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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 LEGISLATIVE ACTIVITY

Senate Adopts Resolution Promoting Personal Retirement Savings

As part of the debate on minimum wage legislation (H.R. 2), the Senate approved a non-binding resolution concerning the nation's low personal savings rate and called for policies that would encourage retirement savings.

The resolution was sponsored by Senator Jeff Sessions, who used the opportunity to promote his forthcoming retirement savings legislation. Sessions is seeking to create "Portable, Lifelong Universal Savings (PLUS) Accounts," which would be funded with one percent of every employee's paycheck before taxes, plus a one percent matching contribution from their employer. The contributions would be invested in a national 401(k)-type system. The proposal would also establish an account for every newborn U.S. citizen, beginning in 2008, immediately endowed with $1,000.

Legislative Language Approving Limits on Executive Compensation Proposal Now Available

Statutory language is now available for the Small Business and Work Opportunity Tax Act of 2007, a collection of small business tax incentives including two revenue-raising provisions that would severely limit nonqualified deferred compensation for executives. The provisions were approved by the Senate Finance Committee on January 17. The provisions would:

- Amend Internal Revenue Code Section 409A to impose a dollar cap on the annual accrual of nonqualified deferred compensation ("NQDC") that is the lesser of $1 million or the individual's average annual compensation determined over five years. Failure to satisfy the cap would trigger ordinary income tax plus the 20-percent additional tax under Code Section 409A.

- Amend Code Section 162(m) ("million dollar deduction" limit) to treat any former employees (and their beneficiaries) as continuing to be covered by Code Section 162(m) limits in the future (e.g., after termination of employment).

These provisions raise significant concerns for deferred compensation arrangements. Types of plans that are defined as NQDC plans under Code Section 409A – such as excess benefit savings and retirement plans – would be much less attractive for executives in comparison to equity arrangements and long-term incentive plans not subject to Code Section 409A which can be easily designed into one of the regulatory exceptions to Code Section 409A. Numerous technical questions are raised by these provisions, including questions about valuation, which is an area in which the IRS and Treasury have yet to provide any detailed regulatory rules.

A Joint Tax Committee description of the revenue raising provisions (with the relevant section beginning on Page 25) and a revenue estimate of the full legislation are available on the American Benefits Council's ("Council") Web site.

The Senate is expected to pair these small business tax breaks with legislation to increase the minimum wage, although the House of Representatives Ways and Means Committee Chairman Charles Rangel has said he does not want any tax provisions added to the House minimum wage bill.

White House Administration Provides Additional Details on Taxation of Health Benefits Proposal

The White House has provided additional details on the Administration's proposal, which was first unveiled during the President's January 23 State of the Union address, to provide a standard deduction for health insurance coverage and subject to individual income taxation and payroll tax all employer-sponsored health insurance provided above the standard deduction limits. In addition, the White House has made available the transcript of an extensive press briefing during which questions on the new health proposal were addressed.

The key features of the Administration's tax proposal for health benefits are:

- Families with health insurance would pay no income or payroll taxes on the first $15,000 of compensation and individuals with self-only coverage would pay no income or payroll taxes on the first $7,500 of compensation. These standard deduction amounts would apply to health coverage obtained in both the individual insurance marketplace and under employer-sponsored plans.

- Taxpayers with employer-sponsored health coverage would be subject to income and payroll taxes on the cost of any health insurance coverage above the standard deduction limits.

- Taxpayers with employer-sponsored coverage would be required to include the total premium cost of health coverage (both the employer and employee share) in their earnings for tax purposes.

- The total premium for self-insured employer plans would be determined based on the methodology for determining premiums for COBRA coverage.

- Employers would also be required to pay the employer share of payroll taxes on the cost of health insurance above the standard deduction limits.

- Employers would continue to be able to take a full deduction for their health insurance expenses, including for any additional payroll tax expense resulting from the payment of the employer share of FICA tax on the cost of health insurance above the standard deduction limits.

- Taxpayers whose health insurance costs less than $15,000 for family coverage or $7,500 for self-only coverage would still be able to claim the entire standard deduction amount. In addition, the deduction would be determined on an above-the-line basis and would only be available up to the extent of taxable income (i.e., would not be "refundable").

- The standard deduction amounts would not be phased out for higher earner taxpayers.

- Taxpayers would be required to obtain at least catastrophic health coverage in order to claim the standard deduction for tax purposes. Catastrophic coverage would be broadly defined in order to provide flexibility in the marketplace to offer such coverage and Administration officials have stated that details on the definition of catastrophic coverage will be provided at a later time.

- Employees would no longer be permitted to make pre-tax payment of health insurance coverage and qualified health expenses under Code Section 125 cafeteria plans and medical flexible spending arrangements (FSAs) would also be eliminated.

- The standard deduction amounts would be indexed in the future to the consumer price index (CPI), and not medical costs which tend to increase at a higher rate than the CPI.

- Current law rules for health savings accounts (HSAs) would not be altered and employer contributions to HSA accounts would continue to not be considered taxable income to an employee.

Administration officials contend that this proposal will create a downward pressure on health insurance premiums and increase demand in the marketplace for lower cost coverage, including high deductible health plan (HDHP) options.

The Administration has further stated that its proposal is expected to result in lower taxes for 80 percent of those with health insurance. However, the document also states that the remaining 20 percent "with more generous policies will have the option to adjust their compensation to have lower premiums and higher wages to offset the tax change," though it is not yet clear how a shift to "higher wages" would result in lower taxes for an employee under the new proposal.

The President's tax proposals for health care may have been influenced by recent state health reform efforts in California and Massachusetts, both of which call for all individuals to obtain health insurance. If enacted, the new federal standard deductions would likely be mirrored under state tax laws, easing the burden further for those who purchase health insurance on their own, including in states that adopt similar "individual responsibility" mandates.

"As we reform the Federal tax code," according to the White House, "we will also support the innovative measures that States are taking to address the problem of the uninsured."

Medicare Prescription Drug Issue Discussed in Senate Finance Committee, House

On January 12, 2007 the House of Representatives approved the Medicare Prescription Drug Price Negotiation Act (H.R. 4), which would repeal the "noninterference" provision of the Medicare Modernization Act (MMA) and would require government negotiation with drug companies for those enrolled in the Medicare Part D program. Several commentators who do not support requiring the government to negotiate with drug companies have noted that Medicare's current approach, which relies on vigorous competition in the marketplace, has resulted in more covered beneficiaries and lower premiums than had been expected when the legislation creating Medicare Part D was enacted.

Recent studies by the Congressional Budget Office and the U.S. Government Accountability Office (GAO) have both stated that government negotiations on Medicare drug prices will not save money. In addition, a statement released by the Centers for Medicare and Medicaid Services said that independent actuaries at the agency have also concluded that negotiations by the HHS secretary would not lead to savings.

The House vote followed a Senate Finance Committee hearing on January 11 in which the panel discussed Prescription Drug Pricing and Negotiation: An Overview and Economic Perspectives for the Medicare Prescription Drug Benefit.

The Senate Finance Committee is expected to hold further hearings to explore the options and consequences of possible changes in the government's involvement in drug pricing before taking any action on the House measure. In addition, the White House has already indicated that the House bill is unacceptable, raising the possibility of a veto by the President if it is subsequently approved by the Senate. We will continue to monitor this issue and will report back on any further developments.

President Signs New Tax Relief Legislation into Law

In late 2006, President Bush signed the Tax Relief and Health Care Act of 2006, the $38 billion tax package passed in the final hours of the lame-duck session of Congress. In his remarks, the President highlighted three of the improvements to HSAs which are included in the new tax bill: the increase in the contribution limits to HSAs starting January 1, 2007, the provision allowing individuals to make a full year HSA contribution regardless of what month they enroll in a HDHP, and the option for individuals to make a one-time, tax-free rollover from an individual retirement account (IRA) to an HSA. "These changes will bring HSAs within the reach of more of our citizens, and ensure that more Americans can get the quality care they deserve," the President said.

A chart summarizing all of the legislation's HSA improvements is available on the Council's Web site. One provision of the new law permits employers to provide participants in a health reimbursement arrangement (HRA) or a FSA a one-time opportunity to transfer funds to an HSA. This provision also sunsets on December 31, 2011.

Many employers may also want to begin communicating to their employees right away about a second provision that permits individuals who are participating in a 2006 FSA with a 2½ month grace period to make contributions to their 2007 HSA without waiting for the close of the FSA grace period. This provision requires participants to either have a zero balance in their FSA as of the end of the plan year (i.e., before the first day of the FSA grace period) or for any FSA balance to have been transferred to an HSA before the end of the plan year.

RECENT REGULATORY ACTIVITY

Treasury, IRS Release Guidance on Explanation of Right to Defer

The Treasury and IRS recently issued distribution guidance under the provisions of the Pension Protection Act (PPA). One area of that guidance that plan sponsors and their consultants may want to analyze is Question and Answer 33 (Q&A 33), especially the safe harbor "requirement" to include information on fees on plan investments for defined contribution plans. Q&A 33 concerns the new PPA requirement that the description of a participant's right to defer a distribution until normal retirement age also include a description of the consequences of failing to defer the distribution.

The IRS has previously issued a model that can be used for the required distribution notice (often referenced as the 402(f) notice) and several aspects of that notice will need to be revised to reflect new PPA requirements, including the new failure to defer

description. Q&A 33 provides a "safe harbor" that can be used to meet the requirement of the description of the consequences of failing to defer. The answer states that the description must be written in a manner reasonably calculated to be understood by the average participant and include the following information:

- For defined benefit plans, a description of how much larger benefits will be if the commencement of distributions is deferred;
- For defined contribution plans, a description indicating the investment options available under the plan (including fees) that will be available if distributions are deferred; and
- A reference to the portion of the summary plan description that contains any special rules that might materially affect a participant's decision to defer.

More Determination Letter Filing Insights

The Treasury and the IRS have published Notice 2007-6 providing interim guidance under the Pension Protection Act's (PPA's) (PL 109-280) provisions on cash balance and other hybrid defined benefit plans. Additionally, information obtained from Treasury and the IRS clarifies the interaction of the reopening of the cash balance determination letter process and the filing of determination letters that cover plan amendments required as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

Under the IRS's new staggered determination letter filing system, established in IRS Revenue Procedure 2005-66, plan sponsors (including sponsors of hybrid plans) generally file for determination letters within staggered cycles that depend on the sponsor's taxpayer identification number. Sponsors with taxpayer identification numbers ending in 1 or 6 will fall in the "A" cycle, with EGTRRA determination letter filings having been subject to a January 31, 2007 deadline. Plan sponsors with taxpayer identification numbers ending in 2 or 7 will fall in the "B" cycle, with EGTRRA determination letter filings due between February 1, 2007 and January 31, 2008.

IRS officials have indicated that hybrid plan sponsors which fall within the "A" cycle needed to file a determination letter application prior to January 31, 2007, in order to preserve the right to make additional plan amendments covered by the current cycle, including plan amendments necessary under EGTRRA. (This is consistent with the IRS' position that plans subject to the moratorium must continue to file new requests by the otherwise applicable deadlines, despite the fact that prior requests were being held.) The IRS indicated the cover letter should have noted the date on which the plan filed a determination letter request that was subject to the moratorium (or the dates of previous filings if more than one is outstanding) so that the IRS can match up the filings. If an "A" cycle determination letter request has already been made, nothing additional is needed.

In addition, the IRS indicated that hybrid plan sponsors that fall in the "B" cycle should consider filing during the first few months of that cycle that began on February 1, 2007. The IRS has indicated that it will process the EGTRRA request and any previously filed determination letter applications that have been subject to the cash balance determination letter moratorium together. These applications (other than applications for plans that did

not satisfy the requirements of Notice 96-8, the Notice that described the old "whipsaw" calculation – and continue to be subject to the moratorium) will be given priority treatment by the IRS. As a result, hybrid plans that file for a new determination letter within their cycle (A or B) will receive a quicker response on the new determination letter request than they otherwise would have if the earlier determination letter had not been subject to the moratorium. The IRS, however, stated that this action would only speed up the process for "B" filers if it is done in the first few months of the "B" cycle. Otherwise, the IRS may have begun processing the earlier determination letter requests, negating the quicker response for the new request.

The Notice indicated significant additional guidance would be provided in 2007 and asked for comments on specific issues to be submitted by April 16, 2007.

SEC Amends Stock Option Reporting

On December 22, the Securities and Exchange Commission (SEC) amended its executive and director compensation disclosure rules to more closely conform to the reporting of stock and option awards as set forth in Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 Share-Based Payment (FAS 123R). The amendment, which is effective upon publication in the Federal Register, was made to the SEC rule adopted on July 26, 2006, which requires enhanced executive compensation disclosure for proxy statements, registration statements, and annual reports filed on or after December 15, 2006 (which are required to include disclosure for fiscal years ending on or after December 15, 2006).

As reported in the SEC press release, the amended rule will require recognition of the costs of the equity awards in the Summary Compensation Table and the Director Compensation Table over the period in which the employee is required to provide service in exchange for the award. The Grants of Plan-Based Awards Table will require disclosure of the grant date fair value of each equity award, computed in accordance with FAS 123R (which will also include disclosure of any option or stock appreciation right that was repriced or otherwise materially modified).

Treasury/IRS Request Comments on PPA Age 62 Distribution Provision

The Treasury and IRS recently published Notice 2007-8, which requests comments by April 16, 2007, on the PPA's new provision allowing in-service distributions from pension plans for participants who have attained age 62. The Notice indicated the Treasury and IRS are considering proposing guidance under the new Code Section 401(a)(36) and are requesting comments on the guidance that should be issued.

The agencies requested specific comments on whether only unsubsidized benefits should be permitted to be distributed under the new Code section or whether subsidized benefits should also be permitted to be distributed. If subsidized benefits are allowed to be distributed, the Treasury and IRS request comments on how they should be characterized and provide two possible examples (but ask for other characterizations):

- the subsidized benefits would be treated as a subsidized early retirement benefit despite the fact that the participant is still working; or
- the subsidized benefits would not be treated as a subsidized early retirement benefit but would be treated as part of the participant's accrued benefit.

The Treasury and IRS also request comments on whether final regulations permitting in-service distributions under a bona fide phased retirement program should be issued in light of the ability of plans to permit in-service distributions after age 62.

Organizations Provide DOL with Defined Contribution Fee Disclosure Glossary and Introductory Q&A

Various trade associations recently submitted additional materials to the Department of Labor (DOL) concerning fee disclosure between defined contribution plan fiduciaries and service providers. These documents included an introductory question and answer document and a glossary of related terms intended to be used with a fee and expense reference tool with service- and fee-related data elements submitted to the DOL on July 31, 2006. Participating organizations included the American Bankers Association, the American Benefits Council, the American Council of Life Insurers, the Investment Company Institute, and the Securities Industry and Financial Markets Association (SIFMA).

The Q&A and glossary were developed in response to requests made during meetings this fall with DOL officials after the organizations provided the original materials. These documents offered input for the future formulation of ERISA Section 408(b)(2) guidance related to fee disclosure between defined contribution plan fiduciaries and service providers. The full package is intended to assist defined contribution service providers and plan sponsors when they discuss and/or contract for services provided to the plan.

Bipartisan Group of House Members Urge DOL to Broaden Default Investment Options under PPA Safe Harbor

In a letter dated December 19, 2006, a bipartisan group of 18 members of the House of Representatives urged the DOL to expand the safe harbor under its proposed regulations on defined contribution plan default investment options. "It is critical that there be a broad range of safe harbor default investments available," notes the letter. "If the list is too restrictive, some employers will decide that nothing on the list is suitable for their employees. That will mean, in turn, that such employers might be less likely to adopt automatic enrollment arrangements. And more importantly, many employees will not be placed in the default investment best suited to their circumstances. These are not the results that Congress wanted."

While the proposed regulations state that other investment vehicles may be prudent defaults for those automatically enrolled, it identifies three as falling under a safe harbor: balanced funds, life cycle funds, and managed account options. The bipartisan letter encourages a more expansive list including stable value products, managed accounts not requiring the use of investment managers, and combination options of managed accounts and annuity contracts with liquidity features.

Additionally, the House members wrote that expanding the investment option safe harbor would also facilitate the clarification between the PPA (PL 109-280) and state withholding laws. The PPA preempts state withholding laws for participants in automatic enrollment plans if the plan complies with the DOL default investment regulations. The broadest possible safe harbor would encourage the largest number of plans to be formed in the most states, the letter stated. Further, the DOL was asked to clarify that this preemption also applies to "reasonable prudent default investment

options" already chosen by companies so that existing automatic enrollment plans can be accorded safe harbor protection.

Final HIPAA Non Discrimination and Wellness Program Regulations Released
On December 12, the DOL, the Department of Health and Human Services (HHS), and the IRS jointly issued final regulations governing the nondiscrimination provisions of the Health Insurance Portability and Accountability Act (HIPAA). These provisions prohibit discrimination in group health coverage based on a health factor of a participant or beneficiary. The final regulations, which also include requirements for wellness programs, become effective on February 12, 2007, and apply to plan years beginning on or after July 1, 2007.

Although the final regulations generally adopt the requirements of the interim HIPAA rules or the proposed rules on wellness programs released in January 2001, they do include some important changes and clarifications. The final regulations make clear that:

- Compliance with the HIPAA nondiscrimination rules is not determinative of compliance with other federal laws, such as the Americans with Disabilities Act (ADA) or state laws;
- Carryover of unused HRA amounts do not violate the HIPAA nondiscrimination rules; and
- Benefits may not be denied for injuries resulting from a medical condition, even if the medical condition was not diagnosed before the injury occurred.

The final regulations on wellness programs establish the maximum amount of an award under a wellness program may not exceed 20% of the cost of coverage. The wellness program final regulations also clarify some ambiguities in the proposed rules, make some changes in terminology (eliminates reference to "bona fide" in connection with wellness programs) and organization, and add a description of wellness programs that are not required to satisfy additional standards in order to comply with nondiscrimination programs.

DOL Provides Interim Benefit Statement Guidance
In late 2006, DOL and the Employee Benefits Security Administration (EBSA), released Field Assistance Bulletin (FAB) 2006-03 providing interim guidance on the PPA's new benefit statement requirements. The EBSA indicates that plan administrators should comply with the provisions of FAB 2006-03 pending issuance of regulations or other guidance. Effective for plan years beginning after December 31, 2006, the PPA requires that quarterly benefit statements be provided to participants in defined contribution plans that permit participant-directed investments. Participants in other defined contribution plans are required to receive annual benefit statements. Participants in defined benefit plans are required either to receive benefits statements once every three years or an annual notice that they can request a benefit statement.

Until further guidance is issued, EBSA indicates that plan administrators must make a "good faith" effort to comply with the new requirements and that FAB 2006-03 provides EBSA's views as to what constitutes good faith compliance with some of the

requirements. EBSA's temporary guidance contains several provisions in order to avoid confusion and ease plan administration. Some of the key provisions include:

- Good faith compliance does not preclude the use of multiple documents or sources for benefit statement information provided that participants and beneficiaries have been furnished a notice that explains how and when the required information will be furnished or made available to them. The notice can be furnished in any manner that the statement could be furnished under FAB 2006-03 (see second bullet point below) and must be furnished in advance of the date on which the plan is required to provide the first benefit statement under the new requirements.

- Plan administrators wanting to use electronic media to provide benefit statements can use either the DOL's method (29 C.F.R. Section 2520.104b-1(c)) or the Treasury and IRS's method (26 C.F.R. Section 1.401(a)-21), pending the DOL's further review of its previously issued regulation and issuance of new guidance.

- If the benefit statement information is continuously available on one or more secure websites, EBSA will view that as good faith compliance if participants and beneficiaries are provided a notice that explains the availability and how it can be accessed, provided the notice offers a paper version of the statement (upon request, free of charge). The notice must be provided in advance of the date on which the plan is first required to furnish the benefit statement and annually thereafter.

- Furnishing the benefit statement information not later than 45 days following the end of the period (calendar quarter or calendar year) will constitute good faith compliance.

- The first pension benefit statement for defined benefit plans under the new requirements will be due for the 2009 plan year. If a plan elects to provide the alternative notice, the first required notification must be furnished not later than December 31, 2007.

- A plan that does not permit participant-directed investment that has a loan feature will not be subject to the quarterly benefit statement requirement (the loan feature, by itself, does not constitute participant-directed investment).

- In the absence of guidance to the contrary, benefit statements are only required to provide limitations or restrictions on the participant's right to direct investments that are imposed by the plan, not those imposed by investment funds, other investment vehicles, or by state or federal securities laws.

- FAB 2006-03 contains sample language for the 20 percent diversification warning that uses language cautioning participants and beneficiaries about investing more than 20 percent of their retirement savings in "any one company or industry." This sample language can be used in benefit statements to meet the statutory requirement.

FAB 2006-03 also clarified an issue that had concerned many plan sponsors that have employer stock in their plans where participants had the right to diversify out of the stock prior to enactment of the PPA (rights at least equal to those diversification rights conferred under the PPA). FAB 2006-03 indicates that for those plans, complying with the benefit statement requirements will constitute appropriate notice and no separate diversification notice will be required. However, plans that, prior to January 1, 2007, had more diversification restrictions than are permitted under the PPA, must provide the separate diversification notice as soon as possible following January 1, 2007.

RECENT JUDICIAL ACTIVITY

Fourth Circuit Affirms Appeal Arguments in Challenge to Maryland's "Fair-Share" Act

In a 2-1 decision issued on January 17, 2007, the U.S. Court of Appeals for the Fourth Circuit affirmed a lower court ruling that ERISA preempts Maryland's "Fair Share Act," which would require employers with 10,000 or more employees to spend at least 8 percent of total payroll in the state on health care costs. Under the state law, an employer who did not satisfy the 8 percent mandate would be required to pay the difference to the state. The legislation also imposed annual reporting requirements. Although only one employer, Wal-Mart, was the direct target of the spending requirement, the state law created a potential model for other states and localities. The Retail Industry Leaders Association (RILA) challenged the Act in 2006, arguing that it was preempted by ERISA.

The appeals court held that because the Maryland law effectively requires employers in Maryland to restructure their health insurance plans, the state law conflicts with ERISA's goal of permitting uniform nationwide administration of employee benefit plans. According to the appeals court, "If permitted to stand, these laws would force Wal-Mart to tailor its healthcare benefit plans to each specific state, and even specific cities and counties. This is precisely the regulatory balkanization that Congress sought to avoid by enacting ERISA's preemption provision." A dissenting opinion argued that the law was not preempted because the Maryland law offers a compliance option (payment to a state fund) that does not require an employer to maintain an ERISA plan.

New Developments in Cash Balance Litigation

On January 16, the U.S. Supreme Court officially declined to hear an appeal of the landmark Cooper, et al v. IBM case regarding cash balance pension plans. This action upholds the U.S. Seventh Circuit Court of Appeals ruling that IBM did not discriminate against older workers during the company's conversion from a traditional defined benefit plan to a cash balance plan, stating that "treating the time value of money as a form of discrimination is not sensible."

On a related matter, the class-action case of Citigroup Pension Plan ERISA Litigation in the U.S. Second Circuit Court of Appeals addressed whether the administrator of a cash balance plan failed to satisfy advance notice requirements under Section 204(h) of ERISA when making a purely technical amendment to the plan. If the suit is affirmed, the district court's decision would call into question the efficacy of amendments to numerous traditional defined benefit pension plans and a huge number of cash balance and other defined benefit pension plans.

More 401(k) Fee Lawsuits Filed; Service Providers Are Defendants

Plaintiffs' law firms have continued to file lawsuits over fee arrangements in 401(k) plans, generally targeting revenue sharing arrangements. Of note, some service providers have been named in recent suits. The lawsuits basically claim that the service providers are fiduciaries and that fees charged were unreasonable and/or not properly disclosed.

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