BENEFITS INSIDER
A Member Exclusive Publication

Volume 19, June 27, 2006

WEB's ***Benefits Insider*** is a member exclusive publication providing the latest developments from the Nation's Capital on matters of interest to benefits professionals. The content of this newsletter is being provided as a result of a partnership with the American Benefits Council, a premier benefits advocacy organization, which provides much of its core content.

Articles in this Edition

RECENT REGULATORY ACTIVITY 2

Treasury Department Issues Proposed Regulations for Dependent Care Tax Credit 2

IRS Updates Voluntary Correction Program 2

U.S. Energy Department Changes Policy on Pension and Health Contracts 3

RECENT LEGISLATIVE ACTIVITY 3

Pension Bill Conference Updates 3

President Bush Signs Military IRA Contribution Legislation 6

Senate Blocks Medical Liability Reform Bills, Begins Debate on Health Insurance Reform Legislation 7

Cantor Introduces Health Savings Legislation with Important HSA Provisions 8

Federal Government Revises Projections for Social Security, Medicare; Bush Administration Uses Occasion to Push for Pension Reform 8

RECENT JUDICIAL ACTIVITY 9

Unanimous U.S. Supreme Court Decision Affirms Health Plan's Right to Reimbursement 9

Benefits Insider 2006 Sponsor

RECENT REGULATORY ACTIVITY

Treasury Department Issues Proposed Regulations for Dependent Care Tax Credit
On May 24, the U.S. Department of the Treasury (Treasury) proposed regulations incorporating statutory amendments to the dependent care tax credit. The credit — originally enacted as Section 44A of the Internal Revenue Code (Code) and later renumbered as Section 21 of the Code — allows a nonrefundable tax credit for a percentage of expenses for household and dependent care services necessary for gainful employment. Dependent care expenses can also be reimbursed though an employer-sponsored Dependent Care Assistance Program, including a dependent care flexible spending arrangement. Taxpayers cannot, however, use both the credit and an employer-sponsored program for the same expenses.

The proposed regulations reflect statutory amendments enacted since the promulgation of section 44A and include a change in the definition of a qualifying individual, a reduction in the maximum age of a qualifying child from under age 15 to under 13, and an increase in the maximum amount of creditable expenses. The proposed regulations also provide additional rules that address significant issues that arose administratively since publication of the original section 44A regulations and expand the number of examples.

IRS Updates Voluntary Correction Program
On May 5, the Internal Revenue Service (IRS) issued Revenue Procedure 2006-27 updating its voluntary correction program for qualified retirement plans called the Employee Plans Compliance Resolution System or EPCRS. EPCRS allows qualified retirement plans that have failed to meet one or more qualification requirements to be corrected under one of three programs – the Self-Correction Program (SCP), the Voluntary Correction Program (VCP), or the Correction on Audit Program (Audit CAP). Revenue Procedure 2006-27 modifies and supersedes Revenue Procedure 2003-44.

The structure of EPCRS remains relatively the same, but several modifications were made that may make it easier for some errors to be corrected under the program. Some of the more significant changes include:

- Expansion of the VCP and Audit CAP to terminating Orphan Plans and providing for a possible exception to the requirement for full correction and waiver of the VCP fee in some circumstances;
- Adding a correction method for certain plan loan failures, including adding a correction method for a plan that operationally permits plan loans, but does not have the appropriate loan language in its plan document;
- Revising the correction method for a failure to include an eligible employee in a 401(k) plan;
- Adding an alternative correction method for a failure to obtain spousal consent for a distribution (allows payment in a lump sum);
- Several modifications for failure to make appropriate amendments;

- Clarifying submission procedures for Anonymous Submissions and Group Submissions;
- Allowing the IRS to waive the relevant excise tax for failing to satisfy the minimum distribution requirements in appropriate cases filed under VCP or Audit CAP; and
- Reducing the compliance fee for a plan where the sole failure is the failure to satisfy the minimum distribution requirements for 50 or fewer employees.

U.S. Energy Department Changes Policy on Pension and Health Contracts
On April 27, the U.S. Department of Energy (DOE) announced a new policy with regard to its pension plan obligations for contract employees.

According to the DOE's media statement, "[t]he Department will continue to reimburse contractors for costs for current and retired contractor employees' defined benefit pension plans and medical benefit plans under existing contract requirements. For new contractor employees hired after a date no later than March 1, 2007, the Department will reimburse contractors for the costs of their market-based defined contribution pension plans (similar to 401(k)) and market-based medical benefit plans." This policy indicates a shift in the federal government's support from defined benefit pension plans to defined contribution plans, at a time when a congressional conference committee is negotiating wide-ranging pension legislation.

The DOE policy would require contractor pension plans and medical benefit plans to be within five percent of market-based performance benchmarks consistent with those currently in use by private companies. Such requirements may, therefore, encourage more contractors to freeze their defined benefit plans and make certain decisions about their selection of health plans as well.

RECENT LEGISLATIVE ACTIVITY

Pension Bill Conference Updates
The staffs of the congressional conferees for pension reform legislation — for the conference assigned with resolving the differences between the House of Representatives-passed Pension Protection Act (H.R. 2830) and the Senate-passed Pension Security and Transparency Act (S. 1783) met throughout the Memorial Day recess. The next target date for reaching consensus is the July 4 recess, though that is very uncertain at this point. We have put together this summary in order to bring you up to date on the various issues before the conferees.

One issue before the conferees pertains to credit rating and credit balances, but it appears that no decision has yet been made on these top-tier funding issues. Discussions are ongoing among the conferees. Other issues, such as hybrid plans and changes in the prohibited transaction rules, have been discussed only at the staff level. Thus far, permanence of the EGTRRA retirement provisions has not arisen as a topic of discussion.

Employers are encouraged to weigh in with conferees (names and phone numbers available here) and voice their priority issues in the legislation, especially if the Employer has an interest in permanence of the EGTRRA retirement provisions.

In related news, on May 22, Senate Finance Committee Chairman Charles Grassley (R-IA) and Ranking Minority Member Max Baucus (D-MT) introduced legislation that would require congressional confirmation of the executive director of the Pension Benefit Guaranty Corporation (PBGC). The PBGC position, recently vacated by Bradley Belt, is currently appointed by the U.S. Secretary of Labor and does not require confirmation. Under the proposed bill, the Senate Finance Committee and the Senate Health, Education, Labor and Pensions Committee would be responsible for approving future executive directors. Grassley and Baucus intend to attach this measure to the pension legislation discussed in this section.

This proposal is one more example of greater scrutiny of PBGC's practices. The American Benefits Council has repeatedly brought to the attention of Congress the need for much greater accountability by the PBGC of its financial assumptions and other operations. For instance, throughout the pension funding reform debate, in letters to Congress and in an independently prepared research paper, the American Benefits Council has consistently called for more transparency in how the PBGC values its own assets as well as the funding levels of plan sponsors whose pensions the agency guarantees.

Sources have indicated that the conferees are also working out the differences in the bills' funding provisions, particularly those addressing credit rating (for determining at-risk liability) and credit balances. While no final agreement has been reached, legislators are leaning toward some use of a credit rating element as well as some restrictions on the use of credit balances. Once these issues are resolved, conferees are expected to tackle other controversial issues like hybrid plans, multiemployer issues and investment advice and other prohibited transaction rules. Permanent enactment of the EGTRRA savings provisions is still on the table, though there continues to be concern from some legislators on the revenue cost of those provisions.

Cost concerns also threaten the House bill provision that would allow participants in flexible spending arrangements (FSAs) to carry forward up to $500 for use in their FSA the following year or to roll over these amounts into a health savings account (HSA). As a result, modifications to the House FSA provision to make it less costly are reportedly under active consideration. These could include delaying the effective date of the FSA provision, reducing the amount that could be carried forward, or phasing-in the provision over several years.

While much of the attention and controversy regarding the legislation has focused on the defined benefit pension plan provisions, there are also numerous defined contribution plan matters under consideration. On May 17, the American Benefits Council distributed to all conferees a document summarizing the defined contribution plan issues in the

pension reform legislation. This document covers automatic enrollment, investment education and advice and diversification requirements, among other topics.

Nonqualified plans area also a potential topic for discussion amongst the conferees. On May 3 the House of Representatives approved, by a vote of 299-125, a "Motion to Instruct" the House pension bill conferees with regard to executive compensation, as addressed in a Senate amendment to the bill. The motion was proposed by Representative George Miller (D-CA), ranking minority member of the House Education and the Workforce Committee and member of the pension bill conference. (A Motion to Instruct is non-binding and the House conferees are not required to follow it.)

The motion asks the conferees to agree to the Senate provisions on nonqualified deferred compensation and to make some additional changes to further expand the impact of the provisions. Under the Senate bill, if during a "restricted period," any assets are set aside or reserved in a trust (or other arrangement determined by the IRS) for the payment of deferred compensation of an "applicable employee" (generally, the CEO and the other four highest paid officers), such assets would be immediately taxable (and subject to the 20 percent penalty under Code Section 409A) to the extent vested. In general, a restricted period includes (1) a period after the plan year of a defined benefit plan when the plan is below 60 percent funded (80 percent in the case of a plan which is considered "at risk" under the Senate bill rules), (2) the company is in bankruptcy, or (3) the 12-month period beginning 6 months before the termination date of an underfunded plan. Like the House bill, the Senate bill applies on a controlled group basis, so that any defined benefit plan in the controlled group can trigger the restrictions on nonqualified deferred compensation. The Senate bill would also create a cause of action for fiduciaries to recover assets transferred in violation of this rule, thus inviting extensive new litigation.

The motion would expand these provisions to require that the restrictions for nonqualified deferred compensation mirror restrictions on qualified plans to the extent possible. For example, if a participant in a defined benefit plan cannot receive a lump sum benefit because the plan is too underfunded, lump sums would not be available under the nonqualified plan. The motion also suggests that the Senate's definition of "covered employee" be broadened to include other corporate insiders. Finally, the motion recommends enacting the House bill's earlier effective date. This would make the provisions applicable to transfers or reservations of assets after December 31, 2005 and thus, would be retroactive.

The provisions of the retirement bills affecting nonqualified deferred compensation raise numerous concerns for plan sponsors and the additional provisions recommended by the motion would exacerbate these concerns, particularly the potential mirroring of requirements and restrictions that might be or become applicable to the qualified plan and the retroactive effective date.

In related news, the House of Representatives and Senate have approved a final compromise version of the Tax Increase Prevention and Reconciliation Act (H.R. 4297), a tax reconciliation bill. The final tax reconciliation bill passed the House on May 10, by

a vote of 244-185 and passed the Senate by a vote of 54-44 on May 11. President Bush is expected to sign the legislation. An official summary of the final conference agreement is available on the American Benefits Council's website.

Under the terms of the agreement, several items extending certain tax provisions were dropped from the reconciliation bill because of revenue limitations, but are expected to be included in a separate bill. In particular, the Saver's Credit – which was contained in the House and Senate bills – was not included in the conference agreement. There are indications that the pension reform legislation, now the subject of congressional negotiations between the House and Senate, will become the vehicle for remaining tax provisions. (The Saver's Credit is already contained in the House pension bill).

The bill will extend the 15 percent top tax rate on capital gains and dividend income for an additional two years (through 2010) and provide alternative minimum tax (AMT) relief for 2006. The tax provisions that might be added to the pension legislation include credits -- that have either already expired or will expire at the end of 2006 -- for research-and-development and education. Several of the "conferees" (i.e. the Congressional negotiators) working on the tax reconciliation bill are also conferees on the pension bill.

H.R. 4297, the tax reconciliation measure that has passed the House and is now awaiting action in the Senate, includes several provisions that would raise revenue to offset the costs associated with the bill:

- elimination of the income limitation for Roth IRA conversions beginning in 2010 (and taxpayers can elect to pay tax on amounts converted in 2010 in equal installments in 2011 and 2012);
- an increase in July through September 2006 estimated tax payments for corporations with assets over $1 billion (as well as some future changes starting in 2010);
- modification of certain foreign sales corporation (FSC) provisions including elimination of grandfathering provisions; and
- an increase from under 14 to under 18 the age of minor children whose unearned income is taxed at the parent's rate.

President Bush Signs Military IRA Contribution Legislation

On May 29, President Bush signed the Heroes Earned Retirement Opportunities Act (H.R. 1499), which allows military personnel to include combat zone compensation in the determination of allowable individual retirement account (IRA) contributions. Normally, combat zone compensation is nontaxable and, therefore, not included in determining whether an individual has includible compensation sufficient to permit an IRA contribution. However, the bill allows combat zone compensation to be included in taxable income solely for the purposes of calculating the yearly maximum IRA contribution.

The bill has an effective date of December 31, 2003. The retroactive effective date would allow prior IRA contributions that were made on the understanding that combat zone

compensation would be counted for purposes of the limit and would explicitly allow military personnel to make retroactive IRA contributions for the 2004 and 2005 tax years (and receive income tax refunds attributable to such years). This retroactive contribution opportunity for 2004 and 2005 would be available for three years beginning on the date of enactment.

The House of Representatives version of the pension reform legislation, currently pending in a congressional conference (see above story) contains a similar provision allowing combat zone compensation to be considered for IRA contributions. The House bill also contains a provision on qualified reservist distributions that provides that (1) the 10 percent premature distribution penalty does not apply to a "qualified reservist distribution," and (2) that the distribution can be repaid to an IRA during the 2-year period beginning on the date after the end of the active duty period.

Finally, proposed tax code Section 415 regulations provide that differential pay is considered Section 415 compensation (allowing 401(k) deferrals from differential pay, which refers to payments made by the employer while the employee is in military service to make up some or all of the difference between military pay and their normal salary).

Previous differential pay legislation was considered but not enacted in the previous Congress.

Senate Blocks Medical Liability Reform Bills, Begins Debate on Health Insurance Reform Legislation

Two medical liability bills failed to move forward on May 9, after falling short of the 60 votes necessary to avoid delay tactics through use of a filibuster. The Medical Care Access Protection Act (S. 22), introduced by Senator John Ensign (R-NV), and the Healthy Mothers and Healthy Babies Access Act (S. 23), introduced by Senator Rick Santorum (R-PA), were considered as part Senate Republicans' “Health Week” campaign for priority health initiatives.

The ultimate outcome was expected; although medical liability reform has been approved by the House of Representatives many times, it has never cleared the Senate. Further, while the issue is a priority for Republicans and President Bush, medical liability reform bills have met with stiff opposition from the plaintiffs' trial bar and its congressional allies.

Among the reforms in S. 22, was a limit on noneconomic damages of $250,000 per defendant up to a total of $750,000. The motion to invoke cloture (and therefore avoid a filibuster) for S. 22 failed, 48-42. The vote on S. 23, a narrower bill that applied specifically to the services of obstetrician-gynecologists, was 49-44. The protections in both bills applied only to health care providers and not to those who pay for health services such as employers, health plans and insurers.

Also on May 9, the Senate voted 96-2 to allow debate on the Health Insurance Marketplace Modernization and Affordability Act (S. 1955), the health insurance reform legislation developed by Senate Health, Education, Labor and Pensions (HELP) Committee Chairman Mike Enzi (R-WY). S. 1955 allows small employers (and larger

employers, if they also choose to participate) to pool together to purchase insured health coverage under rules that would largely preempt state mandates but still subject the arrangements to oversight by State insurance regulators. Association health plan legislation – like liability reform – has passed the House of Representatives numerous times but never in the Senate, and the outlook for the legislation in the Senate is uncertain. The Enzi measure is facing strong opposition and numerous amendments from opponents of the legislation who assert that it would weaken state protections for those enrolled in the small business health plans and drive up health care costs for those who obtain health coverage outside of these arrangements.

Cantor Introduces Health Savings Legislation with Important HSA Provisions

On May 3, the Chief Deputy Whip of the U.S. House of Representatives, Rep. Eric Cantor (R-VA) introduced the Tax Free Health Savings Act (H.R. 5262), which aims to "make Health Savings Accounts (HSAs) an even more affordable and attractive health coverage option." The American Benefits Council had applauded Rep. Cantor for the inclusion of several provisions that have been proposed to improve HSAs such as:

- Permitting contributions to HSAs by employers and employees up to the maximum out-of-pocket limit for an individual’s high deductible health care plan.
- Allowing coordination of HSAs with flexible spending arrangements (FSAs) and health reimbursement arrangements (HRAs). By combining these other health plan options with a health savings account, new plan designs can be developed which allow employees to take greater control of their health care spending decisions.

The legislation also allows employers to make higher contributions to the HSAs of employees who are expected to have higher than average health care costs because of their chronic health care conditions, and improves the tax benefits for those who purchase HSA-compatible health care coverage on their own in the individual insurance marketplace.

H.R. 5262 was introduced in advance of the House of Representatives "Health Week," which ran from June 19 through June 23, and focused on the Administration's agenda or other priority health initiatives introduced by House Republican leaders. Representative Cantor is a member of the House Ways and Means Committee, which has jurisdiction over HSA legislation.

Federal Government Revises Projections for Social Security, Medicare; Bush Administration Uses Occasion to Push for Pension Reform

As has been widely reported, on May 1 the boards of trustees for Social Security and Medicare announced updated projections for the two troubled entitlement programs.

The Social Security Trustees Report projects that the program's trust funds will be exhausted in 2040, one year earlier than last year’s projection. The report explains that the program's unfunded obligation is higher than last year’s report largely because of the passage of a year and small revisions to several key assumptions including a lower assumed real interest rate.

Likewise, the Medicare Trustees Report estimates that Medicare's Hospital Insurance (HI) Trust Fund will be exhausted in 2018, two years earlier than estimated in last year's report, resulting from slightly higher costs in 2005 than previously estimated and some upward revisions in the short-range assumptions about utilization of HI services.

In his 2006 State of the Union Address, President Bush called for a bipartisan commission to study the retirement of the baby boom generation and its expected effects on entitlement programs, but such a commission has not yet been named. The President convened a blue-ribbon panel early in his first term and devoted much of his 2005 legislative agenda to Social Security reform, but no legislative proposals were ever formally developed and there does not appear to be enough time or appetite in Congress to address the issue before the 2006 elections.

In response to the release of the trustees' reports, U.S. Secretary of Labor Elaine L. Chao took the opportunity to promote the comprehensive pension reform bill currently pending in a congressional conference committee. "What we continue to see is a looming fiscal crisis facing these two programs," Chao said. "As the Baby Boomers begin to retire, our retirement system is facing increasing strain. In addition to the challenges facing Social Security, our private sector defined benefit pension system is underfunded … Congress must act quickly to pass strong pension reform legislation based on the President's proposal that will ensure America's workers, retirees and their families receive the benefits they have earned."

RECENT JUDICIAL ACTIVITY

Unanimous U.S. Supreme Court Decision Affirms Health Plan's Right to Reimbursement

On May 15, the U.S. Supreme Court handed down a unanimous decision in Sereboff v. Mid Atlantic Medical Services, Inc. (MAMSI), clarifying that plan terms may be enforced when they require a plan participant, who is injured by the act or omission of a third party, to reimburse the plan for amounts the plan has paid on the participant's behalf if the participant recovers for those injuries from the third party. Various business and health plan groups joined together on an amicus (friend of the court) brief in support of the plan's right to obtain reimbursement in these circumstances.

According to the facts of the case, the Sereboffs were involved in an automobile accident and suffered injuries for which MAMSI paid medical expenses. After the Sereboffs settled a lawsuit against third parties for the accident, the plan sought to collect the payments it had paid for their medical expense. The Sereboffs challenged MAMSI's right to recovery and the amounts were set aside in an investment account pending the outcome of the challenge. The U.S. Court of Appeals for the Fourth Circuit ultimately ruled in Mid Atlantic's favor and ordered the funds to be paid to the plan. The appeals court decision also noted that the Courts of Appeals in other jurisdictions were divided on the question of whether ERISA 502(a)(3) – which Mid Atlantic relied upon as the legal basis for its right to reimbursement – permits recoveries in these circumstances. The U.S. Supreme Court's decision resolves this split among the federal circuits by clarifying that plan terms may be enforced when they properly establish the plan's right to be

reimbursed in such circumstances and where the funds in question are identifiable as part of a tort settlement or similar action.

The Supreme Court's decision, authored by Chief Justice John Roberts, provides important clarity regarding the long standing practice of ERISA plans to seek reimbursement when participants have obtained third party recoveries for injuries and the plan has made payments on the participant’s behalf for medical expenses.