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May 2007 Employee Benefits Update

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SELECT COMPLIANCE DEADLINES

Contingency Plans May Extend Deadline for Use of National Provider Identifiers

As reported in our April 2007 Employee Benefits Update, the Health Insurance Portability and Accountability Act ("HIPAA") requires health plans to use a new National Provider Identifier ("NPI") when electronically conducting certain HIPAA standard transactions, such as billing. HIPAA requires large health plans (more than $5 million in annual receipts) to comply by May 23, 2007. Small health plans ($5 million or less in annual receipts) have until May 23, 2008 to comply.

The Centers for Medicare & Medicaid Services ("CMS") recently released guidance providing that through May 23, 2008, CMS will not impose penalties for noncompliance on covered entities that implement contingency plans if such entities make good faith efforts to become compliant and, when applicable, facilitate the compliance of their trading partners. According to the CMS, factors that illustrate good faith include increased external testing with trading partners and making testing opportunities available to its provider community.

NONQUALIFIED DEFERRED COMPENSATION

IRS Publishes Code Section 409A Final Regulations

On April 17, 2007, the Internal Revenue Service ("IRS") published final regulations under section 409A of the Internal Revenue Code ("Code"). Sponsors of nonqualified deferred compensation plans that are subject to Code section 409A will be expected to comply with these regulations by December 31, 2007. Because the final regulations address numerous topics totaling nearly 400 pages, we will publish several separate mailings to keep you informed of necessary action items.

Relief for Code Section 409A Compliance to Split-Dollar Arrangements

In connection with publishing the regulations under Code section 409A, the IRS has issued guidance on the application of these regulations to split-dollar life insurance arrangements. IRS Notice 2007-34 (April 10, 2007). The Notice addresses several issues relating to split-dollar arrangements, including the application of Code section 409A to "materially modified" arrangements.

Split-dollar arrangements entered into before September 18, 2003 generally receive more favorable tax treatment than subsequent arrangements, but only to the extent that they were not "materially modified" after that date. However, because these arrangements are subject to Code section 409A, sponsors likely will need to modify such arrangements to comply with the final 409A regulations. Without additional relief from the IRS, these modifications may "materially modify" many split-dollar arrangements, causing any such arrangement entered into before September 18, 2003 to lose its favorable tax treatment.

Notice 2007-34 provides relief to the extent that the IRS determines that the modifications to the specific split-dollar arrangement are necessary to bring the arrangement into compliance with Code section 409A.

RETIREMENT PLAN DEVELOPMENTS

IRS Publishes Code Section 415 Final Regulations: Contribution Limits

On April 5, 2007, the IRS issued final regulations on the limits applicable to benefits and contributions for qualified plans under Code section 415. These final regulations consolidate miscellaneous IRS guidance and various statutory changes that have occurred since 1981, when the IRS last issued final regulations under Code section 415. These regulations generally are applicable for plan limitation years beginning on or after July 1, 2007. Accordingly, most calendar year plans will need to be amended to comply with these regulations by December 31, 2008.

For defined contribution plans, Code section 415 imposes general limits on certain annual additions that plan sponsors may make to a qualified plan on behalf of participants. For these purposes, "annual additions" include the sum of contributions and forfeitures allocated to the participant's account for the year, including elective deferrals (both regular and Roth) and after-tax, matching and profit-sharing contributions, but excluding catch-up and deemed IRA contributions.

The following outlines several of the key items addressed in these final regulations under Code section 415:

- Post-Severance Compensation: Required. The definition of 415 compensation generally includes post-severance "regular pay" that is paid within a specified timeframe and that would have been paid had the participant remained employed (such as wages, overtime and shift differential pay, commissions,

bonuses and other similar compensation). For these purposes, the specified timeframe is the later of 2-1/2 months following the employee's severance from employment or the end of the limitation year that includes the employee's date of severance.

- Post-Severance Compensation: Optional. The final regulations permit, but do not require, plan provisions to specify that any of the following types of post-severance payments be included as 415 compensation: (1) cash-outs of accrued bona fide sick, vacation or other leave, if the employee would have been able to use that leave if employment had continued; (2) payments of nonqualified deferred compensation that would have been paid at the same time if the employee had remained employed; (3) select payments to a permanently and totally disabled participant; and (4) certain differential payments to individuals in qualified military service. items of post-severance compensation can not be included in 415 compensation. Samples include severance pay, parachute payments and deferred compensation if payment is triggered by termination of employment.

These clarifications are important for 401(k) plan sponsors since post-severance compensation may be deferred to a 401(k) plan only if the item of compensation constitutes 415 compensation. For example, if a 401(k) plan participant terminates in November and receives a cash-out of accrued paid time off ("PTO") in January, the participant can make an elective deferral from the cash-out. However, if the participant is paid a bonus on April 1 relating to his prior calendar year services, the participant cannot make a deferral from the bonus to the 401(k) plan because the bonus was paid too late to constitute 415 compensation. The terms of the 401(k) plan will control in determining post-severance compensation that can be deferred.

- Restorative Payments. Restorative payments are not subject to Code Section 415 if they restore plan losses resulting from fiduciary action for which there is a reasonable risk of fiduciary liability under the Employee Retirement Income Security Act ("ERISA"), or under other applicable federal or state law.
- Aggregation Rules. The final regulations make a number of changes to the aggregation rules that, among other things, apply in determining when a predecessor plan must be aggregated with the employer's plans.
- Regulatory Correction Method. The final regulations replace the existing regulatory method for correcting excess annual additions, and adopt the correction methods now provided under the IRS' Employee Plans Compliance Resolution System.

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IRS Publishes Code Section 402A Final Regulations: Roth Accounts

On April 27, 2007, the IRS published final regulations under Code section 402A that address the distribution, taxation, rollover and recordkeeping of designated Roth contributions under Code section 401(k) ad 403(b) plans. These final regulations also make conforming amendments to regulations for implementing designated Roth contributions in Code section 401(k) plans and to rules for elective deferral limits and Roth IRAs. These regulations generally apply for taxable years beginning on or after January 1, 2007, with limited exceptions. If your plan allows designated Roth contributions, the plan may need to be amended to reflect these regulations by the end of the 2007 plan year.

The final regulations under Code section 402A revise several sections of the proposed regulations that the IRS published in early 2006. The following outlines several of the key items addressed in these final regulations:

- Qualified Distributions. To qualify for favorable tax treatment, distributions from a designated Roth account must satisfy certain requirements, including age requirements. The final regulations clarify that for a distribution to an alternate payee pursuant to a qualified domestic relations order or to a beneficiary, the age, death or disability of the participant (not of the alternate payee or beneficiary) generally will be used to determine whether the distribution is a qualified distribution. In contrast, an alternate payee's or surviving spouse's own age, death, or disability will be used if the distribution is rolled over to a designated Roth account under his or her employer's plan.
- • Rolling Over Designated Roth Contributions. The final regulations make several changes to the rules governing rollovers of designated Roth contributions. More specifically, the final regulations clarify that only a Code section 401(k) plan with a designated Roth program may receive a rollover of designated Roth contributions. The IRS noted that designated Roth rollovers need not be separately accounted for because they should be included in the recipient plan's separate accounting for all designated Roth contributions.
- Clarification of Code Section 401(k) Regulations. The final regulations clarify several issues relating to previously issued regulations under Code section 401(k). These new regulations, for example, confirm that a participant's designated Roth account and other accounts are treated as two separate plans for applying the withholding rules on small distributions, the automatic rollover rules for mandatory distributions and the rules for allowing split distributions. Additionally, the preamble confirms that catch-up contributions may be designated as Roth contributions.

- Reporting. The final regulations provide that, until the IRS publishes relevant forms and instructions, a plan that accepts an indirect rollover of any otherwise taxable portion of a distribution from a designated Roth account does not have to report its acceptance of the rollover contribution to the IRS.

ERISA May Impose Contribution Requirements in Addition to Terms of CBA

A district court held that the trustees of a multiemployer pension plan could pursue a $100 per month per employee contribution ("supplemental payment") to ensure that the plan satisfied its minimum funding obligation under ERISA section 302, even though the employers were contributing all amounts owed under their collective bargaining agreements ("CBAs"). *Gastronomical Workers Union Local 610 v. Dorado Beach Hotel Corp.*, 2007 WL 646178 (Dist. Puerto Rico).

According to the plaintiff trustees of the pension plan, the contributing employers must make these supplemental payments to the plan to meet the minimum funding requirements under ERISA section 302 because the plan was underfunded. Despite ERISA's minimum funding requirements, the defendant contributing employers argued that they were exempt from the minimum funding requirements, in this case, because their CBAs with the unions bound them only to pay fixed contributions to the pension plan, even if these fixed contributions are not sufficient for funding purposes.

The court agreed with the trustees, and found that the minimum funding obligation under ERISA section 302 could impose an obligation on a contributing employer that was in addition to the terms of the applicable CBA. The court reasoned that the case was not about the defendants' obligations under the CBAs, but the defendants' obligations under ERISA. The court, citing to ERISA section 302, noted that the amount of any contribution required by minimum funding standards shall be paid by the employer responsible for making contributions to or under the plan. Accordingly, the court held that ERISA clearly states that the defendants must adequately fund the pension plan they have agreed to sponsor, regardless of the terms of the applicable CBA.

HEALTH AND WELFARE PLAN DEVELOPMENTS

Proposed Regulations on Tax Exemption for Children of Separated Parents

On May 2, 2007, the IRS issued proposed regulations addressing when parents who are divorced, separated or living apart may claim a child as a dependent. These proposed regulations reflect changes to the definition of the term

"dependent" found in Code section 152, pursuant to the Working Families Tax Relief Act of 2004 ("WFTRA"). Additionally, these proposed regulations apply to taxable years beginning after the date the IRS publishes them as final regulations.

In general, Code section 152 provides that a noncustodial parent may claim a dependency exemption for their child if the following three requirements are met: (1) over half of the child's support during the tax year is from one or both parents; (2) the child is in the custody of one or both parents for more than half of the tax year; and (3) the custodial parent signs a written declaration that he or she will not claim the child as a dependent ("Noncustodial Parent Rule").

The proposed regulations provide further guidance regarding the Noncustodial Parent Rule under Code section 152, including the following main points:

- The proposed regulations define the term "custodial parent" as the parent with whom the child resides for the greater number of nights during the calendar year. The proposed regulations also provide guidance regarding how to treat nights when the child does not reside with either parent.
- A child who is treated as a qualifying child or qualifying relative of a noncustodial parent under the Noncustodial Parent Rule shall be treated as a dependent of both parents for purposes of the tax exclusions for health coverage in Code sections 105 and 213.
- The Noncustodial Parent Rule may apply to parents living apart who were never married to each other, and the proposed regulations establish detailed requirements regarding the custodial parent's declaration and methods for revoking the declaration.

IRS Extends Cutoff Date for Archer MSA Program

The IRS has announced that the years 2005 and 2006 will not be the cutoff dates for the Archer medical savings accounts ("MSA") program. IRS Ann. 2007-44 (April 17, 2007). In general, Archer MSAs are tax-favored medical savings accounts that can be created by certain self-employed individuals and employees of small employers covered under qualifying high-deductible health plans. Code section 220 provides that the Archer MSA program will terminate (or be "cut off") in a calendar year prior to 2007 if the total number of MSAs established as of that prior year exceeds the statutory limit of 750,000 total accounts.

Because the IRS has determined that the number of accounts for years 2004 - 2006 did not exceed the statutory limit, the IRS announced that neither 2005 nor 2006 would be a cutoff year for the MSA program. The IRS has not yet established

a new cutoff year for the MSA program.