February 2007 Employee Benefits Update

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SELECT COMPLIANCE DEADLINES

Qualified Retirement Plans

• **Amendments for Final 401(k) and 401(m) Regulations**. The deadline for making interim amendments for the final 401(k) and 401(m) regulations is March 15, 2007 (or September 15, 2007 if the employer's federal tax return is extended) for a calendar year plan. The final regulations under Internal Revenue Code (the "Code") sections 401(k) and 401(m) are generally effective for plan years beginning on or after January 1, 2006 and make operational changes to defined contribution plans with a cash or deferred arrangement or matching contributions. Plan amendments required to maintain a plan's tax-qualified status must be adopted by the later of the last day of the plan year in which the change is effective, or the due date of the employer's tax return (including extensions) for the tax year in which the change is effective. Discretionary plan amendments must be adopted by the last day of the plan year in which the change is effective (subject to anti-cutback rules which may require earlier adoption).

• **Mutual Fund Redemption Fees-Written Agreements with Administrators or Recordkeepers**. As reported in Reinhart's April 2005 Employee Benefits Update, the Securities and Exchange Commission ("SEC") adopted a final rule (Rule 22c-2) in March 2005 providing for possible redemption fees not to exceed two percent of the amount redeemed when a mutual fund redeems shares shortly after purchase. Rule 22c-2 is designed to address abuses associated with short-term trading of mutual fund shares. The rule also requires most mutual funds to enter into written agreements with certain financial intermediaries. A financial intermediary in the context of an employee benefit plan may be either a plan administrator or recordkeeper. A mutual fund's compliance deadline for such written agreements is April 16, 2007.

• **Periodic Benefit Statements**. The Pension Protection Act of 2006 (the "Act") 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

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participant-directed investments will be due no later than May 15, 2007. See Reinhart's *January 2007 Employee Benefits Update* for details of the latest guidance on the contents of these statements.

• **Cycle B Individually Designed Plans' Submission Date**. Remedial Amendment Period Cycle B individually designed plans must be submitted for a favorable IRS determination letter during the period beginning February 1, 2007 and ending January 31, 2008 to rely on the extended period during which qualification amendments may be retroactively adopted. Cycle B plans include those sponsored by employers with tax identification numbers ("EINs") ending in a two or seven. Plan sponsors should ensure that required interim amendments have been timely adopted before submission to avoid compliance fees. If not timely adopted, plans sponsors may be able to correct under the IRS' Employee Plans Compliance Resolution System (or "EPCRS").

Health and Welfare Plans

• **HIPAA Privacy Notice-Small Plans**. The Health Insurance Portability and Accountability Act ("HIPAA") requires a health plan to remind participants of the availability of its Notice of Privacy Practices every three years. For a small health plan ($5 million or less in annual receipts), the third year anniversary date is April 14, 2007.

• **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.

PENSION PROTECTION ACT OF 2006 DEVELOPMENTS

Latest Guidance - IRS "Grab Bag"

On January 2, 2007, the IRS published Notice 2007-7 (the "Notice"). The Notice contains the much anticipated "grab-bag" of guidance primarily on some of the Act's distribution provisions. The Notice covers the following topics:

• **Interest Rate Assumptions for Lump Sum Distributions From Defined Benefit Plans**. Code section 415(b) provides limits on annual benefits under a defined benefit plan. Code section 415(b)(2)(B) provides that, if a benefit is payable in a form other than a straight life annuity, the benefit must be adjusted to an actuarially equivalent straight life annuity for purposes of applying the

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annual benefit limits. Code section 415(b)(2)(E) specifies the actuarial assumptions that may be used in making a benefit adjustment. The Act amends Code section 415(b)(2)(E) to specify a new interest rate for making a benefit adjustment to a lump sum benefit (or certain other non-level annuity benefits).

The Notice confirms that the Act's interest rate change applies to distributions made in plan years beginning after December 31, 2005. Distributions in excess of the Code section 415 limits may have been made due to the retroactive effective date of the Act's interest rate. The Notice provides three methods for correcting excess distributions made in a plan year beginning in 2006. The Notice also explains that a plan may be amended retroactively to comply with the interest rate change without violating the Code's anti-cutback rules, provided the amendment is adopted on or before the last day of the first plan year beginning on or after January 1, 2009 (2011 for a governmental plan) and the plan is operated in accordance with the law change.

• **Hardship Distributions**. An employee's elective contributions under a cash or deferred arrangement may only be distributed upon the occurrence of certain events, one of which is the employee's hardship. A distribution is made on account of hardship only if the distribution is both made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. IRS Regulations provide a "safe harbor" list of expenses deemed to be on account of an employee's immediate and heavy financial need. Several of these listed expenses include expenses of the employee's spouse or dependents. The Act requires the IRS to modify the hardship distribution rules to permit 401(k), 403(b), 457(b) and 409A plans to treat an employee's plan beneficiary the same as the employee's spouse or dependent in determining whether the employee is eligible for a hardship distribution.

The Notice provides that, beginning August 17, 2006, 401(k) and 403(b) plans that permit hardship distributions only for safe harbor events may (but are not required to) permit hardship distributions for a primary beneficiary's medical, tuition or funeral expenses, provided all other criteria for receiving a hardship distribution are satisfied. For this purpose, a "primary beneficiary" is an individual who is named as a beneficiary under the plan and has an unconditional right to all or a portion of the employee's plan account balance upon the employee's death. This appears to mean that a primary beneficiary can be any individual properly designated by a participant or a plan's default beneficiary. In addition, the Notice provides that 457(b) and 409A plans may treat an employee's beneficiary the same as the employee's spouse or dependent in determining whether an

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unforeseeable emergency has occurred.

• **Early Distributions to Public Safety Employees**. Code section 72(t) provides for a 10% additional tax on an early distribution from a qualified retirement plan, unless the early distribution qualifies for an exception to the tax. The Act amends Code section 72(t) to provide that the 10% additional tax on early distributions does not apply to a distribution from a governmental defined benefit plan to a qualified public safety employee who separates from service after attaining age 50. This new exception applies to distributions made after August 17, 2006. The Notice clarifies the definition of "qualified public safety employee," explains how a qualified public safety employee becomes eligible for the exception to the 10% additional tax and addresses issues relating to rollovers and reporting.

• **Nonspouse Beneficiary Rollovers**. Retirement plans typically require nonspouse beneficiaries to take immediate, lump sum distributions of a deceased participant's benefits or to complete distributions over the five-year period following the participant's death. The Act changes the Code's direct rollover rules to provide that, effective for distributions made on or after January 1, 2007, a qualified retirement plan, a 403(a) or (b) annuity plan or an eligible governmental 457(b) plan may permit nonspouse beneficiaries to elect direct rollovers, provided the rollovers are made to individual retirement accounts or annuities ("IRAs").

The Notice clarifies many aspects of the administration of nonspouse beneficiary rollovers. The Notice confirms that plan sponsors are not required to offer rollovers to nonspouse beneficiaries. If a plan sponsor offers rollovers to the nonspouse beneficiaries of some (but not all) participants, the Notice states that such rollovers must be offered on a nondiscriminatory basis. Also, the Notice provides that a rollover by a nonspouse beneficiary is not subject to all of the Code's direct rollover rules. For example, the Code's tax notice and 20% mandatory withholding requirements do not apply to nonspouse beneficiary rollovers.

The Notice further confirms that a nonspouse beneficiary rollover must be a direct rollover, and that if the beneficiary takes possession of the distribution, the amount is no longer eligible for rollover. Also, the Notice explains that the direct rollover must be made to an IRA that will be treated as an inherited IRA, and the IRA must be titled correctly (e.g., "Tom Smith as beneficiary of John Smith"). In addition, the Notice sets forth rules for determining the required minimum distribution in the context of a nonspouse beneficiary rollover. Also, the trustee of a trust which is a designated beneficiary may roll over a distribution to an IRA with

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the trust designated as the IRA beneficiary.

Reinhart Comment: A plan may implement nonspouse beneficiary rollovers at any time provided the plan is accordingly amended by the end of the plan year in which these rollovers were first offered. If a plan permits nonspouse beneficiary rollovers, the plan administrator will need to timely communicate this right to beneficiaries in order for the right to be effectively available under the plan. The rollover right can be communicated through a revised 402(f) notice or a separate communication.

• **Distributions To Pay for Health Coverage for Retired Public Safety Officers**. The Act amends Code section 402 to provide that an eligible retired public safety officer may exclude from gross income amounts distributed from an eligible government plan, to the extent such amounts are used to pay for qualified health insurance premiums. The Notice defines key terms (*i.e.*, public safety officer and eligible government plan) and explains the eligibility rules and applicable limits for this exclusion. For example, the Notice clarifies that the accident or health plan receiving the payments may not be a self-insured plan; rather, the plan must be providing insurance issued by an insurance company regulated by a State (including a managed care organization that is treated as issuing insurance).

• **Vesting of Employer Nonelective Contributions**. The Act accelerates the minimum vesting schedule for employer nonelective contributions to a defined contribution plan. Effective for employer nonelective contributions made for plan years beginning after December 31, 2006, a defined contribution plan must apply at least a three-year cliff vesting schedule or a two-to six-year graded vesting schedule. The Notice confirms that a plan sponsor may choose to continue to apply an old vesting schedule (e.g., five-year cliff) to employer nonelective contributions made for plan years beginning before January 1, 2007, so long as proper recordkeeping is performed. Alternatively, a plan sponsor may decide to use a single vesting schedule for all contributions. For purposes of a dual vesting schedule, the Notice also explains when contributions transferred to a plan after the end of a plan year may be on account of the previous plan year. In addition, the Notice provides that a plan amendment to satisfy the Act's vesting rules must comply with Code section 411(a)(10), which requires no reduction to preamendment vesting percentages and provides an election of schedules to participants with three or more years of vesting service. However, the Notice confirms that no election is required where a participant's vesting percentage at any time under the amended schedule cannot be less than the percentage determined without the Act's amendment.

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• **Distribution Notices**. Effective for notices given in plan years beginning after December 31, 2006, the Act extends the maximum period during which certain distribution notice and consent requirements must be satisfied. Specifically, the maximum notice and consent period relating to qualified joint and survivor annuities and the maximum period during which the tax notice for eligible rollover distributions must be given now extends to 180 days (rather than 90 days) before the annuity starting date. This means that the distribution notices may remain in effect for up to 180 days instead of 90 days under pre-Act law. In addition, the notice given to obtain consent to a distribution must include a statement of a participant's right to defer distribution and must address the consequences of failing to defer receipt of a distribution. The Notice contains a safe harbor guide for plan sponsors to use in modifying distribution notices to comply with the Act. To meet the IRS's safe harbor, the notice for a defined contribution plan must include (1) a description of plan investment options and fees if distribution is deferred and (2) the part of the summary plan description ("SPD") that contains rules that may affect a participant's decision to defer. The Notice provides that a plan is required to revise the content of notices to reflect the Act's changes. However, until 90 days after the IRS issues regulations, the plan need only make a "reasonable attempt" to comply.

More Guidance to Come

The DOL was expected to issue final regulations on qualified default investment arrangements ("QDIAs") by its February 17, 2007 deadline. According to informal guidance from the DOL, relief from fiduciary liability through a QDIA is not available until the DOL issues final regulations. The DOL received over 100 comment letters on its proposed regulations, which it is considering as it works to finalize guidance. Meanwhile, plan fiduciaries should continue to make prudent decisions of how to invest the assets of participants who fail to make investment elections.

RETIREMENT PLAN DEVELOPMENTS

Supreme Court Declines Review of Cash Balance Plan

The U.S. Supreme Court declined to review a Seventh Circuit decision that IBM did not violate ERISA's age discrimination provisions when it implemented a cash balance plan. By declaring IBM's cash balance formula as "age neutral," the Seventh Circuit became the first federal appellate court to definitively address age discrimination challenges to the validity of cash balance plans. Cooper v. IBM

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Personal Pension Plan, 457 F.3d 636 (7th Cir. 2006). The Seventh Circuit's decision is discussed in more detail in Reinhart's *September 2006 Employee Benefits Update*.

Reinhart Comment: 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. The Act's provisions on cash balance/hybrid plans do not clarify the status of cash balance plans for prior periods. Because the Supreme Court declined to review the Seventh Circuit's decision, courts will continue to debate whether cash balance plans are age discriminatory.

IRS Requests Comments on Nontraditional Benefits Under Defined Benefit Plans

In Notice 2007-14, the IRS requests comments on the types of benefits that should be permitted under defined benefit plans. Notice 2007-14 provides that the IRS is concerned that some defined benefit plans include nontraditional benefits that may not be subject to the Code's qualification rules and protections, such as benefits that are payable only upon an employee's involuntary termination or in other limited circumstances that are unrelated to retirement or benefits that could exceed the amount of the accrued benefit payable under the plan. The IRS specifically requests comments regarding the extent to which defined benefit plans currently offer nontraditional benefits and comments regarding any appropriate transition rules. Comments must be submitted to the IRS by May 13, 2007.

HEALTH AND WELFARE PLAN DEVELOPMENTS

HIPAA Security Guidance

The Department of Health and Human Services ("HHS") issued additional guidance on the protection of electronic protected health information ("EPHI") that is stored or accessed outside of a covered entity's physical control. HHS issued this guidance in response to a number of security incidents related to the use of laptops, other portable and/or mobile devices and external hardware that store or are used to access EPHI under the responsibility of a covered entity. As background, the HIPAA Security and Privacy Rules require all covered entities to protect the EPHI that they use or disclose to business associates, trading partners or other entities. A covered entity includes a health plan, health care clearinghouse and certain health care providers.

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In this recent guidance, HHS warns that covered entities should generally be "extremely cautious" about allowing offsite use of, or access to, EPHI. HHS identifies three areas of special concern when dealing with remote access and offsite use of EPHI access, storage and transmission. HHS notes that each covered entity should address these three areas individually in its risk analysis and risk management strategies, policies and procedures and security awareness and training. The guidance includes charts addressing each of the three areas of special concern (access, storage and transmission), and identifies possible risks and risk management strategies in each area. For example, to reduce the risk that improper access to EPHI is gained when a home or other offsite workstation is left unattended, HHS suggests establishing procedures for session termination (time-out).

Maryland's Fair Share Act is Preempted by ERISA The Fourth Circuit held that Maryland's Fair Share Act, aimed at increasing the level of health benefits provided by certain employers, is preempted by ERISA. Thus, the Fourth Circuit concluded that Maryland's Fair Share Act is unenforceable. *Retail Industry Leaders Ass'n. v. Fielder*, 2007 U.S. App. LEXIS 920 (4th Cir. 2007).

The Fair Share Act required nongovernmental employers with 10,000 or more Maryland employees to spend at least a specified percentage of total wages on health care or insurance. Alternatively, an employer could pay the State of Maryland the difference between what the employer actually spent on health care coverage and the percentage required by the Fair Share Act. A trade association challenged the Fair Share Act. The Fourth Circuit affirmed the district court and held that ERISA preempts the Fair Share Act. The Fourth Circuit stated that the Fair Share Act is unenforceable because it effectively mandates the structure of health benefits to meet minimum thresholds and that it disrupts employers' uniform administration of plans on a nationwide basis by requiring them to segregate certain funds for Maryland employees. As pointed out by the Fourth Circuit, other states and local governments have adopted or are considering similar laws. Courts may conclude that similar laws are also unenforceable on ERISA preemption grounds.

GENERAL TOPICS

Demutualization Proceeds The Sixth Circuit and the D.C. Circuit both recently issued decisions regarding the allocation of demutualization proceeds. These cases serve as a reminder that, in the context of an employee benefit plan, allocations of insurer rebates, refunds, dividends, etc., may raise fiduciary duty

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and prohibited transaction issues. Plan sponsors should approach such allocations with caution.

• *Bank of New York v. Janowick, et. al.*, 470 F.3d 264 (6th Cir. 2006) - In 1996, National Southwire Aluminum Company ("NSA") terminated its defined benefit plan. Upon termination, the plan's trustee bought two group annuities from Prudential Financial, Inc. ("Prudential") to cover the benefits owed to plan participants. In 2000, Prudential demutualized and a dispute arose regarding ownership of the proceeds of Prudential stock. The Sixth Circuit concluded that the plan participants (and not NSA) were entitled to the proceeds under three alternative analyses involving an ERISA opinion letter, the Restatement of Contracts and a demutualization analysis.

• *Stewart v. Nat'l Educ. Ass'n*, 2006 U.S. App. LEXIS 30830 (D.C. Cir. 2006) - The National Education Association ("NEA") in 1978 established an ERISA welfare plan to provide certain benefits to its members, including life insurance. The life insurance was provided through an arrangement with Prudential under which employees paid all the premiums. In 2000, when Prudential demutualized, the proceeds were treated as general plan assets to be used for the benefit of all plan participants, regardless of whether they participated in the plan's life insurance program. A plan participant with life insurance coverage sued, claiming that the proceeds should be distributed to or used only for the benefit of life insurance participants, and that the plan administrator violated ERISA by using the proceeds for the benefit of all participants. The D.C. Circuit rejected the plaintiff's claims and found that the demutualization proceeds were surplus funds properly treated as plan assets and there was no breach of fiduciary duty by using the proceeds to benefit all plan participants.

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