

CIEBA

The Committee on Investment
of Employee Benefit Assets

Gifts & Gratuities Rules Primer

January 2010

This Guide is general in nature and does not constitute legal advice on any specific matter.



CIEBA is a Special Committee of the Association for Financial Professionals®

Acknowledgements & Disclosures

CIEBA wishes to thank Morgan, Lewis and Backius, LLP for preparing this educational resource. We also wish to acknowledge the roles of Ray Kanner of IBM Retirement Funds and Sharon Cassidy of U.S. Steel & Carnegie Pensions for their role in helping bring this issue to light and editing this primer.

This Guide is general in nature and does not constitute legal advice on any specific matter.

This January 2010 Update reflects additional Frequently Asked Questions published by the Department of Labor regarding the Form 5500 Schedule C. The principal changes relate to clarifications and special rules for the reporting of gifts & gratuities. In addition, the guide now describes the “good faith effort” relief for plan year 2009.

Committee on Investment of Employee Benefit Assets

Questions and Answers on Employee Benefit Plan Annual Reporting and Disclosure on Form 5500 Schedule C (Service Provider Information)

Introduction

A number of questions have been raised by the new rules governing Form 5500 Schedule C and related gifts reporting. This question and answer guide provides background information for CIEBA members. CIEBA wishes to thank Donald J. Myers of Morgan, Lewis & Bockius, LLP, and other attorneys at the firm for preparing this educational resource. *This Guide is general in nature and does not constitute legal advice on any specific matter.* (Note: This Guide has been updated to reflect additional guidance issued in October 2009.)

Q1 What information needs to be reported?

A1 Under new rules adopted by the U.S. Department of Labor (“DOL”), employee benefit plans subject to the Employee Retirement Income Security Act of 1974, as amended (each an “ERISA plan” or “plan”) are required to report, subject to certain *de minimis* thresholds and limits, all direct and indirect compensation received by their service providers (*i.e.*, bank trustees, custodians, brokers, recordkeepers, *etc.*).

Q2 When did the new rules take effect?

A2 The new rules are effective for plan years beginning on and after January 1, 2009.

Recognizing that it may be difficult for service providers to make all the necessary adjustments to their recordkeeping systems in time for 2009 plan year reporting, DOL has said that plan administrators will not be required for 2009 plan year reports to list a service provider as having failed to provide the information necessary to meet the new rules, if the administrator receives a statement from the service provider that (i) the service provider made a good faith effort to make any necessary recordkeeping and information system changes in a timely fashion, and (ii) despite such efforts, the service provider was unable to complete the changes for the 2009 plan year. DOL has further said that it will not reject a filing or impose penalties if the 2009 plan year report does not include information that was not provided to the administrator by a service provider. DOL added that it expects service providers to provide such information on their reportable compensation that they are able to collect, and that plan administrators will communicate with them about the steps the service provider is taking to be able to provide the necessary information in connection with future filings.

Q3 What do the new rules require?

A3 The rules require each ERISA plan to report annually, as part of the plan’s annual filing on Form 5500 (specifically, on Schedule C), all direct compensation paid by the ERISA plan to its service providers, plus any indirect compensation received by such service providers in connection with their services to the ERISA plan (subject to a reporting threshold).

Q4 What is “indirect” compensation?

A4 “Indirect” compensation is compensation from sources other than the plan or plan sponsor that is received in connection with services rendered to the plan or the person’s position with the plan. It includes the value of non-monetary payments (such as meals, entertainment, free travel or other gratuities) made to the ERISA plan’s service providers (including payments made to the employees of such service providers). However, indirect compensation does not include compensation that would have been received had the service not been provided to the plan and that cannot be reasonably allocated to such a service.

Q5 What is the reporting threshold?

A5 Compensation is reportable when a person is paid or receives \$5,000 or more total in direct or indirect compensation, during the plan year, in connection with services rendered to the plan or the person’s position with the plan.

Q6 What types of recipients are included in the term “person”?

A6 Individuals, trades, and businesses, whether or not incorporated.

Q7 How should the recipients of direct or indirect compensation be identified?

A7 Recipients should be identified separately by name on Form 5500 Schedule C. However, employees of a plan sponsor or other business entity that is reported on Form 5500 Schedule C as a service provider, such as an in-house asset manager (an “INHAM”), need not be separately identified if they did not separately receive reportable direct or indirect compensation in relation to the plan.

Q8 What compensation is reportable?

A8 Reportable compensation includes money and “anything of value” received by a person directly or indirectly from the plan in connection with services rendered to the plan or the person’s position with the plan. Examples of what are treated as services for this purpose include investment management, recordkeeping, claims processing, participant communication and brokerage. The investment of plan assets and payment of premiums for insurance contracts are not in and of themselves considered payments for services, and therefore are not reportable.

Reportable “direct” compensation is compensation paid directly by the plan during the plan year. Reportable “indirect” compensation is compensation received by a service provider from sources other than directly from the plan or plan sponsor and that is based in whole or in part on services rendered to the plan or transactions with the plan. Subject to the exception described below for “eligible indirect compensation,” examples of reportable “indirect” compensation include fees charged against a plan’s investment in a fund (*e.g.*, 12b-1 fees), finder’s fees, brokerage commissions, float revenue and soft dollars.

Note the following special rules regarding “indirect” compensation:

If a service provider is a fiduciary or provides contract administrator, consulting, custodial, investment advisory, investment management, broker or recordkeeping services, additional reporting is required regarding each source from whom the service provider received \$1,000 or more in indirect compensation, and each source for whom the service provider gave the plan a formula instead of an amount or estimated amount of indirect compensation.

Certain categories of indirect compensation, called “eligible indirect compensation,” need not be reported if the service provider’s compensation is limited to these categories, and the plan receives certain required disclosures regarding that compensation. The covered categories are fees or expense reimbursement payments that are charged to investment funds and reflected in the value or return on the investment, finder’s fees, “soft dollar” revenue, “float” revenue, and/or brokerage commissions or other transaction-based fees. The definition is limited to the specific categories described.

Q9 What is the special reporting rule for indirect compensation under a bundled service arrangement?

A9 The new Schedule C provides a special reporting rule for a bundled service arrangement, defined as an arrangement where one company provides a range of services to the plan either directly, through affiliates or subcontractors, or through a combination, priced as a single package rather than on a service-by-service basis.

The special rule, designed to simplify reporting for such arrangements, is that direct payments by the plan to the bundled service provider should be reported solely as direct compensation to the bundled service provider, and need not be separately reported as indirect compensation received by the other providers within the bundled package. However, there are three exceptions:

- If the amount is paid by the bundled provider to another provider on a per transaction basis, such as brokerage commissions, it would be treated as reportable indirect compensation to that other provider (subject to the rules described in **Q8**).
- Fees charged separately against the plan’s investment and reflected in the net value of the investment – such as mutual fund management fees, float revenue, commissions, finder’s fees, 12b-1 fees and revenue sharing payments charged as a separate amount against the plan’s investment – must be treated as separately

reportable compensation by the recipient for Schedule C purposes, and thus may be reportable as indirect compensation (subject to the rules described in **Q8**). However, if an investment provider pays a service provider within the bundled arrangement out of its overall investment management charge, that payment would not be treated as a separate fee for this purpose.

- A person who is a fiduciary to the plan or provides the following services – contract administrator, consulting, investment advisory, investment management, securities brokerage or recordkeeping – would be required to treat the following types of compensation as separate compensation for Schedule C purposes: Commissions and other transaction-based fees, finder’s fees, float revenue, soft dollar and other non-monetary compensation.

According to DOL, so long as all the compensation required to be reported is identified on the Schedule C, there is flexibility in determining what services or providers are included as part of a bundled arrangement.

Q10 What does “anything of value” comprise?

A10 “Anything of value” can include:

- 1) Meals
- 2) Travel expenses and/or reimbursements
- 3) Gifts
- 4) Tickets to sporting or other entertainment events
- 5) Products or services (*e.g.*, food and other consumer goods)
- 6) Social events/parties (*e.g.*, contract-signing parties)
- 7) Fees paid to attend union-sponsored events¹
- 8) Political/charitable contributions
- 9) Awards
- 10) Lodging
- 11) Use of facilities under preferential terms or terms not otherwise available to the public
- 12) Travel, meals and lodging associated with attending an educational conference, as well as waiver of the conference registration fee (but an allocated share of the cost of conference rooms and audio-visual equipment need not be included)

¹ Gifts and other gratuities may be separately reportable for purposes other than Form 5500, such as the LM-10 form that employers are required to file to disclose certain specified financial dealings with unions, union agents and labor relations consultants.

Q11 What types of gifts or gratuities are not reportable?

A11 Non-monetary compensation of insubstantial value can be excluded, if the compensation is deductible for federal income tax purposes by the person providing the gratuity and is not taxable income to the recipient, and

- 1) The gratuity is valued at less than \$50; and
- 2) The aggregate value of such gratuities from one source in a calendar year is less than \$100; provided that
 - (a) Gratuities with a value of less than \$10 need not be counted toward the \$100 limit;
 - (b) If the \$100 aggregate value limit is exceeded, then the value of all the gratuities is reportable (except those under \$10);
 - (c) Gratuities received by one person from multiple employees of one entity must be treated as originating from a single source when calculating whether the \$100 threshold applies; and
 - (d) Gratuities received by multiple employees of one entity from one person can be treated as separate compensation when calculating the \$50 and \$100 thresholds.

Promotional gifts of little intrinsic value – such as coffee mugs, calendars, greeting cards, plaques, certificates, trophies or similar items intended solely for the purpose of presentation and displaying a company logo – can be presumed to have a value of less than \$10 for this purpose, and therefore need not be tracked. However, a gift that clearly has a value in excess of \$10, such as a \$400 golf club, would not fall into this category.

Gifts and gratuities are not reportable if neither the amount of the gift nor eligibility to receive the gift is based, in whole or in part, on the recipient's position with an ERISA plan, or the amount or value of business conducted with ERISA plans. For example, a hospitality suite at a business conference that is open to any conference attendee, without regard to whether the person holds a position with an ERISA plan, does not result in reportable indirect compensation. Also, an exchange of holiday gifts based on personal relationships does not give rise to reportable indirect compensation.

Q12 How is the value of a gift estimated?

A12 The following formulas may be reasonable depending on the circumstances:

- 1) An estimate of the payment or benefit provided to each individual; or
- 2) The per person cost for a meal or event.

Q13 How is the compensation paid to a person in connection with services to several plans allocated?

A13 Where reportable compensation is received in connection with several plans, any reasonable method of allocating the compensation among the plans may be used, provided that the allocation method is disclosed to the plan administrator. In calculating the \$5,000 threshold, include the amount of the compensation received by the person that is attributable to the plan filing the Form 5500, not the aggregate amount received in connection with all plans.

Q14 In practice, how will an ERISA plan or sponsor obtain information about direct and indirect compensation received by service providers?

A14 ERISA plans will generally look to their service providers to record and report all such direct and indirect compensation received in order for the plan to meet its annual reporting requirement.

Q15 How are payments made directly by the plan sponsor reported?

A15 Only payments made directly by the plan sponsor that are reimbursed by the plan are reportable.

Q16 How is the Schedule C reporting handled if the plan sponsor pays all of the fees and costs of a particular service provider (whether affiliated or unaffiliated with the sponsor), without reimbursement from the plan?

A16 No reporting regarding that service provider is required on the Schedule C, unless the service provider or its employees receive other compensation in connection with the services to the plan (*i.e.*, indirect compensation from sources other than the plan and plan sponsor, such as soft dollars or gifts and gratuities) that exceeds \$5,000, in which case only that indirect compensation would be reported.

Q17 What reporting is required on Schedule C if the plan pays the “direct expenses” that the plan sponsor or an affiliate incurs in providing services to the plan, and those payments exceed \$5,000?

A17 The sponsor or affiliate would be listed on the Schedule C, and these payments would be reportable compensation for purposes of the Schedule C.

Q18 Where the direct expenses reimbursed by the plan in Q16 include individual employee salaries, should the Schedule C report only the aggregate amount reimbursed to the particular entity, or should it break out the payments for the individual employees?

A18 Only the aggregate amount paid to the entity should be reported, because the plan pays the entity and the entity, not the plan, pays its employees. The result would be different if the plan were treated as paying the employees directly.

Q19 Since reportable indirect compensation may include gifts and gratuities received by the employees of the plan sponsor as well as the sponsor itself, how should the sponsor track this reportable indirect compensation (assuming it is required to be listed on the Schedule C)?

A19 To be able to demonstrate compliance, the sponsor (or, as applicable, its affiliate that provides services to the plan, such as an in-house investment manager) should adopt and implement policies and procedures for its employees to report and track all gifts and gratuities they receive in relation to the services that the sponsor provides to the plan. The sponsor would then determine if the amounts exceed the reporting thresholds.

Note that if the total direct and indirect compensation received by the plan sponsor (or its affiliate) from the plan is less than \$5,000, then it would not be listed on the Schedule C and its indirect compensation need not be reported.

The following examples illustrate the types of gifts and gratuities that may have to be tracked:

- 1) Broker-Dealer takes Employee (an employee of the plan sponsor) to breakfast to discuss plan matters at a cost of \$9.50. As this is below \$10, it need not be reported and need not be tracked for purposes of the \$100 threshold.
- 2) Assume the cost of the breakfast in (a) is now \$11, but Employee manages the sponsor's cash investments in addition to handling plan matters, and the discussion at the breakfast is limited to the corporate cash account. As Employee is not receiving this meal in connection with the services he renders to the plan or his position with the plan, it is not reportable and need not be tracked.
- 3) Broker-Dealer takes Employee to lunch to discuss plan matters at a cost of \$27. Employee is responsible for the management and administration of three in-house plans to which Broker-Dealer provides or may provide services. Assuming it is reasonable to allocate this amount equally among the three plans, the result is \$9 per plan, which is below \$10, so that the amount need not be reported nor tracked for purposes of the \$100 threshold.
- 4) The same facts, but the cost is \$45. As the allocation results in a \$15 cost per plan, the amount should be tracked for purposes of the \$100 threshold, but need not be reported absent aggregation with other gifts and gratuities from Broker-Dealer that reach the \$100 threshold.
- 5) The same facts as in (c), but the cost is \$60 and allocable only to one plan. As this amount is above \$50, it is reportable and must be aggregated with other gifts and gratuities exceeding \$10 to determine if the \$100 threshold is met.

- 6) Five of the sponsor's employees attend a closing dinner for a private equity fund transaction. Two of the sponsor's three plans invested in this fund. The cost per employee is \$80. Each employee has a gift or gratuity of \$40 for each of the two plans that need not be reported on its own, but counts towards the \$100 reporting threshold for that employee.
- 7) An employee of the sponsor who works on investment matters for corporate treasury and three of the sponsor's employee benefit plans attends a conference sponsored by a consulting firm that does work for the sponsor and its plans. The sponsor pays a registration fee for the conference, but does not pay for a \$60 dinner and \$100 theatre tickets that the consulting firm provides to attendees. Assuming it is reasonable to allocate the \$160 total of gifts and gratuities from the consulting firm proportionately among corporate treasury and the three plans, the result would be an allocation of \$40 per plan, which amounts would not have to be reported on their own, but would count towards the \$100 reporting threshold. If the consulting services are provided mainly to one of the plans, the entire \$160 should be allocated to that one plan, which would then be reportable indirect compensation of the sponsor (if the sponsor meets the \$5,000 threshold for Schedule C reporting for that plan).

Q20 How are these reporting rules affected by the recent adoption by DOL of a new enforcement policy on gifts and gratuities?

A20 The reporting rules are not affected by the enforcement policy change in itself, although DOL has extended one of the exceptions described in the change to Schedule C reporting.

The new enforcement policy was adopted in August 2008 as a change to DOL's ERISA Enforcement Manual. A new subsection in the manual's section on fiduciary investigations, entitled "Fiduciary Violations Involving Gifts and Gratuities," directs investigators to determine whether a plan fiduciary's acceptance from a party dealing with the plan of consideration, such as meals, gifts, entertainment, or expenses associated with educational conferences, was for the fiduciary's personal account and in connection with a transaction involving plan assets, thereby violating ERISA. The manual also instructs the investigator to determine whether the fiduciary or plan maintained a reasonable written policy or plan provision governing these matters, and whether the fiduciary adhered to that policy.

After these general instructions regarding what would constitute a violation, the manual describes what should *not* be considered a violation. First, the investigator should treat as insubstantial, and thus not as an apparent violation, the receipt by a fiduciary (or the fiduciary's relatives) of gifts, gratuities, meals, or entertainment (other than cash or cash equivalents), or of reimbursement of expenses associated with educational conferences, where the aggregate annual value from any one party is less than \$250 and the receipt does not violate any plan policy or provision. Second, the investigator should not treat a reimbursement to a plan of expenses for a plan representative's attendance at an educational conference as a violation if a plan fiduciary other than the attendee reasonably determined in writing, in advance and without regard to whether the expenses would be reimbursed, that (a) the plan's payment of educational expenses in the first

instance would be prudent, (b) the expenses would be consistent with a written plan policy or provision designed to prevent abuse, (c) the conference had a reasonable relationship to the duties of the attending plan representative, and (d) the expenses for attendance were reasonable in light of the benefits afforded to the plan by such attendance and unlikely to compromise the plan representative's ability to carry out his or her duties faithfully in accordance with ERISA.

These rules are solely for purposes of enforcement determinations by DOL investigators, and therefore do not, in themselves, change any of the rules for the reporting of gifts and gratuities for Form 5500 purposes. However, DOL subsequently decided that it would not require educational conference expenses meeting the second exception described in the enforcement policy to be reported on Schedule C.

A related point is that the Form 5500 rules and exceptions for gifts and gratuities do not govern enforcement determinations or private lawsuits. The Form 5500 instructions and subsequent DOL guidance specify that thresholds for non-reporting of "insubstantial" amounts are solely for purposes of Form 5500 reporting, and that gifts and gratuities of any amount paid to or received by plan fiduciaries may violate ERISA and give rise to civil liabilities and criminal penalties.

Q21 Since "soft dollar" payments to managers of research and similar services may be difficult to value, are there special reporting rules for soft dollars?

A21 Yes, there are.

According to DOL's preamble to the new Form 5500, soft dollars received by an investment manager in the form of research or other permissible services can qualify as "eligible indirect compensation" that need not be separately reported on the Schedule C if the manager's disclosures in its SEC Form ADV, together with disclosures in the investment management contract, advised the plan administrator (1) that the manager is receiving soft dollars, (2) the reason for receiving the soft dollars, (3) the amount of soft dollars or the formula used to determine the amount that the manager receives, and (4) the parties from whom the manager is receiving soft dollars. Recognizing that it may not be practicable to provide a formula or estimate to calculate certain types of soft dollar compensation, DOL said that a description of the soft dollar eligibility conditions sufficient to allow a plan fiduciary to evaluate them for reasonableness and potential conflicts of interest would satisfy the "amount" disclosure requirement. (This special rule on satisfying the amount disclosure requirement for soft dollars is described only in the preamble, not in the instructions.)

Q22 How would these rules apply to reimbursements of expenses to employees of the plan sponsor who serve on advisory boards for private funds in which the plan has invested?

A22 This would depend on how the expense reimbursements are handled.

If the employee were reimbursed directly by the fund or fund manager for his or her travel, lodging and other expenses incurred in connection with attending advisory board

meetings, and/or receives in-kind benefits such as meals while attending the advisory board meetings, those amounts would be potentially reportable as indirect compensation to the employee for the services he or she provides to the plan, and should be tracked accordingly. If the fund or fund manager reimburses the plan, so that the employee is paid by the plan, these amounts would be potentially reportable as direct compensation from the plan. If the fund or fund manager reimburses the plan sponsor, so that the employee is paid by the plan sponsor, the amount would not be reportable by the employee under the rule in **Q14** above, but it may be reportable by the plan sponsor as indirect compensation to the sponsor.

It would not make a difference for this purpose whether the private fund were treated as holding “plan assets” subject to ERISA. What triggers the potential reporting obligation is that the employee or plan sponsor is receiving these reimbursements or other benefits in connection with providing services to the plan, not the nature of the paying party.

If the employee were also attending the advisory board meeting on behalf of investors other than the particular plan, then the reimbursements can be allocated as described in **Q12** above and illustrated in the examples in **Q18**, which will affect whether they fall below the reporting thresholds.