# August 2006 Employee Benefits Update

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## SELECT COMPLIANCE DEADLINES

### Medicare Part D Compliance Deadline

Group health plan sponsors applying for the Medicare Part D retiree drug subsidy for a plan year ending in 2007 must apply for the subsidy annually. Application must be made no later than 90 days prior to the start of the plan year. For calendar year plans, the 2007 application must be submitted by September 30, 2006. Plan sponsors may request a 30-day application extension, provided the request is submitted no later than 90 days prior to the start of the plan year. For calendar year plans, the application extension request is due by September 30, 2006. The subsidy application and extension should be submitted through the Retiree Drug Subsidy Center website.

### Amendments to Cash-Out Provisions of Qualified Plans

September 15, 2006 is the latest deadline for amending the cash out provisions of calendar year qualified plans to comply with new automatic IRA rollover rules. The automatic IRA rollover rules were added by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and took effect on March 28, 2005. Plan amendments should reflect the operation of the plan since March 28, 2005 as generally either reducing the cash out limit to $1,000 or establishing automatic IRAs for vested benefits of $5,000 or less. IRS Notice 2005-95 clarified that qualified plans have until the due date (including extensions) for filing the income tax return for the employer's taxable year that includes March 28, 2005 to adopt applicable amendments.

## RETIREMENT PLAN DEVELOPMENTS

### Pension Protection Act of 2006 Becomes Law

On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 ("Act"). The Act represents one of the most significant modifications to the private pension system since Congress created comprehensive rules governing employee retirement plans under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The Act most significantly affects the funding of defined benefit pension plans starting in 2008. Other provisions in the Act's 907 pages affect cash balance plans, Internal Revenue Code (the "Code") section

401(k) plans and other defined contribution plans.

Significant provisions in the Act, which are generally effective in 2007 unless noted, include:

- EGTRRA Provisions Made Permanent. Many favorable pension and IRA provisions in EGTRRA were scheduled to sunset in 2010. The Act makes these provisions permanent. EGTRRA provisions include increased limits on contributions to IRAs and qualified plans, modifications to deduction limits and faster vesting of matching contributions, as well as permitting Roth 401(k) contributions and catchup contributions.

- Funding Reform for Single-Employer and Multiemployer Defined Benefit Plans. Generally, the Act wholly overhauls pension funding rules for single-employer defined benefit plans for the 2008 plan year. For multiemployer plans, the Act tightens some funding rules, establishes standards for identifying underfunded plans, provides quantifiable benchmarks for measuring a plan's funding improvement and allows funding flexibility for underfunded plans.

- PBGC Premiums. The Act makes no further changes to the flat-rate premium and continues the 2004-2005 rules for variable rate premiums in 2006 and 2007.

- Cash Balance and Hybrid Plans. The Act provides that defined benefit plans, including cash balance and other hybrid plans, will not violate age discrimination rules if a participant's accrued benefit is not less than the accrued benefit of a similarly situated younger employee. This provision applies prospectively for periods beginning on or after June 29, 2005. Provisions in the Act also affect interest credits, vesting, conversion and calculations of lump sum distributions.
  Note that the August 7, 2006 decision in *Cooper v. IBM Personal Pension Plan* by the U.S. Court of Appeals for the Seventh Circuit held that IBM's hybrid plan design was not age discriminatory.

- 401(k) Plans.
  Automatic Enrollment. ERISA would now preempt state wage withholding laws to the extent the laws interfere with an employer's ability to offer an automatic enrollment feature in its 401(k) plan. Other provisions are effective for plan years beginning on or after January 1, 2008. The Act would create a matching safe harbor plan design for nondiscrimination testing and top heavy requirements, provided the automatic enrollment feature is "qualified." Plans

with a qualified automatic enrollment feature would have to provide an annual notice to participants. For plans with an eligible automatic enrollment feature, excess contributions from failed nondiscrimination tests may be refunded up to six months after the end of a plan year.
Default Investments. Congress has instructed the Department of Labor ("DOL") to issue a fiduciary safe harbor under ERISA section 404(c) for the investment of assets in an individual account plan for participants who fail to make an investment election. The regulations are to be issued within six months from the date the Act becomes law. If a plan sponsor follows the terms of the safe harbor, a participant will be deemed to be exercising investment control under these circumstances. Plan sponsors would be required to provide an annual notice explaining the default option.
DB(k). An employer with 500 or fewer employees may establish a combined defined benefit-401(k) plan with certain required features. The provisions for DB(k) plans apply to plan years beginning after 2009.

- Additional Spousal Protection. Defined benefit plans must provide a "qualified optional survivor annuity" in addition to a qualified joint and survivor annuity ("QJSA"). Generally, plans with a QJSA providing a 50% survivor annuity must now also offer a 75% survivor annuity option to participants. This provision applies to plan years beginning in 2008.

- Missing Participants in Terminating Plans. The Act would make the PBGC's missing participant program available to terminating defined contribution plans, allowing such plans to transfer a missing participant's benefit to the PBGC. This program will not become available until the PBGC issues regulations regarding its administration.

- Reporting and Disclosure. Pension Benefit Statements. Effective for plan years beginning in 2007, benefit plan administrators must begin furnishing benefit statements. Administrators of defined benefit plans must furnish benefit statements to participants and beneficiaries at least once every three years. Alternatively, administrators may provide a notice of availability of pension benefit statements annually. Administrators of defined contribution plans with participant-directed investments must furnish benefit statements each calendar quarter, while administrators of other individual account plans must furnish statements annually. The DOL is required to publish model benefit statements.
Funding Notice. Plan administrators of defined benefit plans must furnish an annual funding notice to participants, beneficiaries, labor organizations and the Pension Benefit Guaranty Corporation ("PBGC") within 120 days after the end of

a plan year, beginning with the 200 plan year. Plans with 100 or fewer participants would furnish the notice coincident with the filing of Form 5500. The DOL is required to publish a model funding notice.
Repeal of SARs for Defined Benefit Plans. Plan administrators of defined benefit plans will no longer be required to provide a summary annual report ("SAR") to participants beginning with the 2008 plan year.
Electronic Display on Annual Report Information. The DOL will display basic plan information and actuarial information on its website within 90 days after the filing of annual reports. Plan sponsors or plan administrators must also display the information on any Intranet Website maintained for communicating with employees. These provisions apply to plan years beginning in 2008.

- Investment Advice. Plan sponsors would be able to enter into arrangements with investment advisors to provide investment advice to participants without subjecting themselves to fiduciary liability for the advice provided. The arrangements would have to satisfy several specific conditions under either a computer model or flat-fee arrangement.

- Bonding Requirement. For plan years beginning in 2008, the maximum bond amount for a qualified plan holding employer securities is increased from $500,000 to $1,000,000.

- Fiduciary Protection During Black-Outs. Effective for plan years beginning in 2008, the Act provides fiduciary relief under ERISA section 404(c) during certain black-out periods and directs the DOL to establish rules on the mapping of investments under which participants will be deemed to retain control during certain changes in investment options.

- Diversification. The Act requires defined contribution plans to permit employees to diversify out of investments in employer securities if the securities are publicly traded. Plans must offer this diversification right to all participants upon entry into the plan with respect to employee contributions or elective deferrals. The plan may require up to three years of participation before this diversification right applies to employer nonelective and matching contributions. This diversification right does not apply to ESOPs that do not permit elective deferrals, employee contributions or matching contributions. Plan sponsors must provide participants who have a right to diversify out of employer securities with 30 days advance notice of such right.

- Distribution Notice and Consent Rules. For direct rollover notices, the general

consent rules for distributions and the rules for waiving qualified joint and survivor annuities, the 90-day notice and consent period is extended to 180 days.

- Phased Retirement. The Act allows in-service distributions from defined benefit plans once participants attain age 62 without any trigger based on reducing the employee's work schedule.
- Amendments. The Act provides protection from the anti-cutback rules for all plan amendments made to comply with the Act or related regulations, provided the amendments are made before the end of the first plan year beginning on or after January 1, 2009.

**SEC Adopts New Executive Compensation Rules**

On July 26, 2006, the Securities and Exchange Commission ("SEC") adopted changes to its rules regarding disclosure of (i) executive compensation, (ii) related person transactions, director independence and other corporate governance matters, and (iii) security ownership of officers and directors. These new rule changes require detailed disclosures of executive compensation and benefits in proxy statements, annual reports and registration statements, in addition to current reporting of compensation arrangements.

**Prohibited Transaction Excise Tax for Late Employee Deferrals**

The Internal Revenue Service ("IRS") recently issued guidance on determining the amount of the excise tax imposed when an employer fails to timely remit employee deferrals. Revenue Ruling 2006-38 provides that if an employer does not timely pay participant deferrals or contributions to an employee benefit plan, the excise tax is based on the interest on those elective deferrals or contributions. Additionally, the Ruling describes which interest rate to use to determine the amount involved for purposes of computing the excise tax and how the amount involved should be calculated.

**Cash Balance Plan Held as Not Age Discriminatory**

The Seventh Circuit Court of Appeals recently held that a defined benefit plan employing a “cash balance” formula did not violate ERISA’s prohibition on age discrimination. *Cooper v. IBM Personal Pension Plan*, 2006 WL 2243300 (7th Cir. 2006). In reaching this decision, the Seventh Circuit reversed a 2003 ruling by the Southern District of Illinois that IBM’s pension plan illegally discriminated against

older workers.

By declaring IBM's cash balance formula as "age-neutral," the Seventh Circuit is the first federal appellate court to definitively address age discrimination challenges to the validity of cash balance plans. The Seventh Circuit reasoned that, at least for purposes of the age discrimination prohibitions, cash balance plans and defined contribution plans should be treated similarly, and that under both of these pension plan types, "benefit accrual" is measured according to what is put into the plan rather than what an employee draws out. Having construed "benefit accrual" in this way, the Seventh Circuit concluded that "[u]nder IBM's plan any differences in pension benefits are a function of differing years of service, salary history, or the years the balance has been allowed to compound; age is not a factor."

**Modern Portfolio Theory Defeats Fiduciary Breach Claim**

A district court held that an employer did not breach its fiduciary duties under ERISA by allowing the stock of its parent company to remain as a plan investment option in the employer's Code section 401(k) plan during a period when the parent company was experiencing financial difficulties. *DiFelice v. US Airways, Inc.*, 2006 WL 1793624 (E.D. Va. 2006). The plan was intended to qualify as an ERISA section 404(c) plan, which allows participants to direct investments and limits a plan sponsor's fiduciary liability for participants' investment decisions if certain requirements are met.

The court held that ERISA's prudence standard should be evaluated in the context of the "Modern Portfolio Theory" and based on risk and return characteristics within the context of the other investment options offered under the plan. In general, Modern Portfolio Theory provides that diversification among different types of investments is the appropriate way to optimize an investor's overall return while minimizing the investor's aggregate risk. The court held that an investment fiduciary for a 401(k) plan with a company stock fund will not be imprudent in continuing to offer company stock if: (i) the plan offers a range of investment options across the risk/return spectrum; (ii) the fiduciary provides participants with accurate information about the particular risk/return characteristics of the company stock; and (iii) participants have the "unfettered ability" to diversify out of the plan's investment options, including company stock.

**No Breach of Fiduciary Duty for Failure to Fulfill Investment Instructions**

The Fourth Circuit Court of Appeals held that a participant's claim whose losses

resulted when the plan administrator failed to make changes to investments in his plan account as the participant had directed was not actionable as a fiduciary breach or under ERISA's other appropriate equitable relief provisions. *LaRue v. DeWolff, Boberg & Associates, Inc.*, 450 F.3d 570 (4th Cir. 2006). The Code section 401(k) plan in this case permitted participants to manage their own accounts by selecting from a menu of various investment options. The participant claimed that he directed the plan administrator to make certain changes to the investments in his plan account, but the plan administrator failed to carry out these directions. The participant argued that reimbursement of his plan account could be had under ERISA section 502(a)(2), which allows for a civil action by a participant, beneficiary or fiduciary for appropriate relief under ERISA section 409. However, ERISA section 409 provides that any fiduciary who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by ERISA is personally liable to make good to the plan any losses to the plan resulting from a breach. The court held that the participant did not qualify for relief under ERISA sections 502(a)(2) and 409 because recovery under these provisions must inure to the benefit of the plan as a whole, not merely to particular persons with rights under the plan. The court also held that restitution, as a form of recovery, was not broad enough to include compensatory relief in this case because an action of restitution seeks only to restore to a plaintiff particular funds or property found in the defendant's possession. Finally, the court held that the participant was not entitled to "make whole" relief, which is available in common law breach-of-trust actions by a beneficiary seeking to recover lost trust profits, because the compensatory damages sought were legal and not equitable.

## WELFARE AND FRINGE BENEFIT PLAN DEVELOPMENTS

### Use of Debit and Credit Cards for Medical Reimbursement Plans

The IRS recently provided guidance regarding the use of credit, debit and stored value cards as a means of reimbursing participants for their out-of-pocket eligible medical expenses under self-insured medical reimbursement plans. IRS Notice 2006-69 expands the approved methods for substantiating claimed medical expenses to include certain matches of multiple co-payments and inventory information approval systems. Key points of this Notice include the following:

- Automatic Substantiation. Under a new automatic co-payment substantiation method, a charge is fully substantiated and no further review is required if: (i) an employer's accident or health plan requires co-payments of a specific dollar amount; and (ii) the employee's payment to a health care provider equals an

exact multiple of not more than five times the amount of the co-payment for the specific service.

- Third-Party Substantiation. If a transaction exceeds a multiple of five times the dollar amount of a co-payment for a specific service, or the dollar amount is not an exact multiple of the co-payment or an exact match of a multiple or combination of different co-payments, the transaction must be treated as conditional. If a transaction is treated as conditional, the plan sponsor must require that additional third-party merchant or provider receipts be submitted for review and substantiation.
- Inventory Control System. An employer may adopt a system by which debit and credit card transactions can be approved or rejected based upon inventory control information, such as stock keeping units, with merchants who need not be health care providers. Card transactions using this method would be fully substantiated without the need for submission of a receipt by the employee or further review.

The guidance also addresses dependent care assistance plans. After an employee has paid the initial expenses to a dependent care provider and the services are provided, the employer, upon receipt of proper substantiation of the expenses, may make available through a payment card an amount equal to the lesser of (i) the previously incurred expense or (ii) the employee's total salary reduction amount to date. The amount available through the card may be increased in the amount of any additional dependent care expenses only after the additional expenses have been incurred. The amount on the card may then be used by the employee to pay for later dependent care expenses.

**IRS Expands Categories Of Coverage In Final HSA Comparability Rules**

The IRS has released final regulations on comparability (nondiscrimination) requirements for employer contributions to health savings accounts ("HSAs") and the exception to these rules for employer contributions made through a cafeteria plan. 71 Fed. Reg. 43056 (July 30, 2006). These final regulations apply to employer contributions to HSAs made on or after January 1, 2007.

Under section 4980G of the Code, if an employer fails to make comparable contributions to the HSAs of its employees during a calendar year, an excise tax equal to 35% of the aggregate amount contributed by the employer to the HSAs of its employees during that calendar year is imposed on the employer. The final

regulations, in the form of 36 questions and answers, provide guidance in the following areas:

- Additional tiered categories of family high deductible health plan coverage;
- Definition of the term "employee" for comparability testing (e.g., collectively bargained employees are disregarded for purposes of the comparability rules);
- Calculating comparable contributions;
- An employer's failure to make comparable HSA contributions (general rules, categories of coverage, etc.); and
- HSA contributions made through Code section 125 cafeteria plans are subject to the nondiscrimination rules of Code section 125 instead of the comparability rules. The final rules clarify when contributions are made "through a cafeteria plan."

## FORM 5500 FILING DEVELOPMENTS

**Final Rule on Mandatory Electronic Filing of Form 5500 Reports**

The DOL recently issued a final regulation requiring plans to file Form 5500 annual reports electronically, effective for plan years beginning on or after January 1, 2008. 71 Fed. Reg. 41359 (July 21, 2006). These final regulations represent a one-year delay, as earlier proposed regulations had required electronic filings to take effect for plan years beginning on or after January 1, 2007.

Under ERISA section 502(c)(2), civil penalties of up to $1,100 per day may be imposed for the failure to file an annual report required under ERISA. The DOL has indicated that, in assessing civil penalties, it will take into account technical and logistical obstacles experienced by plan administrators who are acting prudently and in good faith to comply with the new rules during the first year of the wholly electronic filing system. The DOL noted that the requirement to file annual reports electronically does not affect the record retention or disclosure obligations under ERISA sections 107 and 209.

To accommodate the change to mandatory electronic filing, the DOL, IRS and PBGC have jointly issued proposed revisions to Form 5500, which are to be finalized for 2008 plan years.

**Proposed Regulation Expands Reporting of Service Provider Compensation**

Included in the proposed DOL regulations mentioned above are revisions to Schedule C designed "to ensure that plan officials obtain the information they need to assess the reasonableness of the compensation paid for services rendered to the Plan." The DOL reiterates that an annual review of service provider compensation is part of a plan fiduciary's ongoing obligation to monitor the plan's arrangements with service providers. The revised rules may require investment advisers, hedge fund managers, broker-dealers and other service providers to ERISA plan clients to provide plans extensive and detailed information regarding compensation the service provider receives in connection with providing its services to the plan. 71 Fed. Reg. 41616 (July 21, 2006).

Under the proposed regulations, plans would be required to report on a revised Schedule C nearly all compensation paid to the plan's service providers, including compensation paid to those service providers by third parties if the payment is related to the plan. For example, compensation includes "float" on plan assets retained by the service provider and all brokerage commissions and fees charged to the plan. The proposed regulations would require plans to report the name of each service provider that fails or refuses to provide this information. Marked copies of Form 5500 that identify where changes would be made are available.