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January 2007 Employee Benefits Update

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SELECT COMPLIANCE DEADLINES

Qualified Retirement Plans

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

• New IRS Guidance on Section 409A Reporting and Withholding Employers are not required to report on Forms W-2 (for employees) or 1099-MISC (for nonemployees) amounts deferred during 2005 or 2006 under a nonqualified deferred compensation plan. However, employers are required to report (and withhold for 2006 only) on deferred compensation that is includible in income because of a violation of Internal Revenue Code ("Code") section 409A (i.e., noncompliant amounts). Amounts includible in income are reported on Form W-2, box 1 and box 12, using code Z or on Form 1099-MISC, boxes 7 and 15b, as applicable. For a detailed discussion of IRS Notice 2006-1, see Reinhart's December 2006 Employee Benefits Update.

• Electronic Filing of PBGC Premiums Required for Small Plans The Pension Benefit Guaranty Corporation ("PBGC") issued a final rule June 1, 2006 requiring sponsors of insured defined benefit plans to submit premium filings electronically. The rule requires sponsors of small plans (fewer than 500 participants) to electronically submit premium filings beginning with the 2007 plan year. (Sponsors of large plans were required to comply with the final rule starting July 1, 2006.)

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 plan

(less than $5 million in annual receipts), the third year anniversary date is April 14, 2007.

PENSION PROTECTION ACT OF 2006 DEVELOPMENTS

Latest Guidance

In December 2006, the IRS issued guidance interpreting certain Pension Protection Act of 2006 ("PPA") provisions regarding cash balance/hybrid plans and the Department of Labor ("DOL") issued guidance on good-faith compliance with new pension benefit statement requirements. This guidance is discussed in detail in this Employee Benefits Update. The IRS just recently published Notice 2007-7, the much anticipated "grab bag" guidance primarily on distributions. This guidance will be discussed in Reinhart's February 2007 Employee Benefits Update.

IRS Ends Moratorium on Cash Balance Plans and Provides Transitional Guidance on PPA Provisions

On December 21, 2006, the IRS announced it will resume the processing of determination letters and examination cases for conversions from traditional defined benefit plans to cash balance plans. For conversions prior to June 20, 2005, however, the IRS will not review whether the plan meets new statutory requirements, including the effects of any wear away.

The IRS also issued transitional guidance in Notice 2007-6 that interprets PPA provisions relating to cash balance and hybrid plans. Key issues addressed by the notice include:

- The definition of a statutory hybrid plan;
- Determining the market rate of return;
- Conversion requirements and mergers; and
- Whipsaw calculation.

The IRS also requested comments on several issues for upcoming regulations, including: the definition of market rate of return, defining a methodology for indexing benefits and the application of requirements to pension equity plans. Comments are due by April 16, 2007.

EBSA Issues Guidance for Good-Faith Compliance with New Periodic Benefit

Statement Requirements

On December 20, 2006, the Employee Benefits Security Administration ("EBSA") issued Field Assistance Bulletin No. 2006-3 ("FAB"), providing general guidance to plan administrators concerning good-faith compliance with PPA provisions regarding pension 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.

Members of the benefit community have raised a number of interpretive and compliance issues concerning the new pension benefit statements. The DOL responded to these concerns by issuing the FAB to provide guidance pending the issuance of regulations and a model pension benefit statement. The FAB addressed the following issues:

Form of Furnishing Statements - Multiple documents or sources can be used to provide benefit statement information (e.g., the plan administrator may provide information on vesting, while the recordkeeper provides investment-related account information). However, administrators must send a notice to participants and beneficiaries in advance of the first benefit statement explaining how and when the required information will be furnished.

Manner of Furnishing Statements - Pension benefit statements may be delivered in written, electronic or another appropriate form that is reasonably accessible to the participant or beneficiary. The statements may be provided on a continuous basis through a secure plan Web site, provided certain conditions are met. The statements may also be provided electronically by complying with the DOL safe harbor for electronic delivery or the new IRS regulation on electronic delivery.

Dates for Furnishing Statements - 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. Therefore, the first statement for calendar year plans with participant-directed investments will be due no later than May 15, 2007. For other defined contribution plans, the first statement is due February 14, 2008. Defined benefit plans must furnish the first statement for the 2009 plan year, or an alternative annual notice by December 31, 2007. The alternative notice requirement provides that the statement requirements are satisfied if, at least once each year, the plan administrator provides participants with a notice of

availability of pension benefit statements, and the way in which statements can be obtained.

Participant Loans - A plan that permits participant loans, but does not otherwise allow participant-directed investments does not need to provide quarterly statements.

Limitation on the Right to Direct Investments - Benefit statements must include limitations and restrictions on rights imposed under the plan, but need not include limitations and restrictions imposed by investment funds, other investment vehicles, or by state or federal securities law.

Model Diversification Statement - The FAB provides model language to include in benefit statements that explains the importance of diversification. Notification of Diversification Rights - Plans that include employer securities and that gave participants diversification rights at least equal to the new PPA requirements prior to January 1, 2007, may now send the diversification notice at the same time as the first quarterly benefit statement.

DOL Website - Some pension benefit statements must direct participants and beneficiaries to a DOL website for more information on individual investing and diversification.

IRS Requests Comments on Phased Retirement Provisions

On December 19, 2006, the IRS issued Notice 2007-8, requesting comments on PPA provisions permitting in-service distributions from defined benefit plans for participants who have attained age 62. The IRS specifically asked for comments on whether in-service distributions should include early retirement subsidies and if so, how the subsidized benefits should be characterized for purposes of Code section 411. The IRS also asked whether final regulations regarding bona fide phased retirement programs are necessary in light of the PPA provision permitting in-service distributions. Comments must be submitted to the IRS by April 16, 2007.

DOL Releases Proposed Changes to Form 5500

The DOL, IRS and PBGC jointly published proposed revisions to the Form 5500 Annual Return/Report to reflect changes required by the PPA. These PPA revisions supplement the proposed revisions issued in July 2006. The supplemental proposed revisions:

- Replace Schedule B with separate actuarial schedules for single-employer and multiemployer plans;
- Add questions to collect new information on defined benefit plans as required by the PPA; and
- Establish the Form 5500-SF (short form) as the simplified report for plans with fewer than 25 participants.

The proposed revisions would apply for 2008 plan year filings. The DOL intends to publish a final rule in February 2007.

EBSA Requests Public Comment on Prohibited Transaction Exemption for Investment Advice EBSA released two requests for information soliciting advice from the employee benefits community on determining the level of expertise and procedural standards for qualifying experts to certify computer models that provide investment advice. 71 Fed. Reg. 70427 (Dec. 4, 2006). EBSA also requested information on fee disclosure materials used by plans and the feasibility of using computer models to provide advice to IRA participants. Comments should be submitted to the DOL by January 30, 2007.

RETIREMENT PLAN DEVELOPMENTS

IRS Releases 2006 Cumulative List of Changes in Plan Qualification Requirements

The IRS issued the "2006 Cumulative List of Changes in Plan Qualification Requirements," as Notice 2007-3. The 2006 Cumulative List details the plan qualification requirements that must be adopted by plans submitting for determination letters from February 1, 2007 through January 31, 2008. This list is primarily for use by plan sponsors of defined benefit pre-approved plans (i.e., prototype and volume submitter plans) and sponsors of multiple employer and individually designed plans that fall into Cycle B of the EGTRRA remedial amendment cycle. (Generally, a plan falls into Cycle B if the last digit of the plan sponsor's EIN is 2 or 7.)

The 2006 Cumulative List reflects law changes under EGTRRA, the Pension Funding Equity Act of 2004, the American Jobs Creation Act of 2004 and the Gulf Opportunity Zone Act of 2005. The list also contains special rules for PPA provisions effective in 2007 or earlier. Plan sponsors of defined benefit pre-approved plans must amend their plans for applicable PPA provisions. Other plan

sponsors may amend their plans, but the IRS will not consider the PPA amendments in issuing determination letters and such letters cannot be relied on with respect to the PPA. As a reminder, the notice points out that a plan must comply with all relevant qualification requirements, not just those that appear on the 2006 Cumulative List, to remain qualified.

IRS Issues Final Regulations on Prohibited Allocations for S Corporation ESOPs

The IRS issued final regulations under Code section 409(p) for employee stock ownership plans ("ESOPs") holding stock in S corporations. 71 Fed. Reg. 76134 (Dec. 20, 2006). The final regulations generally adopt the 2004 temporary regulations with some modifications.

Code section 409(p) prohibits accruals and allocations under an ESOP to a disqualified person (generally, a 10% owner) for any year in which disqualified persons own 50% or more of the company ("non-allocation year"). If a non-allocation year occurs, then all the stock in a disqualified person's account and all other ESOP assets attributable to the stock, including distributions, sales proceeds, and earnings, are treated as a prohibited allocations.

The final regulations clarify that a prohibited allocation during a non-allocation year will cause the ESOP to fail to be an ESOP. In addition, the prohibited transaction exemption for a leveraged ESOP loan will cease to apply and the company may owe excise taxes. The plan will also become disqualified and the prohibited allocation is a deemed distribution that is not an eligible rollover distribution.

The final regulations also provide guidance on the prevention of a non-allocation year, the treatment of family members as disqualified persons and the determination of the number of shares of synthetic equity. The final rules apply to plan years beginning on or after January 1, 2006.

PBGC Issues Final Rule on Mortality Assumptions for Missing Participants and Mass Withdrawals

On December 14, 2006, the PBGC issued a final rule changing the mortality assumptions used for calculating the designated benefit paid on behalf of missing participants and for calculating the value of deferred annuities following a mass withdrawal. For missing participants upon plan termination, plan sponsors must use new rates based on a fixed blend of male and female mortality rates to

determine the designated benefit owed to the PBGC. For mass withdrawals, plan sponsors can disregard the mortality of a contingent annuitant during the deferral period for valuing deferred annuities. The direct final rule will become effective February 27, 2007.

Citigroup's Cash Balance Plan is Age Discriminatory

Last month, Reinhart's Employee Benefits Update discussed two recently published cases from the Southern District of New York addressing the status of cash balance plans. See, *Reinhart's December 2006 Employee Benefits Update*. Adding to the controversy, another federal judge in the Southern District of New York has ruled on a cash balance plan, holding that the Citigroup Pension Plan (the "Plan") was age discriminatory. In *re Citigroup Pension Plan ERISA Litigation*, No. 05 CV 5296, 2006 WL 3613691 (S.D.N.Y. Dec. 12, 2006).

In *Citigroup*, several participants alleged that (1) the Plan unlawfully discriminated on the basis of age; (2) the Plan's application of the "fractional rule" violated Employee Retirement Income Security Act's ("ERISA's") minimum accrual rules; and (3) the Plan's 204(h) notice was substantively inadequate. The court ruled in favor of the participant on all three issues. Specifically, the court held that the Plan was age discriminatory as to benefit accruals for the same reasons explained in the J.P. Morgan cash balance case. The court agreed that under cash balance plans, younger workers have more years to earn interest in their hypothetical account balances. As a result, older workers with the same salary and work history would receive smaller retirement benefits simply because they are older. Therefore, the court held that the Plan was age discriminatory.

One week after this ruling, the U.S. District Court granted class action status to a lawsuit charging Citigroup with several violations of federal pension law.

Withdrawal Liability Dispute Subject to Arbitration

The Fourth Circuit held that an employer waived its right to challenge the calculation of withdrawal liability by failing to pursue arbitration for its claim that it was entitled to a reduction of liability due to its sale of assets and insolvency. *Board of Trustees, Sheet Metal Workers' National Pension Fund v. BES Services, Inc.*, 4th Cir., No. 05-1634 (Nov. 29, 2006). The court noted that the reduction of withdrawal liability provision of ERISA section 4225 is conspicuously absent from the list of sections explicitly subject to arbitration under ERISA section 4221. The court reasoned that withdrawal liability determinations under ERISA section 4201 are subject to mandatory arbitration and that section 4201 specifically requires a

pension fund to consider the limitations of section 4225. Consequently, the court held that disputes regarding the reduction of withdrawal liability are also subject to arbitration.

IRS Provides 2007 Inflation Adjustment for Saver's Credit

The saver's credit allows certain individuals to receive a federal income tax credit of up to $1,000 per year for contributions to certain retirement plans, including a 401(k) plan, 403(b) plan or IRA. To qualify for the saver's credit, individuals must have adjusted gross income ("AGI") of $26,000 ($39,000 head of household and $52,000 married filing jointly) or less in 2007. For qualified individuals, the saver's credit provides a dollar-for-dollar tax credit for 10%-50% of the individual's first $2,000 of retirement contributions. Therefore, an individual who made $2,000 in contributions and qualified for the 50% credit rate would receive a tax credit of $1,000.

The PPA made the saver's credit permanent and requires that the AGI for the saver's credit be adjusted for inflation beginning in 2007. The 2006 AGI limits for the saver's credit were $25,000 for individuals, $37,500 for head of household and $50,000 for married filing jointly.

Seventh Circuit Upholds Criminal Conviction for Misuse of Participant Contributions

The Seventh Circuit upheld a jury verdict convicting a Wisconsin business owner of converting plan assets in violation of ERISA section 644. *United States v. Whiting*, 7th Cir., No. 06-1924 (Dec. 15, 2006). The owner of two businesses withheld funds from employee paychecks but did not forward the funds to the health plans and 401(k) plan. The owner argued that because the funds were never segregated from general assets and delivered to the plans that the funds were not "plan assets." The court rejected this argument. Although the court noted that ERISA does not define "plan assets", the court agreed with other circuit courts that have found withheld funds to be plan assets for the purposes of ERISA sections 644. As a result, the court held that the owner had converted plan assets by diverting funds from being delivered to their intended benefit plans.

HEALTH AND WELFARE PLAN DEVELOPMENTS

President Signs the Tax Relief and Health Care Act of 2006

On December 20, 2006, President Bush signed the Tax Relief and Health Care Act of 2006 (H.R. 6111) into law. The new law adds flexibility for participants in health

savings accounts ("HSAs"). The law also extends numerous tax provisions, including the college tuition deduction and state tax deductions as well as extending the Archer MSA pilot project. Key HSA provisions in the law include:

- Higher limits for HSA contributions;
- Limiting the impact of the flexible spending account ("FSA") grace period on HSA eligibility;
- Transfers from FSAs and health reimbursement arrangements ("HRAs") into HSAs; and
- Greater employer contributions for non-highly compensated employees. For more information on the HSA provisions, see Reinhart's newsletter, New Flexibility for Health Savings Accounts.

Mental Health Parity Act Provisions Extended

In addition to overhauling contribution rules for HSAs, the Tax Relief and Health Care Act of 2006 extends the Mental Health Parity Act ("MHPA") provisions in ERISA, the Code and the Public Health Service Act to December 31, 2007. 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.

HIPAA Nondiscrimination and Wellness Program Rules Finalized

The DOL, IRS and the Department of Health and Human Services jointly issued final regulations under HIPAA on December 13, 2006. 71 Fed. Reg. 75014. The final regulations implement the 2001 interim final HIPAA nondiscrimination rules and the proposed wellness rules with few changes. The regulations clarify the following:

Carryovers in HRAs - HRAs that permit participants to carryover unused amounts from one year to the next do not violate HIPAA nondiscrimination rules (even though healthier individuals could build up larger balances over time).

Source of Injury Exclusions - Plans may not restrict benefits under source of injury

exclusions for injuries resulting from a medical condition or an act of domestic violence. This rule applies even if the medical condition is diagnosed after the injury. However, a plan may deny benefits if an injury was due to a participant engaging in a specific activity, such as parachuting.

Nonconfinement Clauses - HIPAA prohibits a plan from denying coverage to an individual who is confined to a hospital when coverage would otherwise begin. Some state laws also require an insurer to continue coverage for a hospitalized individual who would otherwise lose coverage. Such situations may result in dual coverage. Because state law cannot change HIPAA obligations, the state's coordination of benefits laws would apply.

Wellness Programs (Participation only) - If a wellness program does not require individuals to satisfy a health factor or standard, the program does not violate HIPAA nondiscrimination rules. Examples of these types of programs include:

- Reimbursing fitness center memberships;
- Diagnostic testing programs;
- Waiver of co-pays and deductibles for preventative care;
- Smoking cessation programs not conditioned on an employee quitting smoking; and
- Rewards for attending monthly health seminars.

Wellness Programs (with Health Standards) - Wellness programs that provide rewards based on an individual's ability to meet a health factor or standard will violate HIPAA nondiscrimination rules, unless the program satisfies the five conditions in the final regulations. The five conditions are:

- The total reward for wellness programs that require an individual to satisfy a health standard cannot exceed 20% of the cost of coverage;
- The program must be reasonably designed to promote health or prevent disease;
- The program must allow individuals to qualify for the reward at least once each year;
- The reward must be available to similarly situated individuals and the program

must have a reasonable alternative standard for individuals for whom it is unreasonably difficult or medically inadvisable to satisfy the initial standard; and

- The plan must disclose the availability of an alternative standard in all materials describing the wellness program. The regulations provide safe harbor language for this disclosure.

The final regulations apply to plan years beginning on or after July 1, 2007. Employers will want to review any wellness programs, in particular, for compliance with these regulations.

IRS Provides Transition Relief for Use of Debit Cards for Medical Reimbursements

The IRS issued transition relief regarding the use of debit cards at non-health care merchants through December 31, 2007. IRS Notice 2007-2. Previous IRS guidance limited the use of debit cards for FSAs and HSAs to merchants with health care-related merchant category codes ("MCCs") or with inventory approval systems. The transition relief applies to supermarkets, grocery stores, discount stores, wholesale clubs and mail-order and web-based prescription drug vendors and treats them as medical care providers for debit card purchases through December 31, 2007. Employers are still required to obtain after-the-fact substantiation of charges during the transition period. Beginning in 2009, new restrictions will apply to stores with a "drug stores and pharmacies" MCC.

EBSA Releases 2006 Form M-1

EBSA has issued the 2006 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 Year 2006 Form M-1 is due by March 1, 2007, with an extension to May 1, 2006 available. EBSA encourages administrators to file the Form M-1 electronically.

As in 2005, the form's accompanying instructions include self-compliance checklists that are useful for all group health plans, not just Form M-1 filers. The checklists include numerous examples and practical tips to help group health plans comply with HIPAA portability requirements, the MHPA, the Newborns' and Mothers' Health Protection Act ("NMHPA"), and the Women's Health and Cancer Rights Act ("WHCRA").

SEC DEVELOPMENTS

SEC Revises Executive Compensation Disclosures

The Securities and Exchange Commission ("SEC") adopted changes regarding the reporting of stock and option awards for executive officers and directors. The revised disclosure rules require companies to report the value of stock and option grants in the Summary Compensation Table and the Director Compensation Table over the period in which the employee is required to provide service for the award. The original disclosure rules, adopted in July 2006, required the entire value of an award to be reported in the year the award was granted.

The new disclosure rules use the same reporting approach as in the financial statements and the SEC chairman has said that "the new disclosure requirement will be easier for companies to prepare and for investors to understand." Critics say that the new rule will create confusion and make it harder for investors to understand the total value of stock and option awards.

GENERAL TOPICS

Federal Agencies Release 2007 Regulatory Agendas

The IRS, EBSA and PBGC have issued their semiannual regulatory agendas for 2007. Agency personnel have also commented informally on PPA provisions they expect to focus on in 2007. The agencies' agendas include the following:

IRS

- Guidance on PPA's pension funding rules and mandatory benefit restrictions
- Guidance on distributions during working retirement
- Final regulations on Code section 415 benefits and restrictions
- Final regulations for Code section 403(b) plans
- Final regulations on Code section 409A
- Final regulations on designated Roth contributions
- Proposed regulations on deductibility of employer contributions under Code section 404
- Proposed regulations on cafeteria plans

EBSA

- Final guidance on default investment options
- Final guidance on modifications to Form 5500
- Guidance on PPA's prohibited transaction exemption for cross trading
- Proposed regulations on standards for selecting annuity providers
- Interim final rules on new defined benefit plan funding notice, including a model notice
- Proposed guidance on fee disclosures for defined contribution plan investment options
- Proposed regulations establishing a safe harbor for when participant contributions become plan assets

PBGC

- Final regulations on penalty policies
- Proposed regulations amending premium rates and creating a new "termination premium"
- Proposed regulations to add new reportable events for a decline in credit rating below investment grade and for events requiring certain filings with the SEC