January 2006 Employee Benefits Update

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SELECT COMPLIANCE DEADLINES

Compliance With USERRA Regulations Required by January 18, 2006

The Department of Labor ("DOL") has issued final regulations implementing the Uniformed Services Employment and Reemployment Rights Act ("USERRA"). 70 Fed. Reg. 75245 (December 19, 2005). A detailed description of the final regulations will be provided in a separate client communication. The compliance deadline for these regulations is January 18, 2006.

Revised USERRA Rights Notice Must Be Provided by January 18, 2006

The DOL has finalized the interim notice of USERRA rights that was issued on March 10, 2005, with slight revisions. 70 Fed. Reg. 75313 (December 19, 2005). There are two versions of the new notice: one for private sector and state government employers and one for federal government employers. Each notice now clarifies that certain services in the National Disaster Medical System are considered uniformed services for purposes of USERRA and the federal government version of the notice states that USERRA, complaints received by the DOL may be referred to the Office of Special Counsel for resolution.

Employers are required to provide the final notice on or before January 18, 2006. As with the interim notice, employers may provide the notice by posting it where other employee notices are customarily placed or by alternate means such as hand-delivery, mail or e-mail. The private sector version and federal government version can be found on the DOL website.

Disclosure of Creditable Coverage Information Due to CMS by March 31, 2006

Under Medicare Part D regulations, most group health plans offering prescription drug coverage to Part D eligible individuals (including active and retired employees and beneficiaries) must disclose to CMS and to Part D eligible individuals whether the plan coverage is creditable or non-creditable. The only way to comply with the CMS disclosure requirement is by filling out a disclosure form on the CMS website and filing that form electronically.

Disclosure forms must be filed annually. For plan years that end in 2006, the filing

deadline is March 31, 2006. For plan years that end in 2007 and beyond, the filing deadline is 60 days after the first day of the plan year. In addition, disclosure forms must be filed within 30 days after the termination of a plan's prescription drug coverage or a change in its creditable coverage status.

A client communication with additional information regarding the requirements for this filing will be provided separately.

IRS Extends Certain Plan Amendment Deadlines

Last month the Internal Revenue Service ("IRS") 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 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 was extended to the end of the plan's applicable initial five or six year remedial amendment cycle.

HIPAA Security Deadline for Small Plans

The security provisions of the HIPAA Administrative Simplification Rules (the "Security Rule") go into effect for small health plans on April 20, 2006. Under the Security Rule, covered entities, including group health plans, must protect the confidentiality, integrity and availability of electronic protected health information. The rule requires covered entities to implement administrative, physical and technical safeguards to protect electronic protected health information in their care.

LEGISLATIVE DEVELOPMENTS

Gulf Opportunity Zone Act of 2005

The Gulf Opportunity Zone Act of 2005 (the "GO Zone Act") was signed into law on December 21, 2005. This new law expands the tax benefits provided by the Katrina Emergency Tax Relief Act of 2005 ("KETRA") to the "Gulf Opportunity Zone" affected by Hurricanes Rita and Wilma.

The GO Zone Act extends KETRA's tax-favored treatment for up to $100,000 in "qualified Hurricane Katrina distributions" to "qualified hurricane distributions," which have been defined to include certain distributions related to Hurricanes Rita and Wilma. Under KETRA, an individual's qualified Hurricane Katrina distribution could not exceed $100,000. Under the GO Zone Act, all qualified hurricane distributions must be aggregated for purposes of the $100,000 limit. In addition, the exemption from the 10% tax for early withdrawals from qualified plans and IRAs applies to all qualified hurricane distributions. The Act also extends KETRA's favorable tax treatment regarding recontributions of qualified hurricane distributions and recontributions of plan withdrawals for home purchases canceled due to hurricanes. Plan loan limits are also increased and repayments postponed for Hurricane Rita and Wilma victims.

INTERNAL REVENUE SERVICE DEVELOPMENTS

IRS To Raise Some User Fees in 2006

The IRS announced on December 19, 2005 that selected user fees would increase in 2006. The new fee structure is designed to more accurately reflect the costs of processing various applications, ruling requests and opinion letters. Changes effective February 1, 2006 include the following:

- The fee for IRS Chief Counsel private letter rulings ("PLRs") will increase from $7,500 to $10,000. Taxpayers earning less than $250,000 can request a PLR for a reduced fee of $625 and taxpayers earning $250,000 to $1 million will pay $2,500.
- Fees for opinion letters on prototype IRAs, SEPs, SIMPLE IRAs and Roth IRAs will increase from $125-$2,570 to $200-$4,500.
- Fees for exempt organization rulings, which previously cost $155-$2,570, will now range from $275-$8,700.

Other user fees in the exempt organizations and employee plans area will increase July 1, 2006. For example, user fees for exempt organization applications and requests for group exemption letters, which currently range from $150-$500,

will increase to $300-$900. More information on fees is available in Rev. Procs. 2006-1 and 2006-8.

IRS Releases 2005 Cumulative List of Changes in Plan Qualification Requirements

The IRS has released the "2005 Cumulative List of Changes in Plan Qualification Requirements," which was described in Rev. Proc. 2005-66. IRS Notice 2005-101 (Dec. 13, 2005). This list is primarily for use by plan sponsors of individually designed plans that fall in Cycle A of the EGTRRA remedial amendment cycle. (Generally, a plan falls into Cycle A if the last digit of the plan sponsor's EIN is 1 or 6.)

In Revenue Procedure 2005-66 the IRS stated its intention to publish an annual cumulative list to identify statutory, regulatory and guidance changes that must be taken into account in submissions for opinion, advisory and determination letters of plans whose remedial amendment period begins on February 1 following issuance of the cumulative list.

The 2005 Cumulative List reflects law changes under EGTRRA (including technical corrections made by the Job Creation and Worker Assistance Act of 2002), the Pension Funding Equity Act of 2004 and the American Jobs Creation Act of 2004. The notice points out that, in order to remain qualified, a plan must comply with all relevant qualification requirements, not just those that appear on the 2005 Cumulative List.

RETIREMENT PLAN DEVELOPMENTS

IRS Releases Final Regulations for Designated Roth Contributions

On January 3, 2006, the IRS issued final regulations for implementation of designated Roth contributions for 401(k) plans. 71 Fed. Reg. 6. The regulations were finalized in the form in which they were proposed, as amendments to the 401(k) and 401(m) regulations. Most of the changes made by the final regulations are clarifications that were prompted by comments to the proposed regulations. Significant items in the final regulations include the following:

- Roth-Only Plan Not Permitted. The final regulations clarify that a 401(k) plan cannot be designed to offer only designated Roth contributions. Plans also must offer regular pre-tax elective deferrals.
- Basic Requirements. Designated Roth contributions must be (1) designated

irrevocably as Roth deferrals, (2) included in the employee's wages at the time of deferral and (3) maintained in a separate account in the plan.

- Separate Account. The final regulations clarify that no contributions other than designated Roth contributions and rollover contributions of designated Roth contributions are permitted to be allocated to the Roth account. The preamble specifically states that matching contributions and forfeitures cannot be allocated to Roth accounts.
- Elections to Designate Roth Contributions. The final regulations clarify that the annual "effective opportunity" requirement that applies under the final 401(k) regulations to make or change elective deferral elections also applies to designated Roth contribution elections.
- Default Elections. The final regulations specifically permit a plan to use automatic deferral elections for Roth contributions if the default deferral is clearly described in the plan.
- Corrective Distributions to HCEs. The final regulations retain the proposed rule that permits a highly compensated employee ("HCE") to elect whether a corrective distribution is made from designated Roth contributions or from elective deferrals if the HCE has made both types of deferrals for the year. However, a plan need not offer this election.
- Direct Rollovers. The final regulations clarify that a direct rollover of designated Roth contributions can be made only to a Roth account under another qualified retirement plan or 403(b) annuity or a Roth IRA.
- Taxation. The final regulations do not address the taxation of distributions from Roth accounts. The preamble states that proposed regulations will be issued to address taxation.

The final regulations generally apply for plan years beginning on or after January 1, 2006. The preamble states that there are other aspects of designated Roth contributions not addressed by the final regulations that must be reflected in the plan's terms. The preamble also notes that the final regulations do not address the EGTRRA sunset provisions that apply to the designated Roth provisions, which provide that they will not be effective after December 31, 2010 unless future legislation extends the provisions.

IRS Suspends W-2 Reporting for 2005 Nonqualified Deferred Compensation

The IRS has suspended the new W-2 reporting requirements for 2005 deferrals under nonqualified deferred compensation plans under Code section 409A. IRS Notice 2005-94. The IRS had previously issued guidance specifying where particular amounts were to be reported on Forms W-2, 941 and 1099. Despite the suspension, future published guidance may require a corrected information return to be filed and corrected payee statement to be furnished.

IRS Issues Interim Guidance Regarding Application of Section 409A to Outstanding Stock Rights

In response to concerns raised by comments to the proposed Code section 409A regulations, the IRS recently issued Notice 2006-4. This notice grants interim relief from the stock valuation requirements for stock options and stock appreciation rights issued before January 1, 2005. This interim relief will remain available until the proposed section 409A regulations are finalized.

Specifically, commentators expressed concern that although the issuers of the stock rights intended to establish an exercise price not less than the fair market value of the stock at the time of grant, they may not be able to demonstrate that the exercise price of the stock right was determined using a reasonable valuation method in accordance with the requirements set forth in the proposed regulations and Notice 2005-1. Commentators noted further that at the time such stock rights were granted, section 409A had not been enacted and thus no guidance with respect to the application of section 409A to stock rights was available.

Notice 2006-4 adopts the approach the Code has taken with respect to incentive stock options, which provides some leeway for inaccurate valuations performed in good faith. Under this approach, where a company made a good faith effort to set a fair market value exercise price for a stock right granted before January 1, 2005, the stock right will be deemed to have been granted at fair market value for purposes of section 409A. A stock right that meets the good faith standard will not be subject to section 409A as long as other applicable section 409A requirements are met.

The notice indicates that the general valuation requirements of Notice 2005-1 will remain effective for stock rights granted on or after January 1, 2005. These requirements provide that fair market value can be determined using any reasonable valuation method.

Government Levy Permitted to Pay Criminal Fines

The Second Circuit has ruled that ERISA's anti-alienation rule does not protect pension plan benefits from criminal fines. *United States v. Irving*, 2005 U.S. App. LEXIS 28493 (2d Cir. 2005).

In this case, a pension plan participant was sentenced to time in prison plus $200,000 in criminal fines for possession of child pornography and traveling outside of the United States for the purpose of engaging in sexual acts with children. The government apparently attempted to collect the judgment from the participant's pension plan. The participant claimed that the fine should be vacated because it violated ERISA's anti-alienation statute.

The participant argued that *Guidry v. Sheet Metal Workers Nat'l Pension Fund*, 493 U.S. 365 (1990) governed his case. The Supreme Court held in Guidry that there was no judicial exception to ERISA's anti-alienation provision for criminal misconduct and that only Congress can create such an exception.

The Second Circuit rejected the participant's claim and stated that Congress had in fact created an exception from ERISA's anti-alienation provision when it enacted the Mandatory Victim Restitution Act of 1996 (the "MVRA"). The MVRA permits the government to enforce a judgment imposing a fine against all property, exempting only property that it could not reach for unpaid federal income taxes. The court held that because an ERISA pension plan's assets can be reached to pay unpaid federal income taxes, a plan's assets can be reached under the MVRA to pay criminal fines.

Spousal Consent Not Required for 1983 QJSA Waiver

The Sixth Circuit has held that the wife of a deceased pension plan participant was not entitled to spousal survivor benefits under the plan, even though her husband had unilaterally rejected survivor benefits without her knowledge and consent because ERISA permitted such a waiver at the time of his retirement. *Lillie Horton v. Ford Motor Company*, 427 F.3d 382 (6th Cir. 2005).

Ruben Horton retired at age 53 from Ford Motor Company in 1983 after 30 years of service. When he completed the necessary paper work for early retirement, he elected to reject the automatic election of a qualified joint and survivor annuity ("QJSA"). After Mr. Horton's death in 2002, Lillie Horton sought spousal benefits from Ford as Mr. Horton's common law wife. Ford denied her request because of Mr. Horton's election to not provide spousal survivorship benefits. Mrs. Horton brought suit against Ford in state court, which was later removed to District Court. The federal District Court granted summary judgment in favor of Ford and Mrs.

Horton appealed.

The court discussed the Retirement Equity Act of 1984 ("REA") requirement that tax-qualified defined benefit pension plans offer a QJSA automatically to spouses of participants in pension plans. The REA also requires that a spouse of a participant consent if the QJSA was rejected. The court also discussed the applicable dates for REA. Generally, the spousal consent requirement for waiving a QJSA applies to pension plans effective for years beginning after December 31, 1984. However, under a transitional rule, a participant must obtain spousal consent earlier if that participant performed additional services or received paid leave after retirement and after August 23, 1984.

The court held that REA's mandatory spousal consent rules did not apply under the transitional rule because Mr. Horton's last day of employment was May 28, 1983 with his retirement effective as of June 1, 1983. Since Mr. Horton did not work or receive paid leave on or after August 23, 1984, the transitional rule did not apply.

QDRO After Participant's Death Permitted

The Third Circuit recently issued a decision holding that the pension portion of a property settlement incorporated in a participant's divorce judgment could be made into a qualified domestic relations order ("QDRO") after the participant's death. *Files, Rita v. ExxonMobil Pension Plan*, 428 F.3d 478 (3d Cir. 2005).

Ed Rutyna married Rita Files in 1972. He worked for ExxonMobil from September 1972 to April 1993 and participated in a pension plan and a savings plan. Ed left ExxonMobil in 1993 and would have been eligible to receive his pension in September 1996. In 1998, Ed and Rita entered into a property settlement agreement ("PSA"), which was incorporated into a divorce judgment by a New Jersey state court. The decree gave Rita a one-half interest in Ed's Exxon pension and a one-half interest in his ExxonMobil savings account.

In August 2000, Ed's divorce counsel notified the ExxonMobil Benefits Administrator of the divorce and requested a sample QDRO. The Administrator responded and included a statement regarding ExxonMobil's policy to "block" the payment of the plan benefits for 18 months from the time the participant could have first received benefits, once the Administrator received notice of a participant's divorce. Ed died on February 25, 2001 with no QDRO having been submitted to the pension plan.

After Ed's death, Rita requested that benefits be paid to her pursuant to the PSA. The plan denied her request with respect to the pension plan because Ed was not married at the time of his death and the plan did not have a QDRO on file. Because of this denial, Rita obtained a court order intended to make the PSA a QDRO, which was forwarded to the plan on February 28, 2002. Rita then filed a claim for plan benefits in federal District Court. The District Court dismissed her claim and found that the PSA did not meet the requirements for a QDRO.

The Third Circuit Court of Appeals stated that nothing in ERISA requires that the plan must have been notified of Rita's interest in Ed's pension before his death in order for Rita to "qualify" the PSA as a QDRO to enforce her already existing property interest. Therefore, Rita was not precluded from pursuing a QDRO after Ed's death to enforce her 50% interest in Ed's pension. The court determined that the qualification process was triggered by notice to the plan of the PSA. The court said it ultimately did not matter whether the plan was on notice before or after Ed's death. In either case, Rita engaged ERISA's process to qualify the PSA as a QDRO to enforce her preexisting rights.

HEALTH CARE PLAN DEVELOPMENTS

Supreme Court to Review Case Involving Plan's Right to Reimbursement

On November 28, 2005, the Supreme Court granted certiorari in the case of *Sereboff v. Mid Atlantic Medical Services*. The Supreme Court will review the Fourth Circuit's decision on the issue of whether an ERISA plan fiduciary can bring suit against a plan participant to obtain "appropriate equitable relief" under ERISA section 502(a)(3) when the participant is required to reimburse the plan for medical expenses under the terms of the plan.

The case involves a plan participant and his wife, who were injured in an automobile accident. The Sereboffs incurred $75,000 in medical expenses, which were paid by Mr. Sereboff's employer's plan. The Sereboffs recovered $750,000 in a settlement from the responsible party. The Plan Administrator sued the Sereboffs when they refused to repay the plan for the medical expenses.

The Fourth Circuit affirmed the district court's holding that the reimbursement action was permitted under ERISA section 502(a)(3) because the relief sought by the plan was equitable in relief. The court came to this conclusion because the money the plan sought to recover was specifically identifiable, belonged in good conscience to the plan and was within the possession and control of the Sereboffs. See 407 F.3d 212 (4th Cir. 2005).

Mental Health Parity Act Provisions Extended

On January 5, 2006, President Bush signed H.R. 4579 into law. This legislation extends the Mental Health Parity Act (“MHPA”) provisions to December 31, 2006. The MHPA prohibits a group health plan from applying a lower annual or aggregate lifetime dollar limit to mental health benefits than the plan applies to medical/surgical benefits.

The MHPA's provisions were first effective for plan years beginning on or after January 1, 1998 and were originally set to expire for benefits for services provided on or after September 30, 2001. However, various laws passed over the years have extended the MHPA to its current expiration date.

EBSA Releases 2005 Form M-1

The Employee Benefits Security Administration ("EBSA") has issued the 2005 Form M-1. Form M-1 filers generally include multiple employer welfare arrangements ("MEWAs") that provide health benefits and certain entities that claim they are not MEWAs because of the exception for plans maintained under a collective bargaining agreement. The 2005 Form M-1 is due by March 1, 2006, with an extension to May 1, 2006 available.

The form's accompanying instructions include revised self-compliance checklists that are useful for all group health plans, not just Form M-1 filers. The “Self-Compliance Tool for Part 7 of ERISA” includes numerous new examples and practical tips to help group health plans comply with HIPAA portability requirements, the Mental Health Parity Act ("MHPA"), the Newborns’ and Mothers’ Health Protection Act ("NMHPA"), and the Women’s Health and Cancer Rights Act ("WHCRA").