timing and deductibility of contributions are complicated. Additionally, contribution periods for different plan years can overlap. Peculiarities and unusual situations can occur if a client considers making a large deductible cash deposit near the deadline for contributions attributable to a given plan year (i.e., a large contribution made during a plan year but attributable—for purposes of funding or deductibility—to a prior year).

Questions 14 through 18 address circumstances when approval for a change in actuarial cost method may or may not be granted. In its response, the IRS highlighted the fact that it has the authority to reject a request for a method change simply because of the impact of such a change on the required contribution or on the full funding limitation. The Gray Book contains a hypothetical example in which ap-

proval for a method change is not granted. Unfortunately, the example is somewhat ambiguous. However, it is clear that the method change is rejected either because it eliminates an otherwise required cash contribution or because the plan sponsor has changed methods too frequently.

Answers to questions 19, 20, and 21 provide some helpful guidance regarding the newly amended Section 412(c)(9), which, under certain circumstances, allows use of a prior year valuation in the determination of valuation results for the current year. The Gray Book responses provide details on how certain calculations are performed. Guidance is also provided on switching between use of the "prior year valuation rule" and the traditional approach. (Some of the informal guidance in the Gray Book has been incorporated into the recently passed technical corrections bill.) Question 21 also made clear the IRS contention that for a given valuation, it is not acceptable to use data gathered in a prior plan year, other than as allowed by the new "prior year valuation rules."

Segal and Sher also reviewed questions 6, 7, and 8, which address subtleties of the rules with respect to spinoffs. The answer to question 8 indicates that methods for allocating the credit balance to a spun-off plan that are described in Revenue Rulings 81-212 and 86-47 are not the only reasonable approaches. The methods described in these rulings are safe harbors, but other reasonable approaches exist. The presenters also highlighted question 36, which clarifies that it is necessary to transfer a portion of any asset surplus in a de minimis spinoff within a controlled group.

Segal and Sher also touched on questions regarding the application of Section 415, the correct application of certain cost methods in unusual situations, the usefulness of determination letters, and the appropriate method of calculating current liability.

It is important to note that the guidance in the Gray Book does not carry the weight of a regulation or other IRS promulgation. It cannot be relied on as strict guidance. Rather, it gives an indication of regulators' thinking on how unusual situations should be addressed.

BRUCE GAFFNEY is a principal and consulting actuary with Ropes & Gray in Boston and a contributing editor of the *EAR*.

Expanding Actuarial Influence in Washington

THE MARCH 9 PASSAGE OF PENSION INTEREST RATE relief as part of the Job Creation and Worker Assistance Act marked a new level of actuarial influence in the development of public policy.

“Actuaries were instrumental in identifying the problem, they were instrumental in educating folks on the Hill about it, and they were instrumental in developing legislation to solve the problem,” said Bridget Flynn, the Academy’s pension policy analyst, speaking at a panel at this year’s EA meeting on the actuarial profession’s input into new regulations and legislation.

Flynn, a former aide to Rep. Earl Pomeroy (D-N.D.), added that while a permanent substitute still needed to be worked out for the 30-year Treasury replacement rate, “this was one of the fastest-moving fixes I’ve seen—especially in the coalescence around this problem.”

Joining Flynn on the panel were James Delaplaine, vice president for retirement policy for the American Benefits Council, and Brian Graff, executive director of ASPA and former pension counsel for the Joint Committee on Taxation.

Actuarial input on the legislative side of policy development is a relatively new thing, said Graff. But since the passage of ERISA, the actuarial profession has forged strong working re-

lationships with regulators. “We are fortunate in the regulatory agencies and the number of actuaries they have on staff who appreciate the input the profession has,” Graff said.

Because there are fewer actuaries in the legislative and executive branches of the government, the actuarial profession, to be effective, must tailor its message toward a less technical audience. “These are political people, not technical people,” said Delaplaine. When speaking to political leaders and staff in Congress and the White House, Delaplaine advised actuaries to:

- ▶ Think of the big picture and in themes.
- ▶ Have polling data to support their position.
- ▶ Fit their issue into the politician’s broader message and philosophy.

It is also better to become involved on an issue earlier rather than later. “It’s a lot harder to change things when they’ve gone far in the legislative process,” said Flynn. One of the biggest assets an actuary takes into a meeting with policy-makers, the panel agreed, was the solid reputation of the actuarial profession.

“One of the most effective aspects of the actuarial profession is that it is viewed as a profession that provides candid and balanced input into the process,” said Graff. “This gives us a standing that is very effective in making an impact.” ▲

Small Plans Workshop

BY MARJORIE MARTIN

HAVE YOU EVER WISHED FOR THE OPPORTUNITY to discuss your technical problems with a group of peers? The annual small plans workshop at the EA meeting, led by Larry Deutsch and myself, is an open forum on current problems and issues specific to sponsors of small, and sometimes not so small, plans.

While our agenda is unstructured, the pattern for the session is fairly clear. We start with a roundup of questions that folks want to explore, then go down the list to the very end, asking audience members to share ideas and solutions on each topic until “old Paint is dead.” Participating audience members bring a variety of talents to the table in exploring the issues presented by each topic, focusing on tax and ERISA issues, financial issues, and Actuarial Standards of Practice.

Topics explored this year included:

- ▶ Considerations in determining the additional pension that can be provided by a DB plan in light of the EGTRRA increases where a new plan is established to supplement a previously terminated plan.

- ▶ The requirement that a DB plan observe QJSA notice and consent rules when starting benefits at age 70½ even if the payment is to be made using the (now obsolete) “account balance method” in the proposed minimum distribution regulations.
- ▶ The selection of funding assumptions when the valuation is performed as of the beginning of the plan year but after the plan year has in fact ended.
- ▶ How to handle transfers from a nonqualified plan set up to maximize deferrals to the 401(k) plan after determining the nondiscrimination test results for the underlying 401(k) plan.

The session focuses on practical problems and solutions and affords attendees the opportunity to share special knowledge they may have about unique issues. More important than the specific topics discussed is the opportunity to hear how other consultants pick apart an issue and think through an array of options for solving each problem.

The session is not recorded. Join us next year—new ideas and questions are always welcome!

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Trends in Health Care

BY ADAM REESE

HERE WERE TWO TRENDS UNDER CONSIDERATION at the session on trends in health care led by Dale Yamamoto of Hewitt Associates and myself at this year's EA meeting: recent and projected health care cost increases (and their implications for FAS 106 calculations) and changes in plan design, particularly the movement toward DC retiree medical plans.

Yamamoto presented a recent Hewitt study that showed a significant disconnect between the maximum annual cost increases companies indicated they could absorb over the next few years and the rate increases they expect. Over 50 percent of the companies expected health care cost increases in 2002 to be 15 percent or greater, with only one-fifth of that number agreeing that such a level of increase would be acceptable.

In response to these high cost increases, some employers have introduced choices in plan design to cushion the impact on premium increases. These "consumer choice" options permit employees to customize their coverage by selecting their own deductible levels for physician and drug coverage.

"One implication for actuaries conducting retiree medical valuations in this high trend rate environment is to examine the leveraging effect on plan designs with high deductibles," said Yamamoto.

When developing the claims cost assumption for an FAS 106 measurement, Yamamoto reminded attendees to take account of risk selection for plans with multiple options and high retiree contribution requirements, and to be especially cautious when developing costs for plans with employer caps. Yamamoto described a common situation in which caps are based on a blend of active and pre-65 retiree costs and the company subsidy for retirees can easily be twice the blended active/retiree subsidy (see box below).

In the area of employer plan designs, I pointed out that employers are increasingly shifting away from DB health care plans toward retiree health care accounts. In their purest form, these accounts give each employee a check or voucher to use in purchasing health care in the open market.

I explored how an employee would access the health care market as an individual. Not only is it important to learn what benefits various plans cover, but employees need to understand the underwriting process before choosing coverage that matches their individual situation, their preference for health care delivery systems (i.e., with or without network restrictions), and their tolerance of financial risk.

One implication for conducting retiree medical valuations in this environment is to examine the leveraging effect on plan designs with high deductibles.

For the important pre-Medicare market, I discussed options such as self-insurance, obtaining coverage under a spouse's plan, enrolling in an association plan, or exercising a continuation policy option under an employer's plan. When none of these approaches are possible, employees can avail themselves of federal coverage and portability protections provided under COBRA and HIPAA, although their success in obtaining affordable coverage will depend in part on how their state implemented the "group to individual" requirements under HIPAA.

ADAM REESE is a senior retirement consultant with the Hay Group in Arlington, Va. He is a member of the editorial board for the *Actuarial Update*.

	Blended Rate	Retiree Rate	Comment
Total cost	\$3,000	\$5,500	Retiree rate is the age-graded cost
Participant contribution	600	600	The retiree contribution (20%) is based on the blended rate
Company subsidy	2,400	4,900	The true retiree subsidy is over twice the blended rate subsidy

The Future of the Determination Letter Program

BY JAMES A. KENNEY

ONE OF THE SESSIONS AT THIS YEAR'S EA MEETING featured two speakers from the IRS who provided a fascinating glimpse into one of those government programs everyone loves to complain about but few would dispense with (it is difficult to deny the comfort provided by a clean letter of determination from the IRS.)

Those actuaries who have been around since the passage of the Tax Reform Act of 1986 know the problems engendered by waiting for the IRS to issue such letters. After passage of the act, plans operated for nearly a decade in the fuzzy never-never land of "good-faith compliance," with laws and regulations that no one fully understood and guidance that was spotty and unreliable. Model amendments froze benefit accruals until the government could figure out its own laws. Plans were operated contrary to their explicit provisions, without any amendments being adopted, in order to comply with new rules not yet clarified.

This period has given the phrase "remedial amendment period" a sinister aftertaste in the minds of many practitioners. But according to IRS spokesmen Bruce Settell and Jim Flannery, this old approach is gone. "We asked ourselves, Is there a more rational way? Maybe we can do a little better than saying, Just operate regardless of what your plan says," Settell said.

One of the major changes is the elimination of the requirement that plan sponsors demonstrate compliance with the non-discrimination provisions of 401(a)(4) and 410(b). Previously, only plans that used the General Test or the Average Benefit Test could forgo furnishing a demonstration of non-discrimination. Now, this is optional for all plans. Frankly, Settell admitted, the IRS would prefer not to get such demonstrations.

The downside to this is that sponsors will no longer be able to rely on their determination letters in this regard unless they submit Schedule Q and its associated demonstrations. The changes described in Announcement 2001-77, and subsequently reflected in Rev. Proc. 2002-6, provide greater flexibility to plan sponsors, and make it much easier to submit a plan for review. However, they also make the resulting letter less valuable.

Under the old approach, unless a determination letter was issued with caveats, the letter proved the plan was qualified in form, and that it met the coverage and non-discrimination requirements. Now, letters won't be issued with caveats; instead the letter must be viewed in conjunction with what was submitted in order to determine what it actually covers. Sponsors and practitioners must carefully preserve all documents associated with their submissions in order to prove what their letter of determination means.

Settell also discussed how the IRS plans to handle the volume of submissions for GUST. The IRS had expected roughly 50,000 applications by the end of the remedial amendment period, which for most plans was Feb. 28. As of the Friday before the beginning

of the EA meeting, only 25,000 applications had been received. This could represent a widespread failure to comply, a delay in processing by the Postal Service, a wave of company consolidations, or an indication that many sponsors have given up on individually designed plans in favor of pattern or pre-approved plans.

When an application is received, it is logged into the IRS inventory control system. The application is then assigned to one of five remote sites, where it is decided whether the case can be closed with minimal contact with the sponsor. The current thinking is that this process should be completed in four or five months unless the application is submitted with the optional Schedule Q demonstrating compliance with non-discrimination requirements, in which case the process will probably take twice as long.

Flannery discussed EGTRRA and how to deal with the changes it requires. After previous legislation, plans were allowed to function without amendment as long as they complied in operation with the new legislation. Now, sponsors must "make their best shot at amending," after which the IRS will hold open a remedial amendment period until the end of 2005, and sponsors will have an opportunity to "true up" their amendments as guidance is issued. This approach is spelled out in Notice 2001-42. The key point here is that the remedial amendment period is available *only* to employers who adopt good-faith amendments in the proper plan year. Another key point is that "good faith" will be determined by the IRS, and employers can only be guaranteed their amendments meet this standard if they employ the language set forth by the IRS in a series of model amendments. A number of such amendments are provided by Notice 2001-57, which serves as a form of early guidance on how the IRS interprets EGTRRA.

This new approach puts employers at greater risk unless they adopt the IRS amendments, and will likely lead to greater use of such amendments in order to bulletproof plans against future challenge. This is unfortunate, since language developed by the government tends to be less vibrant and robust than language crafted by experienced ERISA advisers specifically for the plan in question.

Flannery continued with a discussion of a white paper on the future of the employee plans determination letter program issued by the IRS last August and available at www.irs.gov/ep. This paper, intended as a conversation starter, lists 10 options the IRS is considering, including a complete elimination of the determination letter program. Unfortunately, feedback on these proposals has been scanty. The comment period ends July 1, so it behooves us to give the IRS some constructive suggestions before then. This can be done most easily by e-mailing the EA session speakers at either Bruce.A.Settell@IRS.gov or James.P.Flannery@IRS.gov.

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the plan sponsor. This will undoubtedly make compliance easier in many cases, generally less expensive, and—for the most part—less painful.

On the other hand, it also means that unanswered questions remain, and plan sponsors (as well as the actuaries who advise them) will still face situations in which the appropriate level of disclosure is unclear.

As is often the case, the definition of amorphous terms such as “significant” or “reasonable” could become crucial in considering whether a notice is required. The regulations (in Q&A 8) explicitly pose the question of when a reduction should be considered significant, but provide no clear answer. When is an amendment “reasonably expected” to reduce future accruals or subsidies? What are the “reasonable expectations” upon which we should base this determination?

Another area where the IRS has provided less stringent guidance than expected is in the treatment of wearaway. The regulations clearly indicate that notice is required when a plan change results in a wearaway period, but state that wearaway due only to changes in variables over time (such as unexpected wearaway resulting from changes in the interest rate used to determine lump sums) may be disregarded.

The IRS appears to have recognized the wide variability in types of plans and nature of plan changes, as well as the tension between adequate disclosure and the cost of preparing notices and illustrations. The proposed regulations do not require individual, customized statements. The effect of a plan amendment can be illustrated by providing examples addressing the impact of the change on hypothetical participants. Further, the regulations do not require that examples be based on a specific

payment form, but allow the use of whatever approach best illustrates the situation. The regulations allow examples under varying assumptions, but multiple scenarios are not required. Rather, examples must be based on reasonable assumptions.

This could be a two-edged sword—allowing for shorter, more concise, and easier-to-produce communications, but also placing the burden of choosing the appropriate illustrative assumptions on the plan sponsor.

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New Guidance at a Glance

The new regulations under ERISA Section 204(h) and Internal Revenue Code Section 4980F provide detailed guidance on the application, timing, and content of communications on plan amendments, as well as the ramifications of intentional or unintentional failure to comply.

Significant provisions include:

- ▶ In general, notice must be provided at least 45 days prior to the effective date of the amendment (but only 15 days is required for certain small plans or if the amendment is adopted in connection with certain business transactions).
- ▶ Notice must be provided to any participant or alternate payee reasonably expected to be facing a significant reduction in his or her accrual rate, early retirement benefit, or retirement-type subsidy (but need *not* be provided to participants whose benefit is unaffected or is expected to increase). If varying employee groups are affected differently, separate notices can be provided to each.
- ▶ The notice must include sufficient information to allow the recipient to understand the effect of the amendment and the approximate magnitude of the expected reduction in his or her benefit. The notice must be written so that it is understandable to the average plan participant.
- ▶ The effect of the plan amendment must be explained, including a description of plan provisions before and after the amendment. If the approximate magnitude of the benefit reduction is not reasonably apparent, further information—either additional descriptions or illustrative examples—must be provided.
- ▶ Examples of all possible scenarios are *not* required. Rather, examples must show the range of reasonably expected reductions or a worst-case example with a statement that less severe reductions may occur.
- ▶ Notices should be distributed in a manner that is reasonably calculated to reach all participants affected by the amendment. The regulations specifically allow distribution of a paper or electronic document. Hand delivery and first-class mail are acceptable methods, while electronic posting is not. Various special rules apply in the case of electronic distribution.
- ▶ In an instance where a participant must choose between benefits, the notice must provide sufficient information to allow for an informed choice.