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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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Articles in this Edition

Recent Regulations

New Final and Proposed HIPAA Portability Regulations Issued

On December 30, the Internal Revenue Service, Department of Labor, and Centers for Medicare and Medicaid Services issued three new sets of Health Insurance Portability and Accountability Act of 1996 (HIPAA) regulations: final regulations for health coverage portability and two sets of proposed portability rules affecting tolling of certain time periods and interaction with Families and Medical Leave Act (FMLA) and requests for information on benefit-specific waiting periods under HIPAA.

The final regulations apply for plan years beginning on or after July 1, 2005. These final rules do not significantly modify the framework established in the April 1997 interim rules. Instead, they implement changes to improve the portability of health coverage while seeking to minimize burdens on group health plans and group health insurance issuers.

The final regulations for health coverage portability:

- add new definitions,
- add clarifications to the HIPAA limitations on a plan's or issuer's ability to impose a preexisting condition exclusion,
- add coverage under S-CHIP as an eleventh category of creditable coverage,
- modify the definition of public health plan for purposes of creditable coverage,
- set forth guidance regarding the certification requirements and other requirements for disclosure of information relating to prior creditable coverage,
- update the model creditable coverage certificate,
- clarify that procedures to request a certificate need to be in writing,
- reorganize and clarify the special enrollment rules,
- create rules regarding when an HMO affiliation period can be an alternative to a preexisting condition exclusion,
- add new rules defining limited scope dental and vision benefits and for determining the extent to which benefits provided under a health flexible spending arrangement are excepted benefits, and
- clarify special rules for partnerships.

The first set of proposed rules affecting tolling of certain time periods and interaction with Families and Medical Leave Act (FMLA) proposes to:

- modify the 63-day break-in-coverage rules,
- modify the required elements for the educational statement in certificates of creditable coverage to require a disclosure about FMLA,
- provide proposed rules for tolling of the special enrollment period similar to those proposed for determining a significant break in coverage,
- address how the HIPAA portability requirements apply in situations where a person is on FMLA leave, and
- clarify the rules regarding issuance of a creditable coverage certificate when an employee switches between an employer's benefit plan options.

The second issuance from the Departments on benefit-specific waiting periods is a request for comments. Several comments they received in response to the April 1997 interim final rules asked the Departments to clarify that preexisting condition exclusion would also include any benefit-specific waiting period or other temporary exclusion of specific benefits. Essentially, these comments argue that some plans and issuers use benefit-specific waiting periods that are, in effect, preexisting condition exclusions that do not comply with HIPAA's statutory limits. The Departments are asking for comments related to a number of specific concerns on this issue of benefit-specific waiting periods. All comments to either set of proposed guidance are due by March 30, 2005.

The Departments have also issued questions and answers concerning HIPAA. Department of Labor publications concerning changes in health care law are available by calling 1-866-444-EBSA (3272) or online at the EBSA Web site. In addition, CMS's publication entitled "Protecting Your Health Insurance Coverage" is available by calling 1-800-633-4227 or online at CMS's HIPAA page, which includes a link to the interactive HIPAA Online.

Treasury and IRS Release Final 401(k) Regulations

On December 28, the U.S. Treasury Department and the Internal Revenue Service (IRS) released final regulations affecting the administration of retirement plans under section 401(k) and in particular the nondiscrimination testing of contributions made to these plans under sections 401(k) and 401(m) of the Internal Revenue Code. The final regulations were published in the Federal Register on Wednesday, December 29, 2004. The final regulations apply for plan years beginning on or after January 1, 2006, but plan sponsors are permitted to apply the final regulations to any plan year that ends after the regulations' publication in the Federal Register.

The final regulations generally mirror the regulations proposed on July 16, 2003, with some modifications reflecting comments received on the proposed regulations (some of the more significant modifications or additions are listed below). The American Benefits Council filed a comment letter on October 22, 2003 and testified in a hearing on the matter on November 12, 2003.

The final regulations:

- Clarified that the exclusion of after-tax contributions from the definition of a cash or deferred arrangement does not include designated ***Roth 401(k)*** contributions (elective contributions that are included in income) and indicated the IRS and Treasury will issue guidance on Roth 401(k) contributions in the near future.
- Clarified that plans that use ***automatic enrollment*** are not limited to a 3 percent contribution amount and indicated that the percentage of compensation used in Revenue Ruling 2000-8 was merely illustrative.
- Rejected most comments concerning ***prefunding*** of elective contributions and matching contributions, generally requiring that they be made after the employee's performance of services relating to the compensation that would have been paid to the employee. However, the regulations provide limited exceptions for (1) early contributions made for an occasional pay period for bona fide administrative considerations (and not made early with the principal purpose of accelerating deductions), (2) forfeitures, and (3) contributions that result in a matching allocation of employer securities released upon loan payments for a

leveraged ESOP, provided the payment is due under the loan terms and not made early with a principal purpose of accelerating deductions.

- Eliminated the ***disaggregation*** requirement of the Employee Stock Ownership Plan ***(ESOP)*** and non-ESOP portions of the plan for nondiscrimination testing purposes (ADP and ACP testing) and allows the disaggregation to be applied to plan years that end after the date the regulations are published provided the plan applies all the rules of the final regulations for that year (could be used for 2004 testing for calendar year plans).
- Makes clear that plans that allow early entry into the plan for employee deferrals but delay matching contributions may use the safe harbor design in lieu of nondiscrimination testing for employees who have satisfied ***minimum age and service requirements*** and only apply nondiscrimination testing to the remaining employees (by treating them as separate plans for testing purposes).
- Made several clarifications to ***hardship distribution*** rules. First, the regulations added funeral expenses and repair of damage to the employee's principal residence to the "safe harbor" events that can result in a hardship distribution. In addition, the regulations clarified that an employee requesting a hardship distribution must elect distribution of an ESOP dividend. The regulations eliminated certain changes made to the definition of dependent under the Working Families Tax Relief Act of 2004 (such as income limitations) would not apply for purposes of determining whether a participant is eligible for a hardship distribution for medical expenses and college tuition for a dependent.
- Added a rule that additional elective contributions made because of the eligible employee's ***military service*** will not be counted in nondiscrimination testing.
- Maintained the rule outlined in the proposed rule that restricts the use of targeted qualified non-elective contributions ***(QNECs)*** but allowed an exception of up to 10 percent of compensation for QNECs made in connection with an employer's obligation under prevailing wage laws. The general rule does not allow the QNECs to be taken into account for nondiscrimination testing purposes if it exceeds 5 percent of compensation unless the contributions meet certain additional requirements designed to ensure that the contributions are not targeted to participants with lower compensation.
- Generally followed the proposed regulations regarding calculation of ***gap period income*** (i.e., income for the period after the plan year) but allowed a distribution of excess contributions to not include income for a period that is no more than 7 days before the distribution.

IRS Provides Automatic Rollover Guidance

On December 28, the U.S. Treasury Department (Treasury) and the Internal Revenue Service (IRS) released Notice 2005-5 that provides guidance on the new automatic (or default) rollover rules for qualified retirement plans. Under the new rules, which are effective March 28, 2005 (but see discussion below of permitted delay of mandatory distributions), plan administrators are required to transfer mandatory distributions of more than $1,000 to an IRA in the absence of an affirmative election from the plan participant. Notice 2005-5 was published in Internal Revenue Bulletin 2005-3 on January 18, 2005.

The automatic rollover rules were enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). EGTRRA provided that this mandatory rollover rule would not become effective until the Department of Labor (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. The DOL regulations were published September 28, 2004, and become effective March 28, 2005.

The IRS and Treasury guidance allows plans to delay mandatory distributions that would otherwise occur on or after March 28, 2005, without being treated as failing to follow the terms of the plan, if the plan administrator has not yet established the administrative procedures necessary to accomplish the automatic rollovers (including establishing agreements with one or more IRA providers as required by the DOL regulations). In any event, the administrative procedures must be established and (delayed) mandatory distributions made on or before December 31, 2005.

The Treasury and IRS guidance clarifies that the automatic rollover requirement will apply to governmental plans, including Code Section 457 plans, 403(b) plans and church plans, although a transition rule with a delayed effective date may apply. The guidance requires that plans adopt a good faith amendment that reflects the automatic rollover requirement by the end of the first plan year ending after March 28, 2005, (by December 31, 2005, for calendar year plans) and provides a model amendment that can be used.

The guidance also (1) clarifies that a mandatory distribution can be paid to an IRA or deemed IRA that is part of the same plan making the distribution, (2) indicates that the customer identification programs required under the USA Patriot Act will not apply until the former employee contacts the IRA institution to assert ownership or exercise control over the account, (3) allows use of the participant's most recent mailing address in the records of the employer and plan administrator for setting up the IRA account and mailing notices even if mailings to that address are returned as undeliverable, and (4) allows elimination or modification of the plan's mandatory distribution provisions without violating the anti-cutback rules of Code Section 411(d)(6).

403(b) Regulations Proposed, New Summary Available

On November 15, for the first time in 40 years, the Internal Revenue Service (IRS) and the U.S. Treasury Department (Treasury) issued proposed and temporary regulations updating the guidance governing tax-deferred retirement savings for employees of public schools, tax-exempt organizations and churches. The new guidance will make obsolete many revenue rulings, notices and other guidance under Internal Revenue Code Section 403(b), according to Treasury and the IRS.

The proposed regulations make a number of significant changes to the current rules, including a written plan document requirement that may have adverse consequences for employers trying to avoid the application of the Employee Retirement Income Security Act of 1974 (ERISA) to their Section 403(b) retirement savings programs. For a more detailed description of some of the provisions of the proposed regulations, including the ERISA ramifications of the new document requirement, the American Benefits Council has prepared a brief summary.

Treasury Issues Phased Retirement Plan Distribution Regulations

On November 9 the Treasury Department (Treasury) and the Internal Revenue Service (IRS) released proposed regulations under section 401(a) of the Internal Revenue Code that allow distributions to be made from a pension plan (*i.e.*, a defined benefit or money purchase pension plan) under a phased retirement program, subject to meeting the requirements set forth in the proposed regulations. Very generally, the proposed regulations permit an employee to receive a "pro rata share" of the employee's accrued benefit under a "bona fide phased retirement program" after attaining age 59 1/2. In other words, an employee who reduces his or her work hours by 20 percent would be considered "20 percent retired" and thus entitled to 20 percent of his or her retirement benefits.

Phased retirement benefit distributions are permitted so long as the benefit payable is limited to the employee's pro rata share, certain early retirement benefits remain available (*e.g.*, early retirement subsidies), the form in which payments may be made is limited, and the employee, prior to entering phased retirement, was a full-time employee. In addition, distributions may only be made to an employee who is partially retired under a bona fide phased retirement program.

The proposed regulations define a phased retirement program as "a written, employer-adopted program pursuant to which employees may reduce the number of hours they customarily work beginning on or after a date specified under the program and commence phased retirement benefits during the phased retirement period, as provided under the plan." A phased retirement program is bona fide if it meets certain additional requirements, such as limiting eligibility to participate to employees who have attained age 59 1/2 and prohibiting key employees from participating. Participation in a bona fide phased retirement program must also be voluntary, and any employee who chooses to participate must reasonably expect to reduce his or her working hours by 20 percent or more.

The proposed regulations are not effective until Treasury adopts them as final regulations, and cannot be relied on before such time. The American Benefit Council filed a comment letter on February 4, 2005.

IRS/Treasury: No Advance Notice Required to Eliminate DC Distribution Options

On January 24, the Internal Revenue Service (IRS) and the Department of the Treasury (Treasury) released final regulations that eliminate the 90-day notice requirement for amendments eliminating optional forms of distribution from a defined contribution plan. The final regulation, under Internal Revenue Code Section 411(d)(6) (which prohibits amendments that reduce or eliminate previously accrued benefits), allows elimination of other optional forms of benefit if the plan allows lump-sum (single-sum) distributions at the same time and under the same conditions as the benefit forms being eliminated.

IRS and Treasury had proposed this rule in July 2003 but at that time proposed requiring that participants receive a notice (summary of material modifications or SMM) at least 90 days before the amendment was to take effect and requested comments on this requirement. If no notice was provided, the amendment eliminating the other forms of benefit could not take effect until the second plan year following the plan year in which the amendment was adopted. The final rule eliminates the 90-day notice requirement, allowing such changes to become immediately effective. The effective date of the final regulation is January 25, 2005.

The regulation was proposed after Congress, in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), amended the Internal Revenue Code to provide that, except to the extent provided in regulations, a defined contribution plan would not be treated as reducing a participant's accrued benefit where a plan amendment eliminates a form of distribution previously available under the plan if a single-sum distribution is available to the participant at the same time and under the same conditions as the form of distribution eliminated by the amendment.

CMS Issues Final Medicare Regulations

On January 21, the Centers for Medicare and Medicaid Services (CMS) issued final regulations implementing the new Part D prescription drug benefit that takes effect in January 2006. CMS has issued a number of helpful documents, including a press release, a fact sheet summarizing the rulemaking, a fact sheet highlighting the principal changes from the proposed rules, and an overview of the retiree drug subsidy option for employers. CMS has already created a Web site dedicated to providing information to employers, which will be continually updated with new resources. Additional guidance is still expected from CMS on the determination of whether an employer's retiree health plans provide coverage that is actuarially equivalent to the Medicare drug benefit, simplified actuarial methods, the subsidy application process, and other issues.

According to CMS Administrator Mark McClellan, "All people with Medicare are now a huge step closer to having a new drug benefit and new health plan options, regardless of their income or how they receive their medical coverage."

Technical Updates

Treasury Releases Guidance for Partnership and S-Corporation HSA Contributions

The Department of Treasury has issued Notice 2005-8 providing guidance on a partnership's contributions to a partner's Health Savings Account (HSA) and an S corporation's contributions to a 2-percent shareholder-employee's HSA. The general rule for employees is that an employer may contribute to an employee's HSA and exclude the contribution from the employee's gross income and wages. The guidance makes clear that a partnership and S corporation may make contributions to partners' and 2-percent shareholder-employees' HSAs. The three questions and answers define the tax treatment that will apply in those instances.

This is the most recent of several rounds of guidance Treasury has provided since HSAs were enacted as part of the Medicare Modernization Act of 2003, which was signed into law in December 2003. HSAs must be offered in conjunction with a high deductible health plan, are fully portable, and provide an opportunity for individuals to save on a tax-free basis for current and future health care needs.

EBSA Releases Rule to Extend Sunset Date for Mental Health Parity Law

The Employee Benefits Security Administration (EBSA) of the Department of Labor (DOL) has released an interim final amendment to modify the sunset date of interim final regulations under the Mental Health Parity Act (MHPA) to comply with action taken by Congress to extend the current law for an additional year. The current law now sunsets (expires) on December 31, 2005.

The current law mandates parity in annual and lifetime dollar limits between medical and surgical benefits covered by a health plan and any mental health benefits covered by the same plan. In the last Congress Senators Pete Domenici (R-NM) and Edward Kennedy (D-MA) sponsored the Mental Health Equitable Treatment Act, which would significantly expand current law requirements, but were also reportedly working on a compromise that would eliminate the requirement in their bill that all mental health diagnoses in the "DSM-IV" (the compendium of mental health disorders) be included in the parity requirement. The compromise would reportedly also permit some limits on mental health benefits if the health plan includes these limits on "substantially all" medical and surgical benefits, a term which is undefined.

ERISA Advisory Council Submits Report on Fees to DOL

The Advisory Council on Employee Welfare and Pension Benefit Plans, created by the Employee Retirement Income Security Act (ERISA) to provide advice to the U.S. Department of Labor (DOL), recently submitted to DOL a report by its working group on fee and related disclosures to participants.

The report essentially summarizes the testimony provided during hearings on August 5 and September 21, including the statement of Louis Campagna, chief of the Division of Fiduciary Interpretations of DOL's Office of Regulations and Interpretations. The report also provides a number of recommendations, including:

- The profile (summary) prospectus of each investment option should be delivered to each employee upon eligibility to participate. Providing this information prior to the initial investment decision should eliminate the need to automatically provide a full prospectus or other information concerning the particular investment options elected immediately after the investment options are elected.

- Along with the prospectus, participants should be given materials (like a glossary) that explain the meaning of the terms used in the profile prospectus (or similar document). Account and investment recordkeepers should also be encouraged, though not necessarily required, to develop Internet Web sites and other Web-based tools where participants can research information about plan investment options and review information about their own investment choices.

- The annual statement must provide the expenses of each investment option expressed as a ratio along with other information provided about the investment options. There must also be an identification of the investment expenses that are paid entirely or in part by the plan sponsor. This requirement should have a delayed effective date as applied to small and medium sized plans, based on the number of participants, allowing service providers time to design necessary systems to provide the contemplated disclosures in a cost effective manner.

- The DOL should provide a sample model disclosure format that is available on its Web site.

Treasury Department Releases Guidance on Nonqualified Deferred Compensation

On December 17, the U.S. Treasury Department released guidance on the recently enacted deferred compensation provisions of the American Jobs Creation Act of 2004. This legislation created a new Internal Revenue Code section 409A for which the guidance provides definitional and transition rules.

The Council previously has urged the Treasury Department to make exceptions from the deferred compensation rules outlined in the law so that existing broad-based nonqualified deferred compensation plans such as severance pay plans and equity appreciation rights programs would not be disrupted. The Council also emphasized the importance of good faith standards of compliance during the transition period due to the onerous nature of the penalties for failure to comply with the new rules.

DOL Addresses Directed Trustee Responsibilities

On December 17, the Department of Labor's (DOL's) Employee Benefits Security Administration (EBSA) provided guidance to field investigators on the responsibilities of directed trustees under the Employee Retirement Income Security Act (ERISA) with respect to publicly traded securities (employer securities purchased or held in qualified retirement plans). Although the DOL declared that directed trustees are fiduciaries under ERISA with a duty to act prudently, the DOL indicated that the directed trustee would rarely need to question the directing fiduciary's instructions regarding transactions involving publicly traded securities.

Field Assistance Bulletin (FAB) 2004-3 was a response to an advisory opinion request filed by Groom Law Group on behalf of several clients. On July 15, 2004, the Council sent a letter to the DOL supporting limitations on the duties for directed trustees.

2005 Legislation

Bush Administration Details President's Pension Reform Proposal

Officials from the Departments of Labor, Treasury, Commerce and the Pension Benefit Guaranty Corporation (PBGC) on January 12 briefed representatives of the business community on the initial details of the Administration's defined benefit pension reform proposal. A copy of the PowerPoint presentation summarizing the briefing is now posted on the American Benefits Council's web site.

Several items in the proposal are of significant interest to employer plan sponsors including: elimination of present-law smoothing of assets and interest rates, elimination of credit balances, permitting plans to deduct contributions up to 130 percent of liability, PBGC premium increases, new designations of “on-going” plans and “at risk” plans used to calculate funding requirements, special limitations on “at-risk” plans and plans of bankrupt sponsors, and expanded disclosure and accelerated filing requirements.

PBGC premium rates
Flat rate premiums for all pension plans will rise to $30 per participant and then going forward be indexed to worker wage increases. Any plan that is underfunded (less than 100 percent of the “funding target” explained below) in any year also would be required to pay risk-based premiums. Risk-based premiums would be adjusted relative to the difference between the plan’s current level and its funding target. The proposal would allow the premium to be adjusted periodically by the PBGC’s board of directors to ensure sufficient revenue to the agency to cover expected losses and to close the agency’s deficit.

“On-going” versus “at-risk” plans
All defined benefit pension plans would be defined as either “on-going” or “at risk” plans. The designation is based not upon the financial health of the pension plan, but of the employer sponsoring it.

“At-risk” plans are sponsored by companies that, for five years, have had a credit rating by all three of the major agencies (or all of the major agencies that rate the company if fewer than three) that any bonds they issue would be considered “junk bonds” or below investment grade. Plans of companies that have been in junk bond status for less than five years are treated as between “on-going” and “at-risk”. Plans of any other employer sponsor would be considered “on-going”.

Both “at-risk” and “on-going” plans will be required to fund up to 100 percent of their calculated “benefits earned to date” to be considered fully funded (the “funding target”). At-risk plans would be required to assume that all employees take lump sums (if available) and retire early, which will raise the plan's liability and thus funding target. Plans between on-going and at-risk would be treated as phasing in to the higher level of liability based on the number of years that the plan sponsor has been in junk bond status. When payments are required to bring up the level of funding to the funding target, the required payment essentially would be amortized over seven years with certain modifications. Agency officials did note however that they have also considered using a ten-year period and would like to hear input from legislators on the appropriate timeframe. The actual required payment amount would be recalculated each year.

The Administration’s previously proposed yield curve would be used for interest rate assumptions in calculating both funding requirements and lump-sum distributions. (Click here for a summary of this proposal.)

Limits to “at-risk” plans and plans of bankrupt sponsors
Depending upon the percentage funding of the plan, “at-risk” plans and plans of bankrupt sponsors may be required to eliminate benefit increases, benefit accruals, and lump-sum distributions. Additionally, “at-risk” plans that are 60 percent funded or less

would not be allowed to provide preferential funding of executive compensation programs. For purposes of this aspect of the rules, if a company is in junk bond status for the year, the plan would be considered at risk (i.e., the five-year rule would not apply).

Expanded disclosure and accelerated filing schedules
Beyond new requirements to disclose financial information currently found on the Form 4010 that plan sponsors file with the PBGC, the Administration's proposal would change summary annual reports (SARs), which are provided to participants, and the timing of the filing of Schedule B of Form 5500. In the newly designed SAR, a plan sponsor would disclose the plan's funding status relative to its funding target for the plan year plus the two previous plan years to indicate a trend in funding. The Administration proposals also shorten the time deadline for plan actuaries to complete and submit their Schedule B of Form 5500, although an exact annual filing date has not been selected.

Senate Republicans and Democrats Announce Priorities for 109th Congress

Senate Republicans and Democrats held separate press events on January 24 to announce their top legislative priorities for the 109th Congress, including a number of benefits-related initiatives. Not surprisingly, Senate Republicans have reserved bill number S. 1 for Social Security reform that would include a proposal to allow younger workers to elect to invest a portion of their payroll taxes in private accounts. The proposal is expected to include other measures intended to address the costs of transforming the system from its current pay-as-you-go structure and to shore up the solvency of the program.

Senate Republicans also announced plans to introduce the "Health America Act of 2005" (S. 4) which will include proposals to make health care more affordable. These ideas were developed by the Senate GOP Task Force on the Uninsured last year. Among the provisions to be included in the bill will be proposals on:

- medical liability reform;
- electronic medical records;
- patient safety and medical errors;
- health insurance tax credits for low-income Americans;
- above-the-line tax deduction for high-deductible health plans to encourage enrollment in health savings accounts (HSAs);
- above-the-line tax deduction for long-term care insurance premiums; and
- support for family caregivers.

Senate Democrats announced plans to introduce three priority bills that will address health care issues. One such bill (S. 18) would make amendments to the Medicare Modernization Act of 2003 (MMA) including addressing "… incentives that encourage employers to drop retiree benefits." The Senate Democrats' comprehensive health care bill (S. 16) will include a provision to legalize importation of prescription drugs from other industrialized countries; address patient safety and medical errors and increase the use of health information technology. Senate Democrats will also introduce a bill (S. 20) that would include a mandate that health plans cover prescription contraceptives.

Timing of Definition of Dependent Technical Corrections Bill

As a follow-up to an article in the November 2004 edition of *Benefits Insider,* during the last Congress the Tax Technical Correction Act of 2004 (H.R. 5395) was filed by Senator Charles Grassley (R-IA), Chairman of the Senate Finance Committee and Senator Max Baucus (D-MT), committee ranking member, in coordination with Representative Bill Thomas (R-CA), Chairman of the House Ways and Means Committee. The bill included an amendment to the Working Families Tax Relief Act of 2004 (the Act) that would exempt the income limitation from the definition of dependent for Health Savings Accounts and Dependent Care Spending Arrangements. The plan to reintroduce and pass the technical corrections bill in this congressional session has been revised; legislation should be introduced or considered in late spring or early summer.

The changes to the definition of dependent included in the Act were intended to make the definition more uniform. However, because many other Code sections and regulations reference Code Section 152, the change in definition has broad implications for health, dependent care spending arrangements, hardship distributions from 401(k) plans, and unforeseeable emergency distributions from 457 plans and non-qualified deferred compensation plans.