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RECENT LEGISLATIVE ACTIVITY

House Passes Ledbetter Pay Discrimination Bill

The House of Representatives recently passed the Ledbetter Fair Pay Act (H.R. 2831) by a vote of 215-187. The bill, was introduced by Education and Labor Chairman George Miller (D-CA) in response to the recent U.S. Supreme Court decision in Ledbetter v. Goodyear Tire & Rubber Co. Inc., and allows employees to file a claim for discrimination within 180 days of receiving any paycheck they believe has been

diminished as a result of discrimination, even if the discriminatory act took place decades ago. This essentially creates a renewable statute of limitations for compensation discrimination claims. By doing so, H.R. 2831 could have potentially significant implications for retirement plans.

A companion bill, the Fair Pay Restoration Act (S. 1843), was introduced in the Senate on July 20, and the Senate Health, Education, Labor and Pensions Committee will likely hold a hearing on the topic after the August recess. Republicans have already voiced their strong opposition to the bill.

Miller Introduces 401(k) Plan Fee Disclosure Bill

As expected, House of Representatives Education and Labor Committee Chairman George Miller (D-CA) recently introduced legislation to address "hidden fees and conflicts of interest" in 401(k) retirement plans. According to an official summary released by Miller's office, the 401(k) Fair Disclosure for Retirement Security Act (H.R. 3185) would impose new requirements on the part of plan sponsors and service providers and step up government oversight of disclosures. Specifically, the bill would:

- Require plan administrators to provide a benefits statement annually that lists the fees assessed on a participant's individual account during the plan year, broken down by individual investments;
- Require plan administrators to provide an annual notice identifying the name of each available investment option along with its risk level, investment objective, historical returns and fee menu;
- Require "401(k)-style plans" to include at least one lower-cost index fund in its investment line-up;
- Require plan administrators to specify where plan participants can obtain additional plan and investment information;
- Require service providers to disclose to the plan sponsor all services and fees that the plan will pay — including sales commissions and estimated trading costs, start-up costs, investment advice and management fees, administration, legal compliance, trusteeship and recordkeeping fees, termination or surrender charges and other costs — and make that information available to participants on request and on the company's Intranet site, where applicable;
- Require service providers to outline any financial or other conflicts of interest to plan sponsors that service providers may have; and
- Require the U.S. Department of Labor (DOL) to review compliance with these requirements every year, with representative sampling, and refer violations to the Securities and Exchange Commission (SEC) and other enforcement agencies.

The bill would also create a 12-person advisory council in which six of the members would be appointed by the president, three members would be appointed by the chairman of the Education and Labor Committee and three members would be appointed by the chairman of the Senate Health, Education, Labor and Pensions Committee (HELP).

The Education and Labor Committee is expected to hold a hearing on the bill in the fall. In addition, the House Ways and Means committee plans to hold two related hearings on fee disclosure in September and other congressional members have expressed interest in introducing alternative legislation.

Education and Labor Committee Rejects Senate Compromise, Passes House Mental Health Parity Bill

The House of Representatives Education and Labor Committee voted to approve the Chairman's version of the Paul Wellstone Mental Health and Addiction Equity Act (H.R. 1424) by a vote of 33-9 in mid-July. Prior to a final vote, the Committee rejected an amendment in the nature of a substitute offered by Representative John Kline (R-MN) by a largely party-line vote of 16-27. Kline's substitute amendment would have replaced the text of H.R. 1424 with the text of the Mental Health Parity Act (S. 558), which was approved by a strong bipartisan vote of 18-3 by the Senate Committee on Health, Education, Labor, and Pensions in February 2007. S. 558, sponsored by Senators Edward Kennedy (D-MA), Mike Enzi (R-WY) and Pete Domenici (R-NM), was developed with the participation of a broad range of employer organizations, insurers and mental health advocates. Unlike H.R. 1424, S. 558 gives employers the flexibility to design the mental health benefits covered by their plans; makes clear that the medical management of these important benefits may not be prohibited by state or federal law; and ensures uniformity between federal and state parity requirements, while maintaining states' current authority to regulate insurance.

The Chairman's version of the legislation modified H.R. 1424 in three important aspects, namely by:

- Including language intended to protect the medical management of mental health benefits, though the provision in the Miller substitute does not provide the extensive protection of those activities as would a comparable provision in S. 558;

- Including a clarification that health plans and employers are not required to cover mental health conditions that are not medically necessary, though the Miller substitute also continues to mandate that plans cover all mental health conditions listed in the DSM-IV manual of behavioral health conditions; and

- Clarifying that states may enact their own mental health parity or mandated benefit laws applicable only to insured group health plans (and not to self-insured health plans) as long as the state standards are greater than the federal standards. Importantly, the provision permitting greater state law standards to apply to insured health plans also permits states to enact greater "rights and remedies" than those in ERISA; those greater state law remedies would also apply in future legal actions related to the enforcement of the new mental health parity requirements. ***This would be a major departure from current law where ERISA's remedies are exclusive for any legal actions related to health plan coverage, regardless of whether the participant is in a fully insured or self-insured plan and for all categories of benefits to which the participant is entitled***.

The measure still requires consideration by the Energy and Commerce Committee as well as the House Ways and Means Committee.

Ways and Means Reviews Social Security Number Privacy Legislation

The House of Representatives Ways and Means Committee recently held a mark-up session that resulted in the passage of the Social Security Number Privacy and Identity Theft Prevention Act of 2007 (H.R. 3046), which would restrict the use of Social Security numbers (SSNs) as individual identifiers by government and business. The legislation did include some exceptions for legitimate use of SSNs, including "the administration of, or provision of benefits under, an employee benefit plan." An exception for the administration of employee benefit plans in previous versions of this proposal had been actively pursued by plan sponsors.

Tax Rules on Expatriation

The House of Representatives Ways and Means Committee also recently approved the Tax Collection Responsibility Act (H.R. 3056), which includes revisions to the tax rules on expatriation and would impose a new withholding requirement on distributions from tax-qualified plans and nonqualified plans. The new withholding rule would apply to distributions paid to persons who have relinquished their U.S. citizenship (or "expatriates") and to persons who were long-term U.S. residents (e.g., "green card" holders) but who gave up their residency status, such as a foreign national who retires to his or her home country. In general, H.R. 3056 would require U.S. employers and pension plans to withhold a tax equal to 30 percent of the taxable distribution when paid.

The provisions in H.R. 3056 contrast with previous expatriation tax proposals. A Senate proposal that was stripped from the minimum wage bill passed by Congress earlier this year would have expanded the tax "toll charge" imposed on expatriates and former long-term U.S. residents. The property covered by the toll charge would have included the present value of the individual's tax-qualified retirement benefits (e.g., an employer pension plan or 401(k)), notwithstanding that these benefits may not have been currently distributed to the individual at the time that the toll charge is owed.

Compared to the earlier Senate proposal, the House version would impose a potentially higher tax rate on pension distributions (30 percent withholding). Some plan sponsors have raised concerns about the inclusion of retirement benefits under these rules, the potential for double taxation of pension benefits paid to foreign nationals, and the overall burden that is placed on U.S. employers who recruit employees on a worldwide basis.

Wellness Bill Introduced in Senate

Senators Tom Harkin (D-IA) and Gordon Smith (R-OR) recently introduced the Healthy Workforce Act (S. 1753), which would provide tax incentives to businesses that offer wellness programs aimed at encouraging employees to lead healthier lives and prevent chronic illnesses. An official summary of the bill is available.

"Much of the cost borne by our health care system is from preventable chronic illnesses as a result of poor diet and lack of exercise," Smith said in a press statement. "By encouraging businesses to educate and motivate their employees to take their health seriously, we can take a significant step toward lowering health care costs and keeping our population healthy." The bill's sponsors note that businesses are increasingly bearing the costs of diet-related chronic disease and obesity through employer-provided health care plans and indirectly through higher rates of absenteeism.

Specifically, S. 1753 would provide a tax credit of up to $200 per employee for the first 200 employees and up to $100 per employee thereafter to businesses that provide comprehensive wellness programs, for up to 10 years. To be eligible for the tax credit, the program must meet at least three of the following four standards:

- Health awareness programs that include education and health risk assessment programs;
- Behavioral change programs that encourage employees to lead a healthy lifestyle through counseling, seminars or on-line programs, including classes on nutrition, stress management, or smoking cessation;
- A supportive environment to encourage employee participation in the workplace wellness programs, which could include offering a meaningful incentive to participating employees, such as a reduction in health insurance premiums; and
- An employee engagement committee, which would tailor the wellness program to the needs of the workforce at a particular company.

RECENT REGULATORY ACTIVITY

IRS Addresses Employer Contributions to Secular Trusts and Issues Technical Corrections for 409A Regulations

The Internal Revenue Service (IRS) has issued additional guidance regarding nonqualified deferred compensation.

The IRS released Revenue Ruling 2007-48 discussing the Federal tax consequences of employer contributions to secular trusts under certain circumstances. The Revenue Ruling addresses:

- *The timing of an employee's income inclusion with respect to an interest in the trust.* The employee must include in income the fair market value of the employee's account as it vests (determined in accordance with Code Section 83), less the employee's "basis" to the extent that amounts have been taken into account in a prior year.
- *The timing of the employer's deduction.* The employer's contributions to the trust are deductible in the tax year in which the employee first includes in income amounts that are attributable to the employer's contributions, provided that the employer maintains separate bookkeeping accounts for amounts allocable to each employee. Thus, the delay in the employee's income inclusion on account of a vesting schedule also delays the employer's deduction consistent with the principles of Code Section 404(a)(5).
- *The taxation of trust income.* Although the trust is designed to pay compensation on behalf of an employer, the trust is not treated as a grantor trust. This holding is consistent with the position in Proposed Treasury Regulation Section 1.671-1(g) and previous private letter rulings. The trust is taxable under the rules in Code Section 641 and may deduct from its income the amounts required to be distributed to beneficiaries pursuant to Code Section 661.

- *The application of FICA and income tax withholding*. If contributions are vested at the time the contributions are made to the trust, the contributions are treated as wages for FICA purposes and the employer is responsible for the FICA withholding. If a contribution is made that is not vested, the amount of FICA wages is, instead, the value of the vested account in the trust at the time of vesting (less any contributions previously taken into account for FICA purposes), and the trust, not the employer, is responsible for the FICA withholding. A separate FICA wage base applies for wages that the trust must report. With respect to income tax withholding, wages are treated as paid on the last day of the taxable year in which the employee vests in an amount equal to the vested account balance (including any amounts distributed during the year but less any "basis" in the account taxed in a prior year). The trust, not the employer, is responsible for income tax withholding.

The holdings and legal analysis in the Revenue Ruling generally conform to the positions that the IRS has taken in other guidance and in private letter rulings. Nonetheless, the Revenue Ruling is of interest to the extent that it confirms the prior IRS views. It also confirms that secular trusts and similar property transfers, when properly structured, may not be deemed to be deferred compensation within the meaning of Code section 409A.

In separate guidance, the IRS issued technical corrections to the final regulations regarding Code Section 409A. The corrections do not make substantive changes to the final regulations that were originally released on April 10, 2007, but instead make clarifications of the IRS' original intent. Many of the corrections are grammatical and typographical in nature, but the update does include certain specific clarifications of the Code Section 409A rules. For instance, it provides help to taxpayers to understand the "expression of the short-term deferral rule." The update also clarifies permissible payments under certain sections of the Code, including subsections dealing with tax-qualified plans linked to nonqualified deferred compensation plans, and various sections of the regulations relating to the application of Code Section 409A, as well as the effective dates.

DOL Collecting Input on 401(k) Plan Fees

As part of several ongoing projects at DOL, the agency is considering which rules should be adopted or modified to ensure that participants and beneficiaries have the information they need to make informed investment decisions when managing their accounts in participant-directed individual account plans such as 401(k) plans. Responding to the DOL's request for information regarding fee and expense disclosures to plan participants, substantial input has been provided in the form of a joint letter from a broad collection of trade associations. Emphasis was placed on disclosure that is meaningful and useful to participants, rather than overwhelming to them.

The recommendations also address current best practices among employers and service providers; the scope, frequency, methods and costs of disclosure; the different kinds of plan fees and the importance of investment education. Additional feedback was provided by industry experts at a recent hearing held by the DOL Employee Benefits Security Administration's ERISA Advisory Council Working Group on Benefits Statements.

As reported above, legislation on 401(k) plan fee disclosure was recently introduced by House of Representatives Education and Labor Committee Chairman George Miller (D-CA).

Treasury Finalizes Final Treasury 403(b) Regulations with DOL Clarification

The U.S. Treasury Department (Treasury) and IRS have released final regulations (Section 1 | Section 2 | Section 3) that require all Code Section 403(b) arrangements (tax-shelter annuity contracts under Code Section 403(b)) to have written plan documents, but delay the general effective date to the 2009 plan year. Subsequently, the DOL Employee Benefits Security Administration (EBSA) released Field Assistance Bulletin (FAB) 2007-02 clarifying the regulations' effect on the application of Title I of ERISA to 403(b) plans.

The final regulations, like the proposed regulations, require employers to maintain written plan documents that contain information on, among other items, eligibility, benefits, and distributions. However, the final regulations allow other documents, such as insurance policies and custodial account agreements, to be incorporated into the written plan by reference. In addition, the IRS and Treasury intend to publish a model plan document for public school plans.

The new requirement to maintain a written plan document could have significant consequences for private employers who have sought to avoid the application of Title I of the Employee Retirement Income Security Act of 1974 (ERISA) to their 403(b) retirement savings programs. Under prior law, private tax-exempt employers could avoid ERISA application, because the arrangement was not deemed to be a plan established or maintained by the employer, by having minimal employer involvement in the arrangements. Title I requirements are similar to those required for plans sponsored by for-profit private employers and include provisions governing participation and coverage, vesting, benefit accruals, disclosure and distributions.

In another controversial area of the regulation, the IRS and Treasury eased the ban on so-called "90-24" exchanges contained in the proposed regulations. Under prior law, 403(b) plans were permitted to exchange 403(b) contacts relatively freely under Revenue Ruling 90-24. The proposed regulations would have virtually eliminated the ability of plans to exchange 403(b) contracts. The final regulations allow exchange of contracts if (1) the other contract includes distribution restrictions not less stringent than those imposed on the contract being exchanged, and (2) the employer enters into an agreement with the issuer of the other contract under which they will exchange necessary information. The regulations also authorize the IRS to issue guidance allowing exchanges in other cases if the contract has procedures reasonably designed to ensure compliance with 403(b) and other tax provisions.

The final regulations, like the proposed regulations, do not include the IRS Notice 89-23 good faith reasonable standard for satisfying the nondiscrimination requirements for non-governmental plans, and instead require compliance with a specific set of nondiscrimination requirements applicable to qualified plans of for-profit employers under Code Section 401(a). After-tax contributions are not subject to any in-service distribution restrictions. The final regulations also permit designated Roth contributions.

FAB 2007-02 establishes a safe harbor under which a 403(b) plan funded with only employee contributions can avoid ERISA classification. To qualify for the safe harbor, a plan must show that:

- Participation of employees is completely voluntary;
- All rights under the annuity contract or custodial account are enforceable solely by the employee or beneficiary of such employee, or by an authorized representative of such employee or beneficiary;
- The involvement of the employer is limited to certain optional specified activities; and
- The employer receives no direct or indirect consideration or compensation in cash or otherwise other than reasonable reimbursement to cover expenses properly and actually incurred in performing the employer's duties pursuant to the salary reduction agreements. In this latter regard, if an employer, or a person acting in the interest of an employer, receives, for example, other consideration from an annuity contractor, the employer could be deemed to have "established or maintained" a plan.

The FAB also explicitly allows a range of activities "to facilitate the operation of the program" under the safe harbor. The employer may:

- Permit annuity contractors, including agents or brokers who offer annuity contracts or make available custodial accounts, to publicize their products;
- Request information concerning proposed funding media, products, or annuity contractors and compile such information to facilitate review and analysis by the employees;
- Enter into salary reduction agreements and collect annuity or custodial account considerations required by the agreements, remit them to annuity contractors, and maintain records of such collections;
- Hold one or more group annuity contracts in the employer's name covering its employees and exercise rights as representative of its employees under the contract, at least with respect to amendments of the contract; and
- Limit funding media or products available to employees, or annuity contractors who may approach the employees, to a number and selection designed to afford employees a reasonable choice in light of all relevant circumstances.

Treasury Preparing to Address 457 Bona Fide Severance Pay Plans, Substantial Risk of Forfeiture Provision

The Treasury and IRS recently released Notice 2007-62, announcing plans to issue guidance defining bona fide severance pay plans under Section 457(e)(11) and "substantial risk of forfeiture" under Section 457(f)(1)(B). The notice describes the guidance that Treasury anticipates issuing, which in many respects would be similar to the rules in the final 409A regulations issued in April 2007, and requests comments on

the possible impact of this approach. The Notice stated that the future guidance would be prospective and no inference should be made from the anticipated guidance for previous periods. However, pending issuance of further guidance, taxpayers can rely on the definition of bona fide severance pay plan contained in the Notice (along with a portion of the definition of "substantial risk of forfeiture").

The Notice indicates Treasury anticipates issuing guidance that defines a bona fide severance pay plan as not being subject to Section 457 if: "(1) the benefit is payable only upon involuntary severance from employment, (2) the amount payable does not exceed two times the employee's annual rate of pay (taking into account only pay that does not exceed the maximum amount that may be taken into account under a qualified plan pursuant to Section 401(a)(17) for the year in which the employee has a severance from employment), and (3) the plan provides that the payments must be completed by the end of the employee's second taxable year following the year in which the employee separates from service." Exceptions for window programs, collectively bargained separation pay plans, and certain in-kind benefit and reimbursement arrangements are expected to be included in future guidance the notice noted.

The Notice also states that Treasury anticipates issuing guidance adopting the rules relating to "substantial risk of forfeiture" detailed in the final 409A regulations to plans falling under Section 457(f). Section 409A defines a participant's compensation as being at a "substantial risk of forfeiture" if the participant's entitlement to it is conditioned upon his or her performance or the employer's business activities and organizational goals. Notice 2007-62 indicates that Treasury intends to extend the 409A rules to plans subject to Section 457(f) and requests comments on this issue as entities usually sponsoring 457(f) plans (such as state and local governments and some tax-exempt organizations) may not have comparable business activities or organizational goals compared to for-profit organizations.

Finally, compensation deferrals under section 409A do not occur if the plan does not provide for deferred payments or the participant takes "constructive receipt" of a payment on or before the last day of an applicable 2½-month period. Payments under section 457(f) are subject to this short-term deferral rule under section 409A. Treasury asserts, according to Notice 2007-62, that if the definition for substantial risk of forfeiture described above is adopted under future regulation, the substantial risk of forfeiture under section 457(f) could not lapse later than the date of lapse under section 409A. (For example, Treasury wrote that if a participant in an ineligible plan under section 457(f) includes an amount of deferred compensation in his or her gross income after it was no longer subject to a substantial risk of forfeiture under section 457(f), it would also not be subject to section 409A because it would qualify as a short-term deferral.) The right to earnings previously included under section 457(f) would be deferred compensation under section 409A, however, unless they qualified under a separate 409A exclusion.

Comments as to the need and type of transition guidance required by plan sponsors based upon this anticipated rulemaking are being requested. The deadline for comment is October 15, 2007.

Treasury, IRS Continue to Study Pension Backloading Issue

Treasury and IRS officials continue to examine an ongoing problem with the application of backloading rules. In meetings with company and plan sponsor representatives, the agencies requested concrete proposals to address the application of the anti-backloading rules to "greater-of" formulas used in cash balance pension plan conversions.

The backloading rules were designed to prevent avoidance of the vesting rules; under the 133 percent rule, a plan benefit must accrue ratably from year to year. In the context of the recently opened determination letter process for hybrid pension plans, the IRS's interpretation of the backloading rules would preclude the use of the "greater-of" transition in which participants receive the greater of the benefits calculated under the traditional plan formula or benefits calculated under the hybrid formula. This interpretation of the backloading rules as applied to the generous pro-participant approach to conversions could also negatively affect "greater-of" formulas in other contexts (such as traditional plans with a minimum benefit, or plans that provide the greater of the buyer's plan formula or the seller's plan formula immediately following a corporate acquisition).

A number of Treasury officials are still advocating the current position on "greater-of" formulas and have scheduled conferences with plan sponsors prior to issuing negative determination letters. The group letter urges the agencies to suspend those efforts and consider alternatives.

A number of industry trade organizations submitted a letter to the U.S. Treasury Department regarding its official position on the backloading rules, recommending that the IRS permit "greater-of" formulas as long as each formula individually satisfies the anti-backloading rules and allow plan sponsors to elect to apply the 133 percent rule on an accrued-to-date basis. Either approach would avoid penalizing plan sponsors that included "greater-of" formulas in their plans in reliance on long-standing interpretations by the government, not only in the cash balance conversion context but in numerous other settings as well, including collective bargaining and mergers and acquisitions, usually for the sole purpose of protecting employee expectations. The letter also suggests IRS issue an affirmative declaration of a change in its position through a field memorandum or directive recommending that agents reviewing these plans apply the anti-backloading rules using this alternative interpretation.

ERISA Advisory Council Examines Financial Literacy, Revenue Sharing, Benefits Statements

The DOL ERISA Advisory Council recently held a series of hearings to solicit input from government and private industry witnesses on key benefits-related topics. The ERISA Advisory Council is a group of benefits experts established by the DOL to identify and define subject issues, to investigate, to take testimony from witnesses, and to submit a final or interim report of findings and recommendations.

The first hearing, held by the Working Group on Financial Literacy, centered on ideas and programs to improve the knowledge base for plan participants who make their own investment choices. Witnesses fielded questions from the panel on automatic enrollment

programs, phased retirement and public outreach efforts such as the "Save for Retirement Week" resolution that recently passed Congress.

The second hearing was held by the Working Group on Revenue Sharing and Multiemployer Plan Expenses. In this session, Robert J. Doyle, DOL director of regulations and interpretations, testified that DOL guidance on multiemployer plan expenses issued in 2002 provides "a fair degree of flexibility," and new regulations may not be required. Other plan administrator witnesses at the hearing disagreed with this view, however, recommending further guidance on the issue.

The third hearing ERISA Advisory Council Working Group on Participant Benefit Statements, focused on the expanded benefits statement requirements under the Pension Protection Act of 2007 (PPA) and Field Assistance Bulletin 2006-3 issued by DOL in December 2006. Witnesses were asked about usage patterns for Web-based benefit statement services, time pressures faced by large employers and the interaction of multiple information sources in formatting a single statement.

As reported above, the ERISA Advisory Council and the House of Representatives Ways and Means Committee as well as the House Education and Labor Committee are likely to hold hearings in September on revenue sharing and fee disclosure.

IRS Warns Plan Sponsors of Late Applications for Opinion or Advisory Letters
The IRS recently issued Revenue Procedure 2007-49, warning plan sponsors and administrators of the penalties for late application for opinion or advisory letters seeking assurance of the plan's qualified status. The procedure also modifies the streamlined procedure under the Employee Plans Compliance Resolution System (EPCRS), the comprehensive correction program to correct qualification issues. Rev. Proc. 2007-49 amends the previous Rev. Proc. 2006-27, in which the EPCRS program was revised and restated. (The components of EPCRS are the Self-Correction Program ("SCP"), the Voluntary Correction Program ("VCP"), and the Audit Closing Agreement Program ("Audit CAP").

Under this new guidance, late applications for an IRS opinion or advisory letter on master and prototype (M&P) or volume submitter (VS) plans may result in a delay of plan review, which would give the plan sponsor less time to formally implement its plan as submitted. "As a result," the IRS warned, "an employer adopting such a plan may have less than two years to adopt the late submitted pre-approved plan." This warning applies to all late submissions for opinion or advisory letters made after January 31, 2008.

RECENT JUDICIAL ACTIVITY

Suffolk County 'Fair Share' Law Overturned
The U.S. District Court for the Eastern District of New York recently overturned Suffolk County's "Fair Share for Health Care Act," ruling that the law was preempted by ERISA. The law would have required covered employers, namely large retailers selling groceries, to make "health expenditures" equivalent to not less than $3.00 per hour worked by their employees in Suffolk County. Employers who failed to make the mandatory expenditures were required to make up the shortfall and pay civil penalties to Suffolk County. The law also required employer reporting of certain payroll and health spending information to the

Suffolk County Department of Labor. The court rejected the measure, asserting that it mandated the provision of health benefits and interfered with the uniform administration of ERISA plans nationwide.

The suit had been brought by the Retail Industry Leaders Association, which earlier this year scored a similar victory in the U.S. Court of Appeals for the Fourth Circuit against Maryland's "Fair Share Health Care Fund Act." Employer groups have filed an amicus (friend of the court) brief in the Maryland case, supporting the argument that the law violated ERISA's preemption standard.

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