BENEFITS INSIDER
A Member Exclusive Publication

Volume 4, March 15, 2005

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Articles in this Edition

RECENT REGULATIONS

Treasury/IRS Propose Changes to Relative Value Regulations

The U.S. Department of the Treasury and the Internal Revenue Service (IRS) issued proposed regulations that would revise the December 2003 final regulations concerning disclosure of the relative values of optional forms of benefit. The regulations are generally proposed to be effective as if included in the 2003 regulations.

Consistent with Announcement 2004-58, the proposed regulations would modify the effective date of the 2003 regulations by generally providing that Qualified Joint and Survivor Annuity (QJSA) explanations must reflect the new requirements for annuity starting dates beginning on or after February 1, 2006. As indicated in the original Announcement, the original effective date of October 1, 2004 was retained if the plan provides for payment of optional forms of benefit that are subject to the assumption requirements under Code Section 417(e)(3) (such as single sum payments, social security level income options, distributions in the form of partial single sums in combination with annuities or installment payment options) if the actuarial present value of the optional form is less than the actuarial present value of the QJSA (for example, a single sum payment that does not reflect an early retirement subsidy available under the QJSA).

The proposed regulations also:

- Clarify that a plan does not fail the requirement that the QJSA be the most valuable benefit for a married participant simply because calculation of another optional form of benefit (such as a single sum payment, etc.) must be made using the assumptions required under Code Section 417(e)(3). This requirement would be effective as if included in regulations published in 1988.
- Enables a plan to use the delayed effective date rule, provided certain requirements are met, even if there are minor differences between the value of the optional form and the QJSA for a married participant that are caused by the calculation of the amount of the optional form of benefit based on a single-life annuity rather than on the QJSA.
- Allow, for purposes of disclosing the normal form of benefit under the generally applicable information, the use of reasonable estimates of the type permitted to be used to disclose participant-specific information to determine the normal form of benefit if certain requirements are met.
- Allow the QJSA explanation to contain an item of participant-specific information in place of the corresponding generally applicable information.

Council Files Comment Letter with IRS Regarding Phased Retirement

The Council filed formal comments with the Internal Revenue Service (IRS) regarding recently proposed regulations concerning distributions from a pension plan under a phased retirement program.

The proposed regulations, under section 401(a) of the Internal Revenue Code, would 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.

The Council's comment letter applauded the U.S. Treasury Department and the IRS for addressing phased retirement issues, but expressed concerns with a number of elements that may discourage plan sponsorship, including the pro rata reduction in hours requirement coupled with an annual audit of actual hours worked and limiting the program to employees who have attained the age of 59½. The Council also recommended allowing employers to choose whether to make lump-sum payments and early retirement subsidies part of the phased retirement benefits, and suggested a number of other regulatory clarifications.

IRS Allows Cash-out Amendments Eliminating Automatic Rollovers by Year End

The Internal Revenue Service (IRS) has announced that plan sponsors have until the end of the first plan year ending on or after March 28, 2005 (December 31, 2005 for calendar year plans) to amend their plans to limit mandatory distributions to account balances of less than $1,000. The IRS made this announcement in a special edition of *Employee Plan News* published on February 16.

Such an amendment would allow plan sponsors to avoid the new automatic (or default) rollover rules for qualified plans which are effective March 28, 2005. Under the new rules, which were enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), 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.

The Council and other organizations asked for the due date clarification for amendments reducing mandatory distribution amounts below the threshold amount because previous IRS guidance (Notice 2005-5) simply indicated that plans must be amended to include the automatic rollover provisions by the end of the first plan year ending on or after March 28, 2005. The notice did not specify that an amendment reducing mandatory distributions below the $1,000 threshold could be delayed past the effective date.

The *Employee Plans News* guidance reminded plan sponsors that amounts attributable to rollover contributions are included in determining whether a participant's accrued benefit is less than $1,000 for purposes of the automatic rollover requirement even though those amounts are not taken into account in determining whether mandatory distributions are permitted. The guidance also indicated that a sponsor (or volume submitter practitioner) of a pre-approved plan may amend the plan to reduce the mandatory cash-out amount to any amount that is $1,000 or less without causing the pre-approved plan to be treated as an individually designed plan. Notice 2005-5 allowed elimination of the plan's mandatory distribution provisions without violating the anti-cutback rules of Code Section 411(d)(6). The notice also allowed plans to delay mandatory distributions that would otherwise occur on or after March 28, 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.

IRS Hears Testimony on 403(b) Regulations

The Internal Revenue Service (IRS) held a hearing to obtain feedback on proposed and temporary regulations regarding 403(b) plans. These regulations, issued November 15, 2004, would update the guidance governing tax-deferred retirement savings for employees of public schools, tax-exempt organizations and churches. Perhaps most noteworthy, the proposed regulations would require 403(b) plan sponsors to provide a written plan document 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. The Council has prepared a brief summary of the proposed regulations.

IRS and Treasury Department officials heard from many witnesses during the course of the hearing, representing a diverse array of organizations from insurance and annuity companies to education associations. The recurring message from these witnesses was to treat 403(b) arrangements more like individual retirement accounts than qualified plans that are subject to ERISA. Witnesses also argued that the effective date of the regulations – applicable to plan years beginning after December 31, 2005 – should be substantially delayed, and the regulations should not be applied retroactively since federal tax policy prohibits such action in non-abuse situations.

GAO Recommends Review of U.S. Health Care System

The Government Accounting Office (GAO) issued a report on February 17 "intended to help the Congress in reviewing and reconsidering the base of federal spending and tax programs." The GAO is Congress' investigative arm and prepares reports on government departments and programs. Included in the report is a recommendation calling for a complete review of the U.S. health care system, including the tax treatment of health benefits. The report specifically asks whether tax preferences for health care should be designed to cap the health insurance premium amount that can be excluded from an individual's taxable income.

There has been increasing speculation that efforts to pursue tax reform could include proposals affecting the tax-treatment of employer-provided coverage and limitations on the value of health coverage that an individual may exclude from taxation. A change of this sort is considered by some as more feasible than any limit on the amount of the deduction an employer may claim for the cost of health coverage provided to employees. While there is no legislative proposal receiving serious consideration on this issue, the Joint Committee on Taxation did list providing "consistent FICA treatment of salary reduction amounts" as a tax reform expenditure option in a report issued on January 27. The Joint Committee on Taxation regularly issues such reports describing different revenue options.

IRS Opens EGTRRA Opinion and Advisory Letter Program for Pre-Approved Pension Plans

On February 17, the Internal Revenue Service (IRS) released Rev. Proc. 2005-16 to officially open the opinion and advisory letter program for pre-approved defined contribution pension plans. The IRS will accept applications for letters from February 17, 2005 until January 31, 2006 for defined contribution pre-approved plans that take into account the requirements of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) as well as other qualification requirements and guidance. Pre-approved plans include master and prototype (M&P) plans as well as volume submitter (VS) plans. M&P plans generally consist of a basic plan document and adoption agreement that may not be amended by adopting employers, except by choosing among permitted options under the adoption agreement. VS plans are generally sample or specimen plans which are submitted for approval and then adopted by individual employers. The IRS will announce the deadline for employers to timely adopt the plans after the pre-approved documents have been reviewed.

The IRS intends to accept applications for determination letters for individually designed plans beginning on or after February 1, 2006, and applications for opinion and advisory letters for pre-approved defined benefit plans beginning February 1, 2007. The opening of these programs will be announced at a future date.

TECHNICAL UPDATES

AARP Files Suit to Block EEOC's Publication of Retiree Health Rule

The EEOC voted on April 22, 2004, to finalize its July 2003 proposed rule on retiree health benefits to clarify that an employer-sponsored retiree health plan would not violate the Age Discrimination in Employment Act (ADEA) even if it does not provide the same level of benefits to early retirees and to older retirees who are eligible for coverage under Medicare. The agency's rule was subject to review and comment by other federal agencies and OMB was the last agency to review the rule. A two-page Council summary of the expected EEOC rule is available on the Council Web site. The rule would become final when it is published in the Federal Register. The rule's publication was imminent when AARP filed for a temporary restraining order to block its publication.

Under a previous order issued by the United States District Court for the Eastern District of Pennsylvania, AARP now has until March 7 to respond to the brief filed by the government in this case which supports allowing the EEOC to proceed with issuing its retiree health rule. Oral arguments on AARP's motion to block the rule are scheduled to be held on March 31, after which time the court is expected to rule on the question of whether the EEOC acted properly in interpreting the application of the Age Discrimination in Employment Act (ADEA) to retiree health benefits. The Council, joining with other employer groups, has filed an *amicus* (friend of the court) brief supporting EEOC's position. Whichever way the court rules, it is very likely there will be an appeal in this case and the Council and others are expected to file an additional brief at that stage if it is required.

2005 LEGISLATION

Grassley, Baucus Reintroduce NESTEG

Senators Charles E. Grassley (R-IA), chairman of the Senate Finance Committee, and Max Baucus (D-MT), ranking minority member of the committee, reintroduced their pension legislation bill, the National Employee Savings and Trust Equity Guarantee (NESTEG) Act. In an environment where most retirement legislation is focused on defined benefit plan matters, NESTEG is noteworthy for addressing several defined contribution plan matters (as well as some important defined benefit issues). NESTEG received unanimous Finance Committee support in 2004 but was never presented to the full Senate. Grassley and Baucus issued a press release and summary in connection with the introduction of the bill.

The 2005 version of NESTEG is essentially unchanged from the 2004 bill. Some of the major provisions in both the 2004 and 2005 version of NESTEG would require companies to:

- Allow their employees to diversify out of company stock (immediately for employee contributions, after three years of service for employer contributions);
- Provide additional protections for spouses including an additional survivor annuity option to married participants (if survivor portion of qualified joint and survivor annuity (QJSA) is less than 75 percent, the new annuity option must be 75 percent; if QJSA is equal to or greater than 75 percent, the new annuity option must be 50 percent);
- Expand the portability of retirement plan assets;
- Apply the faster matching contribution vesting schedule to other employer contributions (six year graded or three year cliff); and
- Replace the 30-year Treasury interest rate with the phase-in of a permanent yield curve to be used for pension funding, PBGC premiums and determining lump sum distributions for plan years beginning after December 31, 2006 (the temporary replacement of the 30-year Treasury rate with the long-term corporate bond rate for funding and premium calculation purposes would remain in place through 2006)

The bill would also allow automatic rollovers of involuntary distributions to be transferred to the PBGC instead of to an IRA. One provision that was not contained in the 2004 version of NESTEG would extend to certain multiemployer plans the ability to transfer excess assets to fund retiree medical benefits under Internal Revenue Code Section 420. Grassley and Baucus said they expect the Finance Committee to consider additional pension funding reforms in light of concerns regarding pension underfunding and the financial health of the Pension Benefit Guaranty Corporation (PBGC).

Democrats Urge Changes to Employer Drug Subsidy in MMA Regulations

A group of House and Senate Democrats – including Senate Minority Leader Harry Reid (D-NV) and House Minority Leader Nancy Pelosi (D-CA) – sent a letter to President Bush expressing concerns with those provisions in the final Medicare Modernization Act (MMA) regulations related to the subsidy for employers who sponsor drug coverage that is actuarially equivalent to the standard Medicare drug benefit.

The letter questions why the actuarial equivalence test in the final regulation does not include the value of the benefit that Medicare beneficiaries will receive once their out-of-pocket drug expenses reach an annual catastrophic limit. The argument fails to recognize that the “true out-of-pocket costs” (TROOP) requirement for the new Medicare drug benefit states that an individual must have at least $3600 in drug expenses which are not paid by an employer’s retiree medical plan, or other third party sources, to satisfy Medicare’s catastrophic limit. As a result, payments made by the employer-sponsored retiree drug plan raise the threshold when catastrophic coverage would begin and therefore would reduce the value of Medicare Part D coverage for many individuals with retiree health coverage.

Democrats also asked that the final rules be altered to include "employer transparency requirements" so retirees will know "what actions their employers are taking to meet the actuarial equivalence standard," which is of particular interest to organized labor.

The letter also urges the Administration to increase the employer subsidy to equal the amount private health plans will be paid by Medicare for covering the new prescription drug benefits. Finally, the Democrats urged the elimination of the "true out-of-pocket" (TROOP) rule to allow employer coverage for retiree prescription drugs to count toward beneficiaries meeting the Medicare catastrophic limit. Both are changes that would significantly increase the cost of the MMA, which is already being scrutinized by policymakers on Capitol Hill. For example, the new Senate Budget Committee Chairman, Judd Gregg (R-NH), has specifically questioned the cost of the employer subsidy included in the Medicare Modernization Act (MMA) to help stabilize employer-sponsored retiree prescription drug coverage.

The Council will prepare a response to the Democrats' letter and continue to educate policymakers about the value of the employer subsidy and how it will encourage employers and unions to continue providing prescription drug coverage.

Bush Administration Budget Includes Pension Reform Proposals

President Bush's budget for Fiscal Year 2006, released on February 7, contains a number of legislative proposals addressing various retirement policy issues. The Council has obtained summaries of the administration's most significant retirement savings initiatives.

The U.S. Department of Labor has prepared a 33-page summary of the administration's funding proposals. A key feature of the President's plan is a substantial increase in the premiums companies must pay to the Pension Benefit Guaranty Corporation to insure their employees' pensions. (The administration's budget calls for premiums to rise to $4.4 billion in 2006, then to $5.9 billion in 2007.)

The U.S. Department of the Treasury has prepared detailed explanations of the budget sections regarding Lifetime Savings Accounts (LSAs), Retirement Savings Accounts (RSAs), Employer Retirement Savings Accounts (ERSAs) and Individual Development Accounts (IDAs) as well as the administration's legislative recommendations for the treatment of hybrid pension plans.

Senate HELP Committee and Full Senate Approve Bill on Genetic Nondiscrimination

The new chairman of the Senate Health, Education, Labor and Pensions (HELP) Committee, Mike Enzi (R-WY) moved the Genetic Information Nondiscrimination Act (S. 306) through his committee with approval by voice vote.

This bill would establish new requirements to prohibit discrimination on the basis of genetic information by health plans, insurers and employers. This bipartisan bill was sponsored by Senators Enzi, Olympia Snowe (R-ME), Edward Kennedy (D-MA) and others and is based on S. 1053, which was unanimously approved by the Senate in October 2003 but never considered by the House of Representatives.

On February 17, the Senate unanimously approved (98-0) the Genetic Information Nondiscrimination Act (S. 306). It is unclear whether the House will consider S. 306 any time soon particularly since three House committees – the Education and the Workforce, Ways and Means, and Energy and Commerce – claim jurisdiction on the issue and House GOP leaders have never expressed a desire to move the bill quickly to the House floor.

Senate HELP Committee Approves Bill on Federal Funding for High-Risk Pools

The HELP Committee also approved the State High Risk Pool Funding Extension Act (S. 288), which would increase federal funding for state high-risk health insurance pools and extend a high-risk pool grant program established by the Trade Adjustment Assistance Act of 2002. High-risk pools are created by states to help individuals who cannot otherwise obtain health insurance in the individual market due to preexisting conditions or can only obtain coverage at very high rates. The HELP Committee approved this bill in November 2004 but it was never considered by the full Senate.

Council Releases 'Funding our Future' Recommendations for Defined Benefit Pension Plan Funding Reform

The Council released Funding our Future: A Safe and Sound Approach to Defined Benefit Pension Plan Funding Reform, a report offering an employer perspective on the steps needed to address the challenges of underfunded plans and that also critiques the Bush Administration's proposed response. The Council briefed Congressional staff and senior executive branch officials, Washington-based representatives of member corporations, and held a media briefing to explain our proposals.

Funding our Future highlights the implications of the most pressing pension legislative items of the new 109th Congressional session: the looming expiration of the replacement rate for the 30-year Treasury bond and the current financial status of the Pension Benefit Guaranty Corporation (PBGC). In depth, it addresses a number of critical issues, including:

- The need to permanently replace the 30-year Treasury rate with a long-term corporate bond rate;
- The importance of reducing volatility and ensuring predictability in funding plans;
- Avoiding direct and indirect incentives to move plan investments away from equities;
- The need to require less well-funded plans to improve their funded status; and
- The need to permit and encourage additional contributions during good economic periods.

This document is the first in a series of policy papers the Council will release this spring on various aspects of the defined benefit pension system and the current threats to sponsorship of these retirement programs. It will be emphasizing policy proposals the Council believes will strengthen and simplify administration of defined benefit plans and will react as needed to the forthcoming legislative debate on pension reform issues that began in January with the Bush Administration's release of its pension reform proposal.

Proposed Legislation to Cut Taxes on Lifetime Annuities but Not from Qualified Plans

On February 15, legislation was proposed in both the Senate and the House of Representatives that would eliminate federal income taxes on half of the payments from a lifetime annuity, up to a maximum of $20,000 annually. S. 381 was introduced in the Senate by Senators Gordon H. Smith (R-OR), Kent Conrad (D-ND), Olympia J. Snowe (R-ME), and Hillary Rodham Clinton (D-NY), and H.R. 819 was introduced in the House by Nancy Johnson (R-CT) and John Tanner (D-TN). The legislation, which was also introduced in 2004 and is sponsored by both Democrats and Republicans, does not apply to payments from qualified plans and 457 plans (plans of tax-exempt and governmental employers).

Pension Funding Issue Picks Up Steam on Capitol Hill and Executive Branch

Attention to proposals to reform pension funding rules is increasing with a number of developments. On March 1, the Senate Finance Committee held a hearing on defined benefit plans. Other committees of jurisdiction are expected to hold hearings in the near future as well, and should be announced shortly.

In response to the release of Funding our Future: A Safe and Sound Approach to Defined Benefit Pension Plan Funding Reform, Secretary of Labor Elaine Chao issued a statement February 19 saying that the Council's report "fails to recognize the reality that the pension funding rules are broken, causing workers and retirees harm and putting taxpayers at risk." The Council believes that the report, in fact, makes very clear the need for reforming the funding rules. However, the approach developed by our task force on funding reform and approved by our Board of Directors differs in a number of key respects from the Administration's recommendations.

Stock Options Bill Reintroduced in House

Representatives David Dreier (R-CA) and Anna Eshoo (D-CA) introduced the Broad-Based Stock Option Plan Transparency Act (H.R. 913), legislation that would require enhanced disclosure for employee stock options while delaying for three years the implementation of the new Financial Accounting Standards Board (FASB) standard for expensing stock options. The new FASB standard, FAS 123(R), Share-Based Payment, generally requires companies to expense all stock options granted, modified repurchased or cancelled after June 15, 2005.

H.R. 913, which does not require any expensing of stock options, would require the Securities and Exchange Commission (SEC) to implement enhanced minimum disclosures for employee stock options, including a "plain English" discussion of the diluting effect of stock option plans and a summary of the stock options granted to the five most highly compensated employees of the company. It also requires the SEC to study the effectiveness of the disclosures over three years and prohibits application of any new accounting standard for stock options during that time. The bill would also require the Secretary of Commerce to conduct a study, and report back to Congress, on the impact of broad-based employee stock option plans on, among other things, expanding employee corporate ownership and the impact of broad-based stock option plans on the economic growth of the United States, including their role in strengthening international competitiveness.

H.R. 913 is similar to a bill introduced by Dreier and Eshoo early in the previous congress. Dreier and Eshoo also introduced a subsequent bill in 2004, the Stock Option Accounting Reform Act (H. R. 3574), which would have required expensing for the top five executives of a company but not for stock options provided to other employees. The legislation would also have effectively blocked FASB's proposal until a study of the economic impact of expensing was conducted. H.R. 3574 passed the House of Representatives on July 21, 2004 but faced considerable opposition in the Senate, particularly from Richard Shelby (R-AL), chairman of the Senate Banking, Housing and Urban Affairs Committee, which has Senate jurisdiction on this issue.