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March 2007 Employee Benefits Update

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SELECT COMPLIANCE DEADLINES

Qualified Retirement Plans

• Required Distributions. April 1, 2007 is the last day to make an initial required minimum distribution pursuant to Internal Revenue Code (the "Code") section 401(a)(9) for 2006. Under Code section 401(a)(9), minimum required distributions must commence no later than April 1 following the later of the calendar year in which (i) an employee reaches age 701/2 (required for 5% owners) or (ii) an employee retires.

• Excess Deferrals. Any elective deferrals, which exceed the Code section 402(g) limit for 2006 ($15,000), plus allocable earnings, must be distributed to affected participants by April 15, 2007 in order to avoid double taxation.

• Excess Contributions. Excess contributions and excess aggregate contributions which exceed the actual deferral percentage ("ADP") test and/or actual contribution percentage ("ACP") test for 2006 must be distributed with gap period income. The final 401(k) regulations require the distribution of gap period income (gains and losses from January 1, 2007 to the actual date of distribution) for 2006 and 2007. The Pension Protection Act of 2006 ("PPA") repeals the requirement that plans distribute gap period income effective for the 2008 plan year. Health and Welfare Plans

• Archer MSA Reporting Due Date. Pursuant to IRS Announcement 2007-24, Archer MSA trustees and custodians must file separate Forms 8851 by March 20, 2007 for each reporting year. The Forms 8851 must state the number of Archer MSAs established between January 1 and June 30, 2005, and January 1 and June 30, 2006. The Internal Revenue Service ("IRS") is to report by April 19, 2007 on the number of Archer MSAs established during those periods and whether April 19 will be treated as a cutoff date for additional Archer MSAs.

PENSION PROTECTION ACT OF 2006 DEVELOPMENTS

Statutory Exemption for Cross-Trading of Securities

The Department of Labor ("DOL") issued an interim final rule creating a statutory exemption for cross-trading of securities for trades occurring after August 17,

2006. In a cross-trading transaction, an investment manager uses its authority to sell a security on behalf of one client and buy that same security on behalf of another client. Cross-trading typically results in lower fees paid by a plan for trades. Provided certain conditions are met, a prohibited transaction exemption may be available for "the purchase and sale of a security between a plan and any other account managed by the same investment manager." Numerous conditions must be met to qualify for an exemption because of the potential for abuse by investment managers.

Of specific relevance, no brokerage commission or fee, other than customary transfer fees, may be charged to a plan. An investment manager cannot base its fee on acceptance of cross-trading. Also, a fiduciary for each party in the transaction must authorize, in a separate document, the investment manager to engage in cross-trades. The fiduciary must receive a disclosure from the investment manager stating the conditions on which cross-trades may occur, including the investment manager's written policies and procedures, which must be clear, concise and in a manner to be easily understood by the plan fiduciary. The investment manager must issue a quarterly report to the plan detailing the specifics of each cross-trade. In addition, the investment manager must adopt and adhere to written cross-trading policies that, among other things, require criteria to be applied to ensure the trade is beneficial to both parties involved and contain procedures to mitigate potential conflicts regarding loyalty and responsibility.

IRS Clarifies Direct Rollovers to Nonspouse Beneficiaries

On February 13, 2007, the IRS published a special edition of Employee Plan News to help clarify the nonspouse beneficiary rollover guidance issued in Notice 2007-7. (*See Reinhart's February 2007 Employee Benefits Update for a detailed description of Notice 2007-7*.) The clarification primarily addressed two issues. First, the IRS stated that a plan may, but is not required to, offer a direct rollover to a nonspouse beneficiary. If a plan chooses to do so, it may not discriminate in administration of the nonspouse beneficiary rollovers.

The second issue the IRS addressed is the requirement that distributions from the inherited IRA had to satisfy the required minimum distribution elections under the plan document. The IRS clarified that if a participant dies before the required beginning date for distributions, a nonspouse beneficiary who would be subject to the five-year payment rule may shift to the life expectancy rule. To make minimum required distributions from the inherited IRA over the life expectancy of the nonspouse beneficiary, the rollover to the IRA must be completed by the end of the year following the participant's death.

DOL Provides Guidance Clarifying Investment Advice Rules

The DOL issued Field Assistance Bulletin ("FAB") No. 2007-01 on February 2, 2007 clarifying various concerns regarding the provision of investment advice to retirement plans and IRAs by financial institutions. The FAB discusses the standards for monitoring and selecting fiduciary institutions. More specifically, the FAB states that the standards for selecting and monitoring advisors essentially replicate the standards under sections 408(g)(10) and 408(b)(14) of the Employee Retirement Income Security Act of 1974 ("ERISA"). Reinhart will soon issue a more in-depth e-newsletter of this FAB and its implications on providing investment advice.

Proposed PTE for Missing Nonspouse Beneficiaries

The DOL issued an interim final rule that would amend two regulations to facilitate the termination of individual account plans by requiring a terminated plan to distribute benefits for a missing nonspouse beneficiary to a Code section 402(c)(11) inherited IRA established for that beneficiary. Prior to the PPA, under a safe harbor to meet ERISA section 404(a) prudence requirements, a qualified termination administrator ("QTA") or a fiduciary could not distribute benefits on behalf of a nonspouse beneficiary to an individual retirement plan. This caused the distribution to be subject to tax withholding and income tax in the calendar year of distribution. The PPA allows rollover distributions to an inherited individual retirement plan on behalf of a nonspouse beneficiary, resulting in tax deferral. The DOL is amending its regulations to allow a QTA or fiduciary to meet the safe harbor prudence requirements by following the provisions of the PPA.

The DOL also concurrently proposed an amendment to PTE 2006-06. The proposed amendment would allow a QTA of an abandoned individual account plan to select itself to provide services for and pay itself fees in connection with the plan's termination. To qualify for the exemption the QTA would need to directly roll over the amended benefits of a missing nonspouse beneficiary to an inherited IRA.

Comments on Deadline for Furnishing Benefit Statements

Many retirement plan policy groups sent comments to the Employee Benefits Security Administration opposing the deadline for furnishing benefit statements required by the PPA for trustee directed defined contribution plans. Under the PPA, benefit statements must be provided: (i) quarterly for participant-directed defined contribution plans; (ii) annually for all other defined contribution plans; and (iii) once every three years for defined benefit plans. To constitute good faith compliance with the PPA's requirements, FAB 2006-03 states that a plan must distribute benefit statements within 45 days of the end of the applicable period. The comments specifically cite several areas of concern with respect to the deadline, including the allocation of earnings, asset valuations and expenses. The groups propose that the deadline for furnishing benefit statements correspond with the due date for filing Form 5500, including extensions.

More Guidance to Come on Qualified Default Investment Alternatives

The DOL failed to issue final regulations on qualified default investment alternatives ("QDIAs") by the February 17, 2007 deadline established by the PPA. 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 regarding investing the assets of participants who fail to make investment elections. Reinhart will alert you as soon as the final guidance is released.

RETIREMENT PLAN DEVELOPMENTS

IRS Issues Updated Mortality Tables for Determining Current Liability

On February 2, 2007, the IRS issued final regulations providing updated mortality tables to be used in determining the current liability for defined benefit pension plans. Treas. Reg. § 1.412(l)(7)-1. The IRS requires the use of the RP-2000 mortality tables. (It determined the 1983 GAM tables were no longer appropriate.) These are the same tables that were used in the proposed regulation issued in 2005. For 2007, the IRS will permit all plans to use the blended tables instead of separate annuitant and nonannuitant tables. This change will only be important to single employer plans in 2007 as the minimum funding requirements under the PPA begin to take effect in 2008.

Third Circuit Upholds Cash Balance Plan

In another victory for cash balance plans, the third circuit held that PNC Financial Services Group, Inc.'s ("PNC") cash balance plan was not age discriminatory.

Register v. PNC Financial Services Group, Inc., 2007 WL 222019 (3d. Cir. 2007). The third circuit upheld the district court's dismissal in favor of PNC by affirming that (i) the cash balance plan was not age discriminatory; (ii) ERISA's anti-backloading rules were not violated; and (iii) the notices regarding the conversion from the defined benefit plan to a cash balance plan met ERISA's notice requirements. While it is a positive sign for cash balance plan sponsors that the third and seventh circuits have ruled in favor of cash balance plans, litigation is still pending in the second, sixth and ninth circuits.

PBGC Proposed Regulations Affecting Flat, Variable and Termination Premiums

The Pension Benefit Guaranty Corporation ("PBGC") issued proposed regulations incorporating provisions of the Deficit Reduction Act of 2005 ("DRA") and the PPA affecting PBGC premiums. The proposed regulations change the flat premium rate, cap the variable rate premium and create a new termination premium that applies in certain circumstances. The regulations reflect the changes made by DRA to ERISA section 4006 that increased the flat premium rate from $19 to $30 for single-employer plans and from $2.60 to $8.00 for multiemployer plans, with future inflation adjustments for plan years beginning in 2006.

The PPA imposes a variable rate premium cap on sponsors of small plans; that is, employers who have "25 or fewer employees [as defined by Code section 410(b)(1)] on the first day of the plan year." The "premium snapshot" date, used to determine the number of employees, is the last day of the preceding plan year. The small plan variable rate premium is capped at $5 multiplied by the number of plan participants on the premium snapshot date squared.

Also included in the regulations is a special termination premium that was added by DRA and PPA. Generally, a premium of $1,250 per participant, per year, must be paid for three years for certain terminations, excluding liquidations. The number of participants is calculated as of the day prior to plan termination.

PBGC Changes Interest Rate Assumption

For premium payment years beginning in January 2007, the PBGC increased the interest rate assumption used in determining the variable rate premium because of the IRS's adoption of new mortality tables. ERISA section 4006(a)(3)(E)(iii)(II) mandates the specific interest rate to be used. The revised mortality tables changed the applicable interest rate beginning January 1, 2007 to 5.75%, up from 4.75%.

Is Your 401(K) or 403(b) Plan in Compliance??

The IRS recently issued checklists to help plan sponsors determine whether their 401(k) or 403(b) plans are in compliance with the IRS's top ten compliance issues. The checklists are designed to raise compliance awareness and allow users to learn more about each compliance issue by accessing the applicable hyperlinks. The 401(k) and 403(b) checklists are designed to be a "quick tool" to gauge a plan's compliance and not to guarantee that a plan is 100% compliant with applicable IRS requirements.

HEALTH AND WELFARE PLAN DEVELOPMENTS

IRS Issues Guidance on Rollovers from Health Flexible Spending Accounts and Health Reimbursement Arrangements to Health Savings Accounts

The IRS issued Notice 2007-22, which provides guidance on "Qualified HSA Distributions," which are allowed under the recently enacted Tax Relief and Health Care Act of 2006 (the "Act"). A Qualified HSA Distribution is a tax-free rollover distribution of existing amounts from a health Flexible Spending Account ("FSA") or Health Reimbursement Arrangement ("HRA") into a Health Savings Account ("HSA"). Plan sponsors do not need to permit Qualified HSA Distributions, but if they do, the distribution must be offered to all HSA-eligible employees. For a list of the pros and cons of allowing Qualified HSA Distributions, please see our *January 15, 2007 Employee Benefits E-News*.

Generally, a person is ineligible to contribute to a HSA if they are covered under a health FSA or HRA. Under the Act, they will not be considered ineligible to contribute to an HSA if they make a Qualified HSA Distribution which satisfies all of the requirements listed in Notice 2007-22. These requirements include:

- An employer must amend its FSA or HSA to allow for Qualified HSA Distributions by the last day of the plan year.
- An employee must have qualifying high deductible health plan ("HDHP") coverage as of the first day of the month during which the Qualified HSA Distribution occurs, and must be an otherwise HSA-eligible employee.
- The employee must elect by the last day of the plan year to have the employer make a Qualified HSA Distribution.
- The employer must make the Qualified HSA Distribution directly to the HSA trustee by the 15th day of the third calendar month after the end of the plan

year and after the employee is HSA-eligible.

- The Qualified HSA Distribution cannot exceed the lesser of the balance in the health FSA or HRA (i) as of September 21, 2006, or (ii) as of the date of distribution.
- Immediately after the Qualified HSA Distribution, the health FSA or HRA must have a zero balance, and the employee must no longer be a participant in any non- HSA compatible health plan. There are several other requirements that must be met to qualify for the tax-favored distribution. There is also special transitional relief for distributions completed by March 15, 2007, subject to additional requirements.

Impermissible Riders or Benefits Eliminate HSA Eligibility

In Private Letter Ruling ("PLR") 200704010, the IRS ruled that impermissible riders or benefits make an individual ineligible to contribute to an HSA. An "eligible individual" can only contribute to an HSA if he or she is covered under a HDHP. Code section 223(c)(1)(B) states that in addition to being covered under a HDHP, the eligible individual can also be covered under permitted insurance as defined in Code section 223(c)(3) or permitted coverage as allowed under Code section 223(c)(1)(B)(ii). In the PLR, the applicant allowed plan participants to choose riders and benefits that were neither permitted insurance nor permitted coverage, thus making the individuals ineligible to make HSA contributions. This PLR is a reminder that all coverage is considered when determining HSA contribution eligibility.

DOL Extends Sunset of Mental Health Parity Act to December 31, 2007

The DOL issued an interim final amendment extending the sunset date of the Mental Health Parity Act ("MHPA") from December 31, 2006, to December 31, 2007. This amendment conforms the regulatory sunset date with the statutory sunset date. The MHPA applies to all group health plans and health insurance issuers that offer health insurance coverage, except small employers with no more than 50 employees. The MHPA prohibits a group health plan from applying a lower annual or aggregate dollar limit to mental health benefits than the plan applies to medical/surgical benefits.

Pharmacy Benefits Manager is not an ERISA Fiduciary

The seventh circuit recently held that a pharmacy benefits manager ("PBM") for a welfare plan was not an ERISA fiduciary. *Chicago Dist. Council of Carpenters Welfare Fund v. Caremark, Inc.*, 2007 U.S. App. LEXIS 1128 (7th Cir. 2007). Chicago Dist. Council of Carpenters Welfare Fund (the "Fund") argued that Caremark, Inc., the PBM, was a fiduciary and subsequently breached its fiduciary duties in various ways. The Fund argued that the PBM had discretion over the plan when it negotiated drug prices, administered the plan's formulary and changed the drug options available to the plan's participants. The Fund also argued that the PBM had control over the drug rebates, which the Fund believed were plan assets.

The court analyzed the three contracts between the Fund and the PBM to determine whether the PBM was a fiduciary. The court ultimately held that the PBM was not a fiduciary because it had no discretion over the plan. The court determined that the PBM had no discretion in negotiating the drug prices because the arms-length contract between the parties contained fixed prices that the Fund was required to pay the PBM. The contract allowed the PBM to negotiate the lowest possible prices and retain as profit the difference between what it charged the Fund and what it negotiated.

The court also looked to the contract in holding that the PBM had no discretion in drafting the plan's formulary and switching the plan's drug options because the plan retained the ultimate authority over these choices and options. Lastly, the court held that the PBM exercised no discretion over the rebates because it was not taking rebates on behalf of the plan, but rather paying contractually obligated amounts to the Fund. This case underscores the importance of careful drafting of contracts with third parties and the impact a contract may have on determining whether a third party is a fiduciary.

GENERAL TOPICS

Disability Benefits Violated ADEA

The sixth circuit has ruled that a government retirement system violated the Age Discrimination in Employment Act ("ADEA") in providing disability benefits. *Equal Employment Opportunity Commission v. Jefferson County Sheriff's Dept.*, 467 F.3d 571 (6th Cir. 2006). The Equal Employment Opportunity Commission ("EEOC") brought suit against the Kentucky Retirement System ("KRS"), alleging that it discriminated against older workers in its provision of disability retirement benefits. The EEOC based its claim on the fact that a participant under the KRS system was ineligible to receive disability retirement benefits unless the individual was less than normal retirement age when they became disabled. The EEOC also argued that the system's disability benefit calculations were discriminatory. Under these calculations, older workers received lower monthly benefits than younger workers, similar in every relevant way except age. When calculating disability benefits, KRS provided workers who had attained normal retirement age and were disabled only normal retirement benefits. However, younger workers had additional years of service added into their benefit calculation.

KRS did not dispute the facts presented by the EEOC. However, KRS argued that the disability benefit provisions were not discriminatory because age was only one of several factors used to determine benefits. KRS also argued that its benefits did not violate the ADEA because it did not have intent to discriminate against older workers. The court partially overruled a prior decision and rejected KRS's arguments in concluding that the KRS plan was facially discriminatory on the basis of age in at least two ways: (1) employees who remained in active service beyond normal retirement age were excluded from disability retirement benefits because of age; and (2) even employees who do become entitled to disability benefits receive lower benefits than similarly situated younger workers.

San Francisco Amends Its Sick Leave Ordinance

On February 27, 2007, San Francisco amended its new Paid Sick Leave Ordinance (see the December 2006 Employee Benefits Update Ordinance). Under the amended Ordinance, employers do not need to comply with the Ordinance until June 6, 2007. Penalties have also been waived on payments made before June 6, 2007. However, employers still must start accruing paid sick leave as of February 5, 2007.