Reinhart

September 2007 Employee Benefits Update

POSTED:

Oct 1, 2007

RELATED PRACTICES:

Employee Benefits

https://www.reinhartlaw.com/practices/employee-benefits

SELECT COMPLIANCE DEADLINES

IRS Announces Form 5500 Deadline Relief for Storm and Flooding Victims

The Internal Revenue Service ("IRS") extended certain tax deadlines for victims of severe storms and flooding in Minnesota, Ohio, Oklahoma and Wisconsin. The IRS extended deadlines for filing returns, including the Form 5500, falling on or after August 18, 2007 to November 15, 2007. Taxpayers whose principal place of business is in the covered disaster areas or whose books, records or tax professionals are located in such areas are eligible for relief.

RETIREMENT PLAN DEVELOPMENTS

IRS Issues Proposed Regulations on the Payment of Accident and Health Insurance Premiums from Qualified Retirement Plans

The IRS issued proposed regulations on August 20, 2007, clarifying the tax treatment of payments from a qualified retirement plan for accident or health insurance premiums. 72 Fed. Reg. 46421. The proposed regulations provide that the payment of accident or health insurance premiums will generally constitute a distribution and be includible in the participant's taxable income for the year in which the premium was paid. Payments received through the accident or health insurance are then excludable from the participant's income under Internal Revenue Code ("Code") section 104(a)(3) and not treated as plan distributions. If a defined contribution plan pays premiums from unallocated contributions or forfeitures, the premium is treated as allocated to the participant and then charged against the participant's benefits and taxed in the same manner.

The general rule that accident and health insurance premiums are taxable distributions does not apply to retiree medical benefits provided under a pension plan as described in Code section 401(h). The proposed regulations also provide an exclusion from income for up to $3,000 per year for certain insurance premiums paid on behalf of eligible retired public safety officers. In addition, the proposed regulations provide that if insurance benefits are paid directly to the plan, instead of the employee, these amounts will be treated as having been paid to the employee and then contributed to the plan.

The IRS expects the regulations to be effective for calendar years after the regulations are finalized. The preamble to the proposed regulations provides that until the effective date, no inference should be drawn that the payment of premiums does not constitute a taxable distribution. Comments on the proposed regulations must be received by November 19, 2007.

EBSA Publishes Final Rule on Civil Penalties for Failure to Provide Diversification Notice

On August 10, 2007, the Department of Labor's Employee Benefits Security Administration ("EBSA") amended regulations under Employee Retirement Income Security Act ("ERISA") section 502(c)(7) to add civil penalties of up to $100 per day for a plan administrator's failure to provide a notice of diversification rights required by the Pension Protection Act ("PPA"). 72 Fed. Reg. 44970. The PPA requires defined contribution plans that permit investments in employer stock to provide participants and beneficiaries certain diversification rights with respect to their investments in employer stock. In addition, the PPA requires plan administrators to provide individuals with a notice of diversification rights no later than 30 days before the individual becomes eligible to exercise his or her right to diversify. The IRS published a model diversification notice last November in IRS Notice 2006-107. *See Reinhart's December 2006 Employee Benefits Update*.

EBSA's final rule provides that each failure or refusal to provide a diversification notice to a single participant or beneficiary constitutes a separate violation. The penalties are computed from 30 days before the date the individual was eligible to exercise his or her diversification rights. The final rule does not change existing penalty assessment procedures or procedures for contesting assessments. Instead, the final rule extends existing procedures for failures to provide blackout notices to failures to provide diversification notices. The final rule is effective October 9, 2007, unless EBSA receives significant adverse comments.

IRS Provides Temporary Relief for Amendments to a Plan's Normal Retirement Age

In May 2007, the IRS issued final rules on phased retirement, clarifying that a pension plan may pay benefits when an employee reaches normal retirement age ("NRA"), even if the employee has not terminated employment with the employer maintaining the plan. The final regulations also set a minimum allowable NRA. For details on the final regulations, see *Reinhart's June 2007 Employee Benefits Update*.

In August 2007, the IRS issued Notice 2007-29 to provide temporary relief from disqualification to plans that may need to be amended to comply with the new

NRA requirements. The temporary relief applies to plans with an NRA lower than age 62. To qualify for relief, a plan cannot permit a participant hired at age 18 or older to reach the plan's NRA before the age of 40. In addition, the plan sponsor must adopt a good faith interim amendment (if necessary) effective for plan years beginning after June 30, 2008, and operate in compliance with such amendment. Thus, plan sponsors have until the end of the plan's remedial amendment period (*i.e.*, the last day of the first plan year beginning after June 30, 2008, or the due date for filing the plan sponsor's tax return, if later) to adopt the amendment. The final regulations were generally effective as of May 22, 2007, and would have required plan sponsors to amend their plans earlier.

The notice also provided that if a plan sponsor acts in good faith and the IRS determines at a later date that the plan's NRA is too low, the IRS will not require the NRA to be raised retroactively. In addition, the notice includes temporary relief for plans with an NRA below age 55. This relief requires plan sponsors to submit a private letter ruling request on whether the plan's NRA satisfies the standards in the final regulations. No safe harbor or relief applies to an NRA that is based on years of service. Furthermore, the temporary relief provided in the notice does not apply to government plans and certain collectively bargained plans.

IRS Issues Proposed Regulations on Benefit Restrictions for Underfunded Defined Benefit Plans

On August 31, 2007, the IRS issued proposed regulations to provide guidance on PPA provisions requiring underfunded plans to restrict benefit accruals, the payment of certain benefits, and plan amendments increasing benefits. 72 Fed. Reg. 50544. The proposed regulations include a number of transition rules and will apply to plan years beginning in 2008.

Areas addressed in the proposed regulations include the calculation of the adjusted funding target attainment percentage, methods for avoiding restrictions on accelerated payments, the effect of a prefunding balance and funding standard carryover balance and limitations on distributions and accruals. Plan sponsors may rely on the proposed regulations for qualification purposes pending final regulations. Comments on the proposed regulations must be received by November 29, 2007.

403(b) Final Regulations for Orphan Plans

Last month's Employee Benefits Update summarized the final regulations under

Code section 403(b). See *Reinhart's August 2007 Employee Benefits Update*. These final regulations are generally effective for plan years beginning on or after January 1, 2009.

The new regulations require 403(b) contracts or custodial accounts to be "maintained pursuant to a plan" of an eligible employer. Under certain circumstances, a contract or account may become "orphaned." These orphan products can result from an employee terminating employment or an employer going out of existence. As of January 1, 2009, these orphan products may no longer be qualified under Code section 403(b) because the regulations only grandfather transfers made on or before September 24, 2007. Orphan products exchanged after September 24, 2007, products that become orphaned after September 24, 2007, and orphan products never involved in an exchange may require attention so they do not violate the "maintained pursuant to a plan" requirement. In some cases, a participant may be able to rollover the orphan product to an IRA. Alternatively, the IRS seems open to discuss other solutions for handling these orphan products.

PPA Technical Corrections Bill Introduced in the Senate and House of Representatives

In early August, almost one year after the PPA became law, the Pension Protection Technical Corrections Act of 2007 was introduced in both the Senate and House of Representatives. (S. 1974, H.R. 3361) The technical corrections bill fixes clerical errors and contains several substantive changes including the following. • Gap Period Income The bill would eliminate the requirement for plans to pay gap period income on distributions of deferrals in excess of the Code section 402(g) limit. For more information on gap period income, see *Reinhart's August 2007 Employee Benefits Update*.

- Combined Deduction Limit
- The bill would clarify that for 2006 and 2007, if an employer's contributions to a defined contribution plan (not including elective deferrals) do not exceed 6% of compensation, then the defined benefit plan is not subject to the combined plan limit. If the employer's contributions exceed 6% of compensation, only contributions in excess of 6% are counted toward the combined limit. (Beginning in 2008, the combined limit is eliminated for single employer plans covered by the Pension Benefit Guaranty Corporation.)
- Non-Spousal Rollovers

- The bill would make rollovers to non-spouse beneficiaries generally subject to the same rules as other eligible rollovers for plan years beginning in 2008. Thus, the bill would require plans to permit non-spousal rollovers.
- Fiduciary Relief Extended
- The bill would extend fiduciary relief provided for blackout periods to periods of less than three consecutive days, provided the fiduciary satisfies ERISA's requirements in the same manner as if the shorter period constituted a blackout period.
- Multi-Employer Plans and Endangered or Critical Status
- The bill removes the requirement that the Department of Labor certify the parties have reached an impasse in bargaining and would require trustees to implement a default schedule within 180 days of the expiration of a collective bargaining agreement. In addition, the bill would clarify that restrictions on accelerated forms of payment only apply to participants with benefit commencement dates after the date the plan's notice of critical status is sent. The bill would also change the excise tax for failure to timely adopt a rehabilitation plan. The bill revises the calculation of the excise tax so it applies to the period beginning on the due date for adopting the rehabilitation plan.

The bill also addresses de minimis cashouts for underfunded plans and vesting and interest crediting rules for hybrid plans.

We will keep you updated on the progress of this legislation.

Seventh Circuit Rules Lump Sum Distribution Must Include COLA

A participant who received a lump sum distribution filed a class action lawsuit against his former employer's pension plan claiming the plan should have included the present value of cost-of-living increases ("COLAs") in his distribution. *Williams v. Rohm and Haas Pension Plan*, 2007 WL 2302173 (7th Cir. 2007). The district court granted summary judgment in favor of the participant and the Seventh Circuit affirmed.

The plan defined the participant's accrued benefit as his normal retirement pension expressed as a single life annuity. The plan also provided COLAs based on the consumer price index of no more than 3% of the participant's accrued benefit. Participants who chose lump sum payments were not eligible for the

COLA enhancement and the plan specifically defined "accrued benefit" to exclude the COLAs.

The Seventh Circuit rejected the plan's interpretation of accrued benefit and held that the COLAs fell within ERISA's definition of accrued benefit, regardless of the plan document's attempt to exclude the COLAs. The Seventh Circuit cited *Hickey v. Chicago Truck Drivers, Helpers and Warehouse Workers Union* to support its decision. 980 F.2d 465 (7th Cir. 1992). In *Hickey*, the court held that COLAs were a method of preserving the value of the monthly retirement benefit and were therefore part of the participant's accrued benefit and not an ancillary benefit. Accordingly, the Seventh Circuit held that the participant's lump sum must include the combined present value of the annuity at normal retirement and the projected COLAs.

Sixth Circuit Holds Cash Balance Plan is Not Age Discriminatory

The Sixth Circuit is the third appellate court to rule on whether the interest crediting mechanism of cash balance plans is inherently age discriminatory. The Sixth Circuit adopted the position held by the Seventh Circuit and Third Circuit and ruled that the phrase "rate of benefit accrual" in ERISA section 204(b)(1)(H)(i) refers to the employer's contributions to the plan. Therefore, any difference in a participant's benefits relating to time and interest compounding does not violate ERISA. *Drutis v. Rand McNally & Co.*, 2007 WL 2409762 (6th Cir. 2007).

WELFARE AND FRINGE BENEFIT PLAN DEVELOPMENTS

IRS Proposes New Cafeteria Plan Regulations and Withdraws Prior Guidance

On August 6, 2007, the IRS published 124 pages of new proposed regulations under Code section 125 for cafeteria plans. 72 Fed. Reg. 43938. Cafeteria plans allow employees to pay for certain benefits on a pretax basis. Under a cafeteria plan, employees agree to reduce compensation in exchange for benefits elected prior to the beginning of the year. To ensure a cafeteria plan maintains its tax-favored status, employers must comply with certain Code provisions when establishing and operating the plan.

The new proposed rules replace prior proposed regulations and temporary regulations. The IRS anticipates that these new regulations will generally apply for plan years beginning on or after January 1, 2009. Plan sponsors, however, may rely on these regulations for guidance pending the publication of final regulations. Key provisions in the proposed regulations include the following.

- Written Plan

- The cafeteria plan must be operated in accordance with a written plan document that is adopted and effective on or before the first day of the plan year to which it applies. The proposed regulations provide specific guidance on what the plan document must contain, including a description of benefits and periods of coverage, rules for eligibility, procedures for making elections, a description of how employer contributions are made and the maximum amount of contributions.

- Qualified Benefits

- A cafeteria plan may only offer qualified benefits. The proposed regulations provide a list of qualified benefits, including medical, dental, vision, disability and life insurance benefits as well as adoption assistance plans and health savings accounts. The proposed regulations clarify that benefits requiring a 2-year lock-in period, such as certain dental or vision contracts, can still be qualified benefits.

- Elections

- Generally, an employee's election under a cafeteria plan is irrevocable and may only apply prospectively (i.e, to future benefits and wages). This requirement created problems for new employees who do not immediately submit enrollment forms for the cafeteria plan. The proposed regulations provide a 30-day enrollment window for new hires and permit plans to provide benefits retroactive to the new employee's hire date. The proposed regulations also include provisions on online enrollment and permit employers to automatically enroll employees in a default plan, such as a medical plan, if an employee fails to select a plan.

- Nondiscrimination

- Cafeteria plans must not discriminate in favor of highly compensated employees. The proposed regulations define "highly compensated employee" and include an objective test for determining when the actual benefits elected are discriminatory. The proposed regulations also include a safe harbor for premium-only plans and guidance on contributions and benefits testing.

- Imputing Income for Life Insurance

- The value of life insurance premiums for coverage in excess of $50,000 must be

Reinhart

included in an employee's gross income. The proposed regulations require employers to use a new table to determine the imputed income beginning August 6, 2007.

- Flexible Spending Accounts
- The proposed regulations confirm that health flexible spending accounts may reimburse employees for advance payments of orthodontia services. The proposed regulations also clarify that expenses for medical equipment, such as wheelchairs, can be reimbursed without violating the rule prohibiting deferred compensation. In addition, the proposed regulations provide guidance on the substantiation of claims and permitted uses of forfeitures, including paying administrative expenses.

The proposed regulations provide welcome guidance for cafeteria plan sponsors. Employers will need to review their cafeteria plans and update them for these new rules. We will provide more information on the new nondiscrimination requirements in a future newsletter.

IRS Issues Final Regulations on Dependent Care Expenses

On August 14, 2007, the IRS finalized regulations on dependent care expenses under Code section 21. 72 Fed. Reg. 45338. The regulations apply for determining qualifying expenses for the dependent care tax credit as well as to expenses that may be reimbursed under a dependent care assistance program ("DCAP"). Under a DCAP, employees can elect to contribute a portion of pay on a pretax basis. The employer uses these contributions to reimburse the employee tax-free for employment-related dependent care expenses.

The final regulations largely track the proposed regulations issued in May 2006 with some clarifications and examples. Clarifications to the proposed regulations include the following.

- Full-Day Kindergarten
- The IRS clarified in the preamble to the final regulations that costs for full-day kindergarten programs are considered primarily for education and not primarily for the care of a qualifying individual. Thus, expenses for full-day kindergarten will not be qualifying expenses while before or after-school care for children attending half-day kindergarten may qualify as employment-related expenses.

- Specialty Day Camps
- The final regulations retain the rule that the full amount for day camps may be a qualifying expense, although the camp specializes in a particular activity, such as soccer or computers. In addition, the final regulations clarify that expenses for summer school and tutoring programs are not qualifying expenses and that day camps must comply with state and local laws.
- Short, Temporary Absences
- The final regulations add a safe harbor for short, temporary absences, providing that an absence of two consecutive calendar weeks or less is deemed to be a short, temporary absence. Furthermore, the regulations eliminate the requirement that the employee pays for expenses on a weekly, monthly or annual basis. Instead, the rule for short absences would apply if the care giving arrangement requires the employee to pay for care during the absence, regardless of how payments are made.
- Shift Workers
- The final regulations provide examples clarifying that expenses for care of a qualifying individual while one parent is working and the other is sleeping (because the parent works at night) may be qualifying expenses.
- Full-Time Students
- The final regulations clarify that a spouse enrolled in an online degree program that does not offer traditional classroom instruction will not satisfy the definition of a fulltime student for purposes of the deemed earned income rule.

The final regulations are effective immediately. Employers should review their DCAP plans and employee communication materials to see if any changes are necessary in light of these final regulations.

EBSA Issues Two Opinion Letters on MEWAs

In August 2007, EBSA issued two advisory opinions concerning multiple employer welfare arrangements ("MEWAs"). In the first letter, EBSA reiterated its position that federal, not state law, determines whether an arrangement is a MEWA under ERISA. DOL Op. Ltr. 2007-05A (August 15, 2007). In the second letter, EBSA advised that stop loss coverage alone does not qualify a MEWA as fully insured under ERISA. Instead, EBSA explained that the insurer must unconditionally guarantee all benefits and participants must have a legally enforceable right to benefits against the insurer. DOL Op. Ltr. 2007-06A (August 16, 2007).

EBSA Advises Tuition Reimbursement Is Not a Prohibited Transaction

A union education program requested an advisory opinion on whether the program could reimburse the union for tuition payments advanced to members for a welding program. EBSA advised that if the conditions of ERISA section 408(b)(2) are met, particularly that the services are necessary for administration of the program and that the contract for such services is reasonable, then the reimbursements would not constitute a prohibited transaction under ERISA section 406(a). DOL Op. Ltr. 2007- 04A (July 18, 2007).