April 2007 Employee Benefits Update

POSTED:

Apr 19, 2007

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SELECT COMPLIANCE DEADLINES

Qualified Retirement Plans

Excess Contributions. Excess contributions and excess aggregate contributions which exceed the actual deferral percentage ("ADP") test and/or actual contribution percentage ("ACP") test for 2006 must be distributed with gap period income. The final 401(k) regulations require the distribution of gap period income (gains and losses from January 1, 2007 to the actual date of distribution) for 2006 and 2007. The Pension Protection Act ("PPA") repeals the requirement that plans distribute gap period income effective for the 2008 plan year.

Periodic Benefit Statements. The PPA requires plan administrators to furnish periodic benefit statements beginning in 2007. Administrators must furnish benefit statements each calendar quarter for participant-directed plans, annually for other defined contribution plans and every three years for defined benefit plans. Statements for defined contribution plans must be furnished no later than 45 days following the end of the period for which the statement is required. The first statement for calendar year plans with participant-directed investments is due no later than May 15, 2007.

The PPA requires that the quarterly benefit statement include the following information, some of which may need to be added to a plan's current statements:

- Total accrued benefit or account balance;
- Non-forfeitable accrued benefit/account balance (or the earliest date on which benefits will become non-forfeitable) or, alternatively, a separate statement with information necessary to enable the participant to determine the non-forfeitable benefit;
- Value of each investment to which assets in the plan have been allocated, determined as of the most recent valuation date, including the value of employer securities;
- Explanation of any plan-imposed limitations or restrictions on the right to direct an investment;
- Explanation of the importance of diversification, including a statement that the risk of investing more than 20% in a given entity would create a non-diversified portfolio (DOL has published model language); and

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- Notice directing recipients to the DOL website.

Health and Welfare Plans

New Medicare Part D Notices. The Centers for Medicare and Medicaid Services ("CMS") have again published new model Medicare Part D disclosure notices. If a group health plan used the model Medicare Part D notice from the CMS Website, the plan must begin using the new model for all notices distributed on or after February 15, 2007. The new notices are discussed in greater detail below.

HIPAA National Provider Identifier - Large Plans. Effective May 23, 2007, HIPAA requires large health plans (more than $5 million in annual receipts) to use a new National Provider Identifier ("NPI") when electronically conducting certain HIPAA standard transactions. Small health plans ($5 million or less in annual receipts) have until May 23, 2008 to comply.

NONQUALIFIED DEFERRED COMPENSATION

Code Section 409A Final Regulations Expected Soon

The Internal Revenue Service ("IRS") published final regulations under Internal Revenue Code (the "Code") section 409A on April 17, 2007. We will publish a separate mailing to keep you informed of necessary action items.

RETIREMENT PLAN DEVELOPMENTS

IRS Publishes Guidance on Deduction Limits

The IRS issued Notice 2007-28 to clarify the changes to the deduction limits under Code section 404, as amended by the PPA, that are effective for years after December 31, 2005 (the "2006 changes"). The remaining PPA amendments to Code section 404, which are not effective until years beginning after December 31, 2007, will be the subject of future guidance.

The 2006 changes primarily affect defined benefit plans. The PPA modified the deduction limit for defined benefit plans to be 150% of a single-employer plan's unfunded current liability (140% for multiemployer plans). The PPA also eliminated the option to use the 30-year Treasury rate in calculating unfunded current liability for 2006 and beyond.

The other significant 2006 change impacts the combined deduction limit for a plan sponsor maintaining one or more defined benefit plans and one or more defined contribution plans. First, multiemployer plans are excluded from the

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combined plans deduction limit. Next, after 2006, the deduction limit takes into account only employer contributions to a defined contribution plan that exceed 6% of the participants' compensation. If the employer contributions to a defined contribution plan do not exceed 6% of compensation, the combined limit will not take into account any of the employer contributions to the defined contribution plan.

QDRO Regulations Leave Unanswered Questions

The Department of Labor ("DOL") published interim final regulations on qualified domestic relations orders ("QDRO"), as required by the PPA. The regulations, which are effective April 6, 2007, clarify certain issues relating to the timing and order of a QDRO. Unfortunately, however, the regulations are narrow in scope and do not address some of the more complicated issues of QDRO administration.

Under the regulations, a domestic relations order ("DRO") that otherwise satisfies the requirements of a QDRO will not fail to be treated as a QDRO solely because the DRO is issued after, or revises another, QDRO. The DOL provides two examples of permissible "subsequent" QDROs:

- Participant and spouse divorce and submit a DRO to the plan administrator, which is approved as a QDRO. Subsequently, before payment under the QDRO commences, the parties submit a second DRO that assigns a smaller portion of the benefit to spouse. The second DRO will not fail to be a QDRO solely because it reduces the amount payable under the first QDRO.
- Participant and spouse one divorce. A QDRO is entered for spouse one. Participant remarries and then divorces spouse two. A DRO assigning spouse two a portion of participant's benefit that was not already assigned to spouse one will not fail to be a QDRO solely because it was issued after an earlier QDRO. Additionally, a DRO that otherwise satisfies the requirements of a QDRO will not fail to be treated as a QDRO solely because of the time at which it was issued. The DOL provided three examples:
- Participant and spouse divorce and submit a DRO to the plan administrator. The DRO is defective (i.e. it does not qualify as a QDRO). Before the parties can submit a revised DRO to the administrator, the participant dies. The revised DRO will not fail to be a QDRO solely because it was issued after the participant dies.
- Participant and spouse divorce and submit a DRO requiring the former spouse to be treated as the surviving spouse for purposes of the plan's death benefit.

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The DRO will not fail to be a QDRO solely because the former spouse no longer satisfies the plan's definition of surviving spouse.

- Participant retires and elects a straight life annuity. The spouse consents to the election and waives his or her surviving spousal rights. Participant and spouse then divorce and submit a DRO assigning half of participant's future benefits to spouse. The DRO does not fail to be a QDRO because it was issued after the annuity starting date.

HEALTH AND WELFARE PLAN DEVELOPMENTS

Appeals Court Holds Plan Not Required to Cover Contraceptives

For the first time, a federal appeals court has answered the question of whether a group health plan must cover prescription contraceptives, such as birth control pills, to plan participants. In re Union Pacific Railroad Employment Practices Litigation, No. 06-1706 (8th Cir. 2007). The court held that Union Pacific's group health plans did not violate the Pregnancy Discrimination Act ("PDA") by denying coverage for prescription and non-prescription contraceptives. Despite its victory, however, Union Pacific intends to continue covering prescription contraceptives, a practice it began after the lawsuit was filed, even though the court gave it permission to discontinue that coverage.

Union Pacific sponsored five health plans for its collectively bargained workforce. All of the plans excluded coverage for all prescription, over the counter and surgical contraceptives except when deemed medically necessary for a non-contraceptive purpose. The exclusion is permissible under the PDA, explained the court, because contraception is not related to pregnancy. The court compared contraception to infertility treatments, which it had previously held was a permissible exclusion under the PDA, because it was a treatment indicated only prior to pregnancy.

The decision in this case is contrary to other district court decisions and the Equal Employment Opportunity Commission's formal position on the subject. Nevertheless, the eighth circuit is the highest federal court to rule on the matter since the PDA was enacted, giving plan sponsors a basis for plan designs that exclude coverage for contraceptives. Commentators expect, however, that this will not be the last word on whether the PDA requires coverage for contraceptives.

CMS Published New Medicare Part D Model Notices Again

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Once again, CMS has issued new guidance and new model notices regarding Medicare Part D creditable coverage disclosures. The new guidance, effective February 15, 2007, is, in part, welcome news for plan sponsors. Unfortunately, however, the new guidance could also create more work for plan sponsors that use CMS's model disclosure notice. The most significant changes are as follows:

- A plan sponsor may distribute the Medicare Part D notice in accordance with the DOL's electronic disclosure regulations, provided that the participant is informed that he or she is responsible for providing a copy to his or her Medicare-eligible dependents;
- A plan sponsor that uses the model notices prepared by CMS must use the new models after February 15, 2007. The new models can be downloaded; and
- The plan sponsor is no longer required to list the participant's social security number on the personalized Medicare Part D notice. Instead, the plan sponsor should list the participant's date of birth or other unique member identification number.

IRS Rules that Self-Insured Group Health Benefits for Partners are Excludable from Income

The IRS ruled that partners can deduct premium payments to their partnership's group health plan and exclude benefit payments from their gross incomes as long as the plan has the effect of accident or health insurance. PLR 200704017 (Jan. 26, 2007). Although a Private Letter Ruling ("PLR") applies only to the party to whom it is addressed, a PLR provides an indication of how the IRS interprets certain issues.

The issue before the IRS was whether the partnership's self-insured medical plan was an arrangement having the effect of accident or health insurance. If it was, a partner could deduct premium payments and exclude benefits received under the plan. The IRS found that the arrangement had the effect of insurance because the risk of economic loss for personal injury or illness was shifted from the partner to the plan and distributed among the plan's participants in exchange for the payment of a premium.

Retiree HRA Can Be Funded with Unused Vacation and Sick Leave

In another PLR, the IRS approved a health reimbursement arrangement ("HRA") funding design whereby the employer made contributions of unused vacation and sick leave to the HRA for the exclusive purpose of reimbursing the medical expenses of eligible retirees and their dependents. PLR 200708006 (Feb. 23, 2007). The IRS noted that the employees were not permitted to influence the type

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or amount of the contribution. This PLR confirms the IRS's position that employer contributions of unused leave and reimbursements from the HRA trust for the medical expenses of eligible retirees and their dependents are excludable from the retiree's gross income.

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