December 2005 Employee Benefits Update

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INTERNAL REVENUE SERVICE DEVELOPMENTS

IRS Grants Withholding and Reporting Relief for Nonqualified Deferred Compensation Plans

The Internal Revenue Service ("IRS") recently released Notice 2005-94, which provides for the suspension of new reporting and wage withholding requirements for nonqualified deferred compensation plans. Under this Notice, plan sponsors are not required to report deferrals for the 2005 calendar year on Form W-2 or Form 1099- Misc., as required under new Internal Revenue Code section 409A. Plan sponsors also are not required to report and withhold on amounts to be included in gross income under Code section 409A if the amounts have not yet been actually or constructively received by the individual in 2005. Without the suspension provided under the Notice, these amounts would have to be reported as wages. Plan sponsors may be required to file corrected forms after the IRS publishes further guidance on this issue. Notice 2005-94 does not suspend FICA tax withholding for nonqualified deferred compensation.

Additionally, if a 409A violation results in an underpayment of tax for the 2005 calendar year, employees and other service providers will be able to avoid penalties, but not interest, if they pay any taxes due in accordance with future IRS guidance expected to be published in the second quarter of 2006.

SELECT COMPLIANCE DEADLINES

IRS Extends Certain Plan Amendment Deadlines

The IRS has extended the deadline for certain plan amendments relating to the final retroactive annuity starting date regulations, the automatic rollover requirements under Code Section 401(a)(31)(B) and the final regulations under Sections 401(k) and 401(m). IRS Notice 2005-95. The possible extensions granted in this Notice are complicated and plan-specific. As a result, the specific facts applicable to each plan should be examined to determine whether an extension would apply.

For example, under Notice 2005-95 qualified retirement plan sponsors must amend plans to comply with the new automatic rollover rules by the latest of: (1) the due date (including extensions) for filing the income tax return for the

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employer's taxable year that includes March 28, 2005; (2) the last day of the plan year that includes March 28, 2005, or (3) December 31, 2005.

Also, the deadline for plan sponsors of defined benefit pension plans to amend calendar year plans to reflect final regulations under Code section 401(a)(9) on minimum distribution requirements is extended to the end of the Plan's applicable initial five or six-year remedial amendment cycle.

409A Compliance

Although regulations extended the December 31, 2005 deadline for many Internal Revenue Code section 409A transition rules, December 31, 2005 is still the deadline for the following amendments or actions:

- Make participant deferral elections with respect to compensation for services performed during 2006 (elections to defer certain bonuses for 2006 may be made in 2006);
- Termination of and distribution of benefits when nonqualified deferred compensation plans or stock options and SARs to avoid compliance with Code section 409A;
- Participant elections to terminate participation in a deferred compensation plan or to cancel outstanding deferral elections with regard to amounts subject to 409A;
- The inclusion in 2005 gross income of "make-whole payments" to participants in connection with cancellation of a discounted option or a stock appreciation right; and
- New payment elections as to the time and/or form of payment of amounts subject to 409A that are payable in 2006.

RETIREMENT PLAN DEVELOPMENTS

DOL Enforces "Blackout Period" Notice Requirements

In January 2003, the Employee Retirement Income Security Act ("ERISA") was amended to require plan administrators to provide a written notice to affected participants at least 30 days (but not more than 60 days) in advance of a "blackout period." A "blackout period" is a temporary suspension, limitation or restriction (lasting more than three consecutive business days) of plan participants' ability to

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direct or to diversify assets in their accounts, obtain loans from the plan or obtain distributions from the plan. A blackout notice must include certain information, including:

- The reasons for the blackout period;
- The expected beginning date and ending date of the blackout period; and
- A description of the rights that will be temporarily suspended, limited or restricted by the blackout period, including identification of any investments subject to the blackout period.

The Department of Labor ("DOL") recently assessed civil penalties on plan administrators for failing to provide a sufficient blackout notice. Such penalties may amount to $100 a day for each separate violation by administrators who fail or refuse to provide a blackout notice to affected participants and beneficiaries. The DOL considers each failure to provide a notice with respect to any single participant as a separate violation.

If the DOL assesses a fine for noncompliance with the blackout period notice requirements, the plan administrator may challenge the fine by filing a written statement of reasonable cause within 35 days of the DOL's assessment. If the plan administrator does not file this statement of reasonable cause in time, the plan will be deemed to have waived its right to appear and contest the facts alleged in the notice.

IRS Continues to Apply "Grandfather Rule" on Pre-Existing Benefits

On November 21, 2005, the IRS clarified that the "grandfather rule" for proposed regulations under Code section 415 will be expanded to cover pre-existing plans until the IRS publishes final regulations. IRS Notice 2005-87.

In May 2005, the IRS issued proposed regulations providing guidance on the compensation and benefit limitations under Code section 415. These proposed regulations provide a "grandfather rule" for benefits existing prior to May 31, 2005. Under the grandfather rule, a defined benefit plan will be deemed to satisfy the Code section 415(b) defined benefit plan limits for benefits accrued or benefits payable under the plan as of the effective date of the final regulations. This grandfather rule applies only to benefits that accrued under certain plan provisions that were adopted and in effect on May 31, 2005.

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When the IRS issues final regulations, the May 31, 2005 date for the grandfather rule in the proposed regulations will be replaced with a date that is not earlier than the date of publication of the final regulations. Accordingly, in the period between May 31, 2005 and the date the regulations are finalized, plan sponsors who adopt new plans will not be subject to the final regulations for certain benefits that accrued before the effective date of the final regulations.

PBGC Adopts Updated Mortality Tables

On December 1, 2005, the Pension Benefit Guaranty Corporation ("PBGC") finalized proposed regulations and updated the mortality tables used to value benefits for PBGC distress or involuntary terminations. The mortality table was updated from the currently used 1983 Group Annuity Mortality ("GAM-83") Tables to the 1994 Group Annuity Mortality Basic ("GAM-94") Tables. PBGC News Release No. 06-08. These final regulations and tables are effective as of January 1, 2006 and apply only to PBGC terminations, not to voluntary terminations of single-employer plans. However, plan sponsors must use these rules to determine the value of plan benefit liabilities for certain PBGC reports and to assure that spin-offs, mergers and transfers comply with Internal Revenue Code section 414(l).

Beginning in 1993, the PBGC based its mortality assumptions on GAM-83, a group annuity mortality table which reflects events that occurred prior to 1983. For pricing purposes, a majority of private insurers have since adopted a version of GAM-94, which reflects recent improvements in life expectancy. Because the mortality component in GAM-83 is based on relatively outdated information, the PBGC's derived interest factor has been lower than the interest factor for private insurers. The PBGC also noted that the updated mortality assumptions are not expected to cause a significant change in the agency's overall claims amount.

IRS Issues Guidance for KETRA Distribution and Loan Provisions

On November 30, 2005, the IRS issued guidance on the provisions of the Katrina Emergency Tax Relief Act of 2005 ("KETRA") that provide tax relief for certain Katrina-related distributions from employer retirement plans and increased limits for plan loans made to Katrina victims. IRS Notice 2005-92. This guidance clarifies the following:

- Administration. The Notice provides that a plan sponsor may choose whether to treat distributions under its plans as "KETRA distributions." Plan sponsors also may adopt reasonable procedures for identifying which distributions are treated as KETRA distributions, so long as determinations are made on a

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consistent basis.

- KETRA Distributions. The Notice provides that even though an individual is required to have sustained an economic loss to receive a KETRA distribution, the amount of the distribution is not necessarily required to correspond to the amount of the economic loss suffered by the individual. The Notice also clarifies that elective deferrals, qualified nonelective contributions and qualified matching contributions may qualify as KETRA distributions, even if they are not otherwise distributable. However, corrective distributions, deemed distributions for defaulted plan loans, ESOP dividend distributions and the costs of current life insurance protection will not qualify as KETRA distributions.
- Taxes and Reporting. The Notice provides that KETRA does not require plan administrators to offer qualified individuals a direct rollover of a KETRA distribution or to provide a Code section 402(f) rollover notice. However, voluntary withholding rules apply and, therefore, plan administrators must provide a voluntary withholding notice to affected individuals receiving a KETRA distribution.
- Loan Provisions. KETRA permits (but does not require) a plan sponsor to suspend loan repayments for certain individuals with outstanding plan loans on or after August 25, 2005 for all or a portion of the period beginning on August 25, 2005, and ending on December 31, 2006. Plan loan repayments suspended under KETRA's provisions must resume no later than December 31, 2006, and the plan may extend the term of the loan by the duration of the suspension period. Additionally, interest that accrues during the suspension period must be added to the remaining loan principal and the amortization schedule must be adjusted to provide substantially level payments over the remaining loan term.

HEALTH CARE PLAN DEVELOPMENTS

IRS Addresses Grace Period's Impact on HSA Eligibility

On May 18, 2005, the IRS released a Notice that allowed plan sponsors to amend cafeteria plans to permit participants to access certain unused amounts remaining in their health flexible spending accounts ("FSA") or dependent care assistance programs ("DCAP") at the end of the plan year to pay for expenses incurred during a grace period of up to 2-1/2 months after the end of that plan year. IRS Notice 2005-42.

On November 22, 2005, the IRS released a second Notice that addresses the

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grace period's impact on participants' eligibility to contribute to health savings accounts ("HSA") and clarifies other various grace period issues. IRS Notice 2005-86. The highlights of this second Notice include:

- General Provisions. A plan may provide a grace period that runs for less than the 2-1/2-month maximum and the plan may limit the grace period to only certain cafeteria plan benefits. However, the grace period must remain in effect for the entire grace period even though a participant may terminate employment before the last day of the grace period.
- Availability of Grace Period. A cafeteria plan that provides a grace period must make it available to all participants who are covered on the last day of the plan year, including participants whose coverage is extended through the end of the grace period because of COBRA continuation coverage.
- HSA Eligibility for FSA Participants. In general, the Notice states that when a cafeteria plan with a general-purpose health FSA provides a grace period, an individual who participates in that FSA will not be eligible to contribute to an HSA until the first day of the first month following the end of the grace period. However, the Notice also provides an option that would allow health FSA participants to become HSA-eligible during the grace period.
- Transition Relief. For cafeteria plan years ending before June 5, 2006, an individual participating in a general-purpose health FSA may be eligible to contribute to an HSA during the grace period if two conditions are satisfied. First, the individual is otherwise eligible to make HSA contributions. Second, either the individual's general-purpose health FSA has no unused contributions or benefits remaining at the end of the plan year or the employer amends the plan to provide that the grace period does not cover individuals who elect high-deductible health plan ("HDHP") coverage.

Transition Relief for Certain Non-Calendar-Year High-Deductible Health Plans

Last year, the IRS issued transition relief for plans that failed to qualify as HDHPs solely because they complied with state-mandated benefit requirements that were in existence as of January 1, 2004. However, this relief treated such plans as HDHPs only through January 1, 2006.

On November 18, 2005, the IRS extended the existing state-mandate transition relief for HDHPs that are non-calendar year plans. IRS Notice 2005-83. The Notice

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provides that for any coverage period of 12 months or less beginning before January 1, 2006, a health plan that otherwise qualifies as an HDHP (except that on its most recent renewal date before January 1, 2006 it complied with state-mandated benefit requirements that were in existence as of January 1, 2004), will continue to be treated as an HDHP. The transition relief in this Notice expires after the health plan's next renewal date or, if earlier, December 31, 2006.

ERISA Preemption Rejected for Law Regulating Pharmacy Benefits Managers

The First Circuit Court of Appeals recently rejected an ERISA preemption challenge to a Maine law that regulates pharmacy benefit managers ("PBM") and requires PBMs to disclose certain information. Pharmaceutical Care Mgmt. Ass'n v. Rowe, 2005 U.S. App. LEXIS 24032 (1st Cir. 2005).

The Maine law requires PBMs to disclose certain conflicts of interest and financial arrangements with third parties. The Maine law also requires PBMs to disclose their clients' benefits received from drug substitution or volume discounts. The First Circuit held that ERISA does not preempt the Maine law because the law did not have an impermissible "connection with" or "reference to" ERISA plans. The court noted that the duties imposed on PBMs under the Maine law were purely ministerial and did not require PBMs to act as ERISA fiduciaries. The court also noted that no conflict existed between the Maine law and ERISA's remedial scheme because ERISA was not designed to regulate or afford remedies against entities that provide services to plans.

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