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## Articles in this Edition

***RECENT REGULATIONS***

**IRS Issues Proposed Roth 401(k) Regulations**

On March 1, the U.S. Treasury Department and the Internal Revenue Service (IRS) issued proposed Roth 401(k) regulations. The proposed regulations would amend the final 401(k) regulations published in December 2004 to provide guidance on designated Roth contributions that will be permitted in 2006 under the provisions of the Economic Growth and Tax Relief Reconciliation of 2001 (EGTRRA).

Under the EGTRRA provision, a plan may permit an employee who makes elective contributions to a 401(k) plan to designate whether some or all of those contributions are "Roth" contributions (versus typical pre-tax 401(k) contributions). Designated Roth contributions are includable in gross income but a later qualified distribution of the Roth contributions, including income, would be excludable from gross income.

The proposed regulations define Roth contributions as elective contributions made under a qualified cash or deferred arrangement that permits Roth contributions that are (1) designated irrevocably by the employee at the time of the cash or deferred election as designated Roth contributions, (2) treated by the employer as includible in the employee's income at the time the employee would have received the contributed amounts if the employee had not made the cash or deferred election (e.g., by treating the contributions as wages subject to applicable withholding requirements), and (3) maintained by the plan in a separate account.

The proposed regulations also clarify that:

- A designated Roth contribution must satisfy the requirements applicable to elective contributions made under a qualified cash or deferred arrangement (such as nondiscrimination testing (ADP), nonforfeitability and distribution restrictions);
- A plan may permit a highly compensated employee (HCE) to designate whether a corrective distribution of excess elective contributions will be made from pre-tax elective contributions or designated Roth contributions (the Roth contribution distribution would be tax-free but the HCE would be taxed on the distribution of applicable earnings on the original contribution); and
- Designated Roth contributions may be rolled over only to another plan maintaining a designated Roth contribution account or to a Roth IRA.

The proposed regulations request comments by May 31 on the issues on which guidance is needed, including taxation of (presumably non-qualified) distributions. The proposed regulations specifically do not provide guidance on the taxation of distributions that are not qualified distributions (e.g., recovery of the employee's investment in the contract associated with his or her designated Roth contributions). Distributions from Roth IRAs are considered to be made first from contributions (resulting in no taxable income) but the 401(k) rules generally require pro-rata recovery of the employee's investment in the contract for after-tax contributions.

**PBGC Proposes New Liability Rule for Facility Shutdowns**

On February 25, the Pension Benefit Guaranty Corporation (PBGC) published a proposed rule specifying how to calculate the amount of escrow or bond liability for a sponsoring employer if more than 20 percent of a plan's active participants lose their jobs because of the shutdown of a facility. The new rule, which borrows from the rules governing multiple employer plans but also applies to single employer plans, would require an employer that has a 20 percent or more reduction in plan participants in connection with cessation of operations at one or more facilities to make a liability payment, that would be kept in escrow by the PBGC for five years and returned if the plan does not terminate. The payment would be equal to the termination liability (as if the plan terminated on the date of the cessation of operations) multiplied by a fraction of the number of participants separated from service over the total number participants. In lieu of the escrow payment, employers could post bond in an amount not exceeding 150 percent of this calculation.

The PBGC has generally used this calculation method on a case-by-case basis but the proposed rule leaves a number of unanswered questions. For example, the proposal does not clearly define when a cessation of operations occurs if it occurs in several stages. It is also not clear whether the new rule is intended to apply to a sale of assets that includes a facility (which the selling employer would cease to operate). If so, the new rule would negate several PGBC opinion letters issued in the 1970s and early 1980s. Comment letters on the proposed rule are due on or before April 26.

**PBGC Issues Two Rules on Electronic Filing**

On March 4, the Pension Benefit Guaranty Corporation (PBGC) issued a final rule requiring electronic filing of financial and actuarial information under Section 4010 of the Employee Retirement Income Security Act (ERISA), as well as a proposed rule requiring electronic filing of premium information. The final rule took effect April 8 but contains some optional delays for some of its requirements.

ERISA Section 4010 requires annual reporting of actuarial and financial information by certain controlled groups with plans that have significant unfunded vested benefits. The final regulation requires electronic filing of certain identifying, financial, and actuarial information. However, for the first year the rule is in effect, filers may email the information in a commonly-used electronic format (the format is specified on the PBGC's Web site). The PBGC's new Web-based software application became accessible on March 14.

In addition, filers may continue to use certain optional assumptions – otherwise eliminated in the final rule – for the first year the rule is in effect to determine whether a 4010 filing is required. The final rule also requires the filing of additional items of supporting information that are readily available to the filer but eliminates the requirement in the proposed rule that would have required filers to provide information on exempt entities (but the PBGC may request this information on a case-by-case basis).

The PBGC also issued a proposed regulation that would make electronic filing of PBGC premium information mandatory on a phased-in basis. Electronic filing is optional for plan years beginning in 2004 and was not available prior to 2004. Under the new rule, plans with 500 or more participants would have to file electronically for the plan year beginning in 2006 and smaller plans would have the same requirement beginning in 2007. The PBGC could grant exemptions to the mandatory electronic filing requirement on a case-by-case basis. Comments are due May 9.

### SEC Releases Final Rule on Redemption Fees

On March 11, the Securities and Exchange Commission (SEC) published a final rule concerning mutual fund redemption fees. The rule requires the boards of mutual funds that redeem shares within seven days to (1) adopt a redemption fee of no more than 2 percent of the amount of the shares redeemed or (2) determine that a redemption fee is not necessary or appropriate for the fund. With this rule, the SEC backed off from its earlier proposal mandating that mutual funds impose a redemption fee for purchase and sales occurring within five days.

The rule also requires funds to enter into agreements with intermediaries (such as broker-dealers and retirement plan administrators). Under the new written agreement requirement, intermediaries such as retirement plan administrators must agree to:

- provide funds with certain shareholder identity and transaction information at the request of the fund (the original proposal would have required intermediaries to provide information to the funds automatically), and
- implement fund instructions to implement trading restrictions against participants the fund has identified as violating the fund's market-timing policies.

The rule becomes effective May 26, 2005, and the compliance date is October 16, 2006, allowing time to negotiate agreements and make necessary system changes. Within the final rule is a request for additional comment on whether the SEC should establish a set of uniform standards to facilitate imposing the fee through intermediaries such as retirement plan administrators. The deadline for these comments is May 9.

## *2005 LEGISLATION*

### Thomas Announces SAVE Initiative Providing for LSAs, RSAs, ERSAs

On March 8, Senator Craig Thomas (R-WY) joined Representative Sam Johnson (R-TX) and U.S. Treasury Secretary John Snow in announcing the SAVE initiative, a series of three proposals designed to improve saving rates and simplify common savings plans. These proposals are the latest incarnation of Lifetime Savings Accounts (LSAs), Retirement Savings Accounts (RSAs) and Employer Retirement Savings Accounts (ERSAs).

Both LSAs and RSAs would have a $5,000 annual contribution limit (indexed for inflation), non-deductible contributions and tax-free earnings. LSAs have no age or income requirements and no minimum distribution rules, while RSA qualified distributions can be made after age 58 or upon the RSA owner's death or disability. The proposed ERSA would combine and simplify current rules for various existing retirement plans such as 401(k), SIMPLE 401(k), 403(b), Government 457, SARSEP and SIMPLE IRA plans.

Thomas has introduced three bills in the Senate (LSA proposal (S. 545) | RSA proposal (S. 546) | ERSA proposal (S. 547)), and Johnson introduced companion bills in the House of Representatives, LSA proposal (H.R. 1163), RSA proposal (H.R. 1162), and ERSA proposal (H.R. 1161). Thomas and Johnson introduced similar legislation in the previous session of Congress, though no action on them was ever taken.

At the press conference to unveil the proposals, Snow supported the role of these accounts as part of the President's FY2006 budget. (Individual Development Accounts (IDAs), also proposed as part of the President's FY2006 budget, will not be addressed as part of the SAVE initiative.) When asked whether these proposals would pre-empt or otherwise affect the President's Social Security proposals including personal accounts, Snow insisted that all these initiatives complement each other as well as broader pension reform efforts from other members of Congress.

**Bankruptcy Reform Legislation Affecting Retirement Plans Signed**

On April 13, the House of Representatives passed The Bankruptcy Abuse Prevention and Consumer Protection Act (S. 256), which had been passed by the Senate on March 10. President Bush signed the bill into law on April 20. Though the bill will reduce debtors' protections against creditors, the bill also includes a number of provisions to protect retirement and savings plan assets in the event of bankruptcy.

This bill extends the protections enjoyed under current bankruptcy law by ERISA retirement plans to non-ERISA plans (such as 457, IRA, and non-ERISA 403(b) plans). The provisions also extend to contributory (i.e., not rolled over from qualified plans) IRAs and Roth IRA assets, but only up to $1 million (indexed to inflation). The legislation further clarifies that bankruptcy will not interfere with plan loan repayment.

The legislation also makes clear that in the event of an employer's filing for bankruptcy, creditors cannot have a claim to assets that have been withheld or received from an employee as contributions to benefit plans, even if those amounts have not yet been contributed to the plan..

**Bipartisan Alzheimer's Funding and Long-Term Care Bill Introduced in the Senate**

On March 10, Senators Barbara Mikulski (D-MD) and Kit Bond (R-MO) introduced the Ronald Reagan Alzheimer's Breakthrough Act of 2005 (S. 602). In addition to doubling the federal funding for Alzheimer's research, the bill would provide an above-the-line income tax deduction for long-term care insurance premiums, institute the phase-in of a tax credit for family caregivers and improve consumer protections for long-term care insurance. The bill does not include provisions that would allow qualified long-term care coverage to be offered as a benefit under employer-sponsored cafeteria plans and flexible spending arrangements (FSAs).

A companion measure (H.R.1262) was be introduced in the House of Representatives by Ed Markey (D-MA), Chris Smith (R-NJ) and Michael Burgess (R-TX) but does not include the long-term care tax provisions. Those provisions are expected to be included in a separate measure to be introduced by Representatives Nancy Johnson (R-CT) and Earl Pomeroy (D-ND), who serve on the House Ways & Means Committee.

The cost of the long-term care provisions is estimated to be approximately $40 billion over ten years, so despite bipartisan support for the measure, the cost of the plan is a significant obstacle to overcome in light of current budget constraints.

**Bill Introduced Extending Retirement Benefit Eligibility to Flexible Workforce**

On March 2, Representatives Carolyn McCarthy (D-NY) and Rob Andrews (D-NJ) introduced the Employee Benefits Protection Act (H.R. 1058), which would eliminate distinctions between common law employees, staffing firm employees and independent contractors for the purposes of eligibility for retirement benefits. The legislation could hamper the operations for many plan sponsors who hire workers through staffing agencies.

H.R. 1058 would amend the ERISA minimum participation rules to require that years and hours of service include an individual's service as a common law employee, regardless of whether the individual is paid by a staffing firm or other third party or directly as a contractor. Exclusion of workers would only be permitted under "reasonable job classifications" and "objective criteria." Plans would not be allowed to exclude an individual from participation if the individual is a common law employee, performs the same or substantially the same work as employees who are not excluded, and meets the plan's minimum service and age requirements.

In cases where an employer changes the job classification of a regular employee to a staffing firm employee, contractor or similar category, the new bill would require that service under the minimum participation rules include all service for the employer after the reclassification. Also, an individual who is already a participant would continue to be a participant, even if the employer requires a conversion to a different category as a condition of continuing to provide services to the company.

Perhaps most notably, H.R. 1058 would generally prohibit all waivers of rights under ERISA unless specifically authorized by ERISA, and under expanded ERISA remedy and enforcement provisions participants would be permitted to sue for compensatory or remedial relief.

Concern remains that this legislation would dramatically increase the burdens of plan administration while exposing plan sponsors to unacceptable tax liability and legal damages.

**Senate Committees Hold Pension Forum**

The Senate Finance Committee and the Senate Health, Education, Labor and Pensions (HELP) Committee held a joint pension forum on March 15, to discuss "the retirement system of the future." Presenters at the forum included a mix of participant advocates and labor unions as well as plan sponsors and service providers.

All of the speakers agreed on the importance of the defined benefit pension plan system and indicated their support for the "three-legged stool" of retirement security – i.e., Social Security, employer-sponsored pensions, and private savings – while many of the plan sponsors predicted that the defined benefit system was in danger of extinction. The speakers did not agree on measures necessary to expand plan sponsorship or to make it more affordable and attractive to corporations.

The speakers also agreed that the low rate at which Americans save for retirement was a disturbing trend. However, they did not agree on ways to encourage or preserve savings. Speakers with labor and participant advocacy backgrounds preferred mandates, such as mandated matching contributions on plan sponsors, others favored greater education or investment advice.

Labor and advocacy speakers expressed concern regarding the stagnation of wages, downward pressure on benefit programs, worries over old-age poverty, globalization, lack of benefits for contingent or part-time workers, need for rules regarding hybrid plans that protect a worker's expectation of their benefits, and better funding by plan sponsors. One of the researchers said that the move in the U.K. to require plan sponsors to move their investments solely to bonds had resulted in a 65 percent freeze / termination rate in their defined benefit plans. In addition, he noted that U.K. companies that had employees in the U.S. were now discontinuing their plans for the employees in the United States.

Business and service provider speakers expressed concern regarding the impact that upcoming pension funding reform could have on the ability of a plan sponsor to budget and predict its pension plan contributions. The need for legal certainty on hybrid plans and conversions to hybrids was equal to the need for stability and predictability in funding, they said. All supported having a strong defined contribution system and were looking for ways to increase participation and reduce leakage. Speakers noted that businesses generally oppose increased burdens on plan sponsors such as additional non-discrimination rules or tests or reduced vesting schedules. Automatic enrollment was universally supported as were other ways to improve savings through 401(k) plans and the importance of annuitization.

The business and service providers speakers predicted, however, that if the flexibility of employers to change or discontinue offering their plans were restricted, there could be a rush to freeze and terminate their retirement plans.