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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.

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Recently Enacted Legislation

With President's Signature, Treasury Has 60 Days to Release Deferred Compensation Regulations

Following President George Bush's October 22 signing of the American Jobs Creation Act of 2004 (H.R. 4520/S. 1637, deferred compensation provisions beginning on page 510) the Internal Revenue Service now has 60 days to issue guidance relating to the deferred compensation provisions included in the bill. These provisions were included in the legislation to generate approximately $1 billion in tax revenue.

The new law eliminates the ability of the Internal Revenue Service to impose payroll tax withholding obligations under the Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) when employees exercise

incentive stock options or purchase stock under employee stock purchase plans. An exception is also contained in the legislation to the "maintenance of cost" requirement applicable when an employer makes a transfer of surplus pension assets (under Code Section 420). This will allow employers to more equitably reduce benefits for all employees covered, rather than significantly reduce or eliminate costs for a portion of those covered.

A side-by-side chart comparing the bill's deferred compensation provisions to prior law, prepared for the American Benefits Council by the Benefits Group of Davis and Harman, is available on the American Benefit Council's web site in addition to a summary of the bill and an employer action plan, both prepared for the American Benefits Council by Groom Law Group.

New Definition of "Dependent" Affects Health Plans

On October 4, President Bush signed into law the Working Families Tax Relief Act of 2004 (H.R. 1308), which extends several expiring tax provisions. Notably, the Act significantly changes the definition of "dependent" in Section 152 of the Internal Revenue Code (Code) for many tax purposes and extends the definition to several Code provisions that provide tax benefits to taxpayers with children (e.g., personal exemption for dependents, dependent care credit, earned income credit, etc.) This change is designed to make the definition of dependent more uniform for these various provisions. However, because many other Code sections reference Code Section 152 (including Code Section 105(b), which allows a taxpayer to exclude amounts received from his employer to reimburse him for medical expenses of his dependent), the change in definition has broad implications. This change in definition, which takes effect December 31, 2004, affects health plans and Dependent Care Spending Arrangements (DCSAs) in the following ways:

Health Plans: Under the new age requirement in Section 152, an individual is a qualifying dependent child if the individual has not attained the age of 19 as of the close of the calendar year or is a full-time student who has not attained the age of 24 as of the close of the calendar year. Plans often have a similar limitation, but Code Section 152 has not contained an age limitation in the past. Employers will need to review and possibly revise their health plan definitions for eligible dependents to conform to these new rules; as a practical matter, the new definition will probably need to limit eligibility to age 18 and 23 due to the operation of the “close of the year” language. However, fully-insured plans may have an additional issue. Some state laws require insured plans to provide coverage later than age 19 and 24 for students. In those cases, the plans will

need to continue providing coverage but the coverage will not be available on a tax-advantaged basis.

Dependent Care Spending Arrangements: For the first time, adult dependents as defined in Section 152 will be subject to a gross income limitation ($3,100 for 2004). If the individual makes more than that amount, that person cannot be a dependent. While the technical and conforming amendments eliminate the gross income limitation for non-child dependents for a number of Code sections, including many benefits-related sections, it does still apply to DCSAs. This may create problems for those who use DCSAs to provide day care services for adult dependents, such as their parents. In addition, Code Section 21(b) used to provide that the dependent adult had to spend at least eight hours per day in the taxpayer's home. That section has been amended so that now the dependent must live with the taxpayer for at least half of the tax year.

The change in definition also affects hardship distributions from 401(k) plans and unforeseen emergency distributions from 457 plans (governmental and non-profit organization plans) and deferred compensation plans. WEB expects the Department of Treasury to correct some of these inconsistencies and will be following this issue closely and will provide any updated guidance from the Department of Treasury on these new Internal Revenue Code (Code) provisions in subsequent volumes of ***Benefits Insider.***

Recent Regulations and Technical Updates

DOL Finalizes Automatic Rollover Safe Harbor Regulation

On September 28, the Department of Labor's (DOL) Employee Benefits Security Administration (EBSA) released final regulations providing a safe harbor for fiduciaries of tax-qualified pension plans that must execute a mandatory rollover to an individual retirement arrangement (IRA). The final regulations eliminated a provision in the proposed regulations that would have limited fees and expenses to the IRA's earnings.

Under provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), plan administrators are required to transfer mandatory distributions of amounts between $1,000 and $5,000 to an IRA, in the absence of an affirmative election by the plan participant. However, EGTRRA also provided that this mandatory rollover rule would not become effective until the DOL prescribed a regulation supplying a safe harbor to protect plan fiduciaries when they select an institution to provide and select the investments for the IRA.

Under the proposed regulations, issued in March of this year, a retirement plan fiduciary had to meet six requirements in order to receive the protection offered

by the safe harbor. One of these requirements related to the fees and expenses that could be assessed against an IRA. Under that rule, fees and expenses (*e.g.*, establishment charges, maintenance fees, investment expenses, termination costs, and surrender charges) had to satisfy two conditions. First, they could not exceed the fees and expenses charged by the provider for comparable IRAs that are not subject to the mandatory rollover rule. Second, and of great concern to plan providers, with the exception of charges assessed for the establishment of the plan, fees and expenses could not exceed the income earned by the IRA. This latter condition elicited a number of comments objecting to such a limitation.

The final regulations remove the limit on fees and expenses to income earned by the IRA. In that regard, the preamble to the final regulation states "the Department is persuaded that a comparability standard, without further limit, is sufficient to protect individual retirement plans from being assessed unreasonable fees, while avoiding the imposition of financial disincentives for individual retirement plan providers to offer plans for mandatory rollover distributions under the safe harbor."

Other significant changes or comments in the final regulations include:

- The safe harbor rule can be applied (on a voluntary basis) to mandatory distributions of $1,000 or less.
- Fiduciaries must enter into a written agreement with one or more individual retirement plan providers that specifically addresses, among other things, the investment of rolled-over funds and the fees and expenses attendant to the IRA. The terms of the agreement must be enforceable by the participant.

Although some who commented on the proposed regulations requested that the DOL address the issue of missing participants, the DOL declined, indicating that these issues are beyond the scope of these regulations.

The DOL also noted that nothing in the regulation precludes an IRA provider from applying its own default beneficiary provisions under the terms of the arrangement until the IRA holder makes an affirmative designation under the terms of the IRA. The DOL declined to transfer the plan beneficiary designation to the IRA.

The DOL left several questions to be answered by the Internal Revenue Service including whether the amount of a participant loan would constitute a portion of the present value of the benefit for purposes of the safe harbor. The safe harbor generally cannot be used for distributions in excess of $5,000 unless the distribution would not exceed $5,000 except for monies attributable to rollovers from previous plans.

The DOL also issued a class exemption in connection with the regulation that will permit employers that are financial institutions or affiliated with financial institutions to act as their own IRA provider for their own plan for purposes of the safe harbor rule. The financial institution can use a proprietary product as the initial investment and can receive fees in connection with the establishment or maintenance of the IRA and the initial investment of the mandatory distribution without violating prohibited transaction rules. However, the class exemption only applies if the fees, other than establishment charges, are limited to the income earned by the IRA (the exemption maintains the fee limitation originally proposed in the regulations).

Both the final regulation and the class exemption will become effective March 28, 2005. However, plans and service providers can rely on the regulation (for selecting the IRA provider and initial investment), but not the class exemption, prior to the effective date.

SEC to Review 12b-1 Fees and Releases Final Directed Brokerage Rule

The Securities and Exchange Commission (SEC) staff will review a number of alternatives and suggestions relating to 12b-1 fees discussed in approximately 1,650 comment letters received by the SEC in response to a request for comment on the need for further amendments to rule 12b-1. The SEC requested comments on 12b-1 in its proposed rule on directed brokerage finalized and published in the Federal Register on September 9. The SEC received only 33 comment letters on the directed brokerage rule itself.

According to the preamble to the final rule, the SEC did not adopt any further changes to rule 12b-1 but has asked its staff to explore some of the recommendations on 12b-1 contained in the comment letters. One approach to be reviewed would refashion rule 12b-1 to provide that funds deduct distribution-related costs directly from shareholder accounts rather than from fund assets. The preamble noted that commentators also addressed concerns regarding revenue sharing.

IRS Clarifies Instruction for Schedule B of Form 5500

On September 28, the Internal Revenue Service (IRS) issued Announcement 2004-80 that provides additional guidance for plan administrators struggling to provide "average cash balance account data" for cash balance and other hybrid plans in response to a question on Schedule B of form 5500. Line 8c of the 2003 Schedule B requires cash balance and other hybrid plans reporting 1,000 or more active participants to provide "average cash balance account data."

The new instructions indicate that, in general, for each age/service bin, the data should include (1) the number of active participants in the age/service bin, (2) the average compensation of the active participants in the age/service bin, and (3) the average cash balance account of the active participant in the age/service bin,

using $0 for anyone who has no cash balance account-based benefit. The guidance provides a couple of alternative methods of providing the data and indicates that the average balances should include only the cash balance component of a benefit. The announcement replaces the previous instructions in order to clarify and simplify the method for reporting data. If plans have already filed under published instructions prior to the issuance of the announcement, they are not required to file again.

PBGC Issues Technical Update for Underfunding Notices

The Pension Benefit Guaranty Corporation (PBGC) recently issued Technical Update 04-4, providing guidance on determining whether a qualified defined benefit plan is required to notify participants and beneficiaries of the plan's funding status and the limits of PBGC indemnity. Certain underfunded plans are required to provide this notice.

The PBGC guidance includes a Model Participant Notice, as well as a detailed description of the rules governing the requirement to issue a 2004 Participant Notice, and a worksheet to help plan administrators determine whether the notice is necessary.

The guidance also explains how the interest rate changes enacted by the Job Creation and Worker Assistance Act of 2002 and the Pension Funding Equity Act of 2004 can affect the requirement to issue a 2004 Participant Notice or the plan funding information required to be disclosed. The Participant Notice is due two months after the due date (including extensions) for the plan's 2003 5500 (annual report) filing, but due dates that fall on a weekend or Federal holiday are extended to the next business day. For example, if the 2003 5500 filing was due September 15, 2004, the notice must be provided by Monday, November 15.

Litigation Updates

IBM Reaches Agreement with *Cooper* Plaintiffs, Plans Appeal

According to a September 29 news release, IBM has reached an agreement with the plaintiffs in the class-action case of *Cooper et al v. IBM* in the U.S. District Court for the Southern District of Illinois. In July 2003, the court ruled that the IBM cash balance plan violated the age discrimination provisions of ERISA, contrary to the legislative history of ERISA and several other federal court cases.

Under the agreement, the judge will not rule on remedies and IBM retains its right to appeal the prior court decision on the cash balance aspects of the suit to the Seventh Circuit Court of Appeals.

Specifically, the agreement provides that the plaintiffs would be eligible to receive an incremental pension benefit worth approximately $300 million (including plaintiffs' attorney's fees) in exchange for the settlement of certain claims unrelated to the cash balance aspects of the suit. Separately, IBM and the plaintiffs negotiated a stipulated remedy in the event that IBM loses the appeal on the cash balance claims. Under the stipulated remedy, IBM's potential liability for the claims being appealed is capped at $1.4 billion. If IBM prevails on the claims being appealed, there will be no additional liability.

IRS Changes Litigation Position on Pension Assets in Bankruptcy Cases

In September, the Internal Revenue Service (IRS) published a notice indicating that it will change its position in future bankruptcy court filings to exclude the value of the debtor's interest in pension plans from its secured claim. The notice acknowledged that the U.S. Supreme Court had previously ruled that the anti-alienation clause under the Employee Retirement Income Security Act (ERISA) constituted a restriction on transfer enforceable under "applicable nonbankruptcy law" and that, accordingly, the pension plan assets were excluded from the debtor's bankruptcy estate.

Other courts have held that the anti-alienation provision of ERISA was ineffective against federal tax liens and the IRS had been arguing (with mixed success) that its secured claim includes the value of the debtor's interest in a pension plan that was subject to a federal tax lien. The notice indicates that the IRS will no longer make this argument but indicates that the debtor's interest in the pension plan is not extinguished by the bankruptcy proceeding. Therefore, the IRS's lien will continue to exist outside of the bankruptcy proceeding, according to the notice.

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