BENEFITS INSIDER
A Member Exclusive Publication

Volume 6, May 16, 2005

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.

If your organization is interested in sponsoring WEB's ***Benefits Insider*** for 2005, please contact Kathleen Klein by email at Kathleen@webnetwork.org or by phone at 888-795-6862.

Articles in this Edition

RECENT REGULATIONS AND GUIDANCE

SEC Issues Guidance then Extends Effective Date for Stock Option Expensing

On March 29, the Securities and Exchange Commission (SEC) released additional guidance on the Financial Accounting Standards Board's (FASB's) new stock option expensing rule that appears to allow a certain amount of leeway in determining the value of stock options under the new rule. Staff Accounting Bulletin No. 107, "Share-Based Payment," (SAB 107) provides interpretative guidance related to the interaction of FAS 123-R, Share-Based Payment and other SEC rules and regulations, and also provides the SEC staff's view regarding valuation of stock options and other share-based payment arrangements for public companies. FAS 123 generally requires companies to expense all stock options granted, modified, repurchased or cancelled after June 15, 2005.

The SEC later on April 14, as part of its plan to implement new rules for the expensing of stock options, extended the compliance date for those new rules. The rules were previously applicable for fiscal *quarters* starting after June 15, but SEC pushed back the compliance date so that the rules will now take effect for fiscal *years* starting after June 15, 2005 – providing most U.S. companies with an extra six months to comply.

Legislation also has been introduced in the House of Representatives that would delay the rules' implementation for three years while instituting enhanced disclosure requirements for stock option programs. The Broad-Based Stock Option Plan Transparency Act (H.R. 913), introduced by Representatives David Dreier (R-CA) and Anna Eshoo (D-CA), also would require the SEC to study the effectiveness of the disclosures over three years, prohibit application of any new accounting standard for stock options during that time, and compel the Secretary of Commerce to conduct a study on the impact of broad-based employee stock option plans in a larger economic context.

Dreier and Eshoo also introduced a 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. Additionally, the legislation would 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 and did not become law in the last Congress.

Voluntary Fiduciary Correction Program Now Covers Plan Loans

On April 6, the Department of Labor's Employee Benefits Security Administration published proposed changes to its Voluntary Fiduciary Correction Program (VFCP), which allows plan fiduciaries to voluntarily correct violations of ERISA that otherwise could result in civil actions and penalties. The guidance expands and simplifies the VFCP program by, among other things:

- providing a model application form,
- reducing certain documentation requirements,
- simplifying the correction amount (and providing an on-line calculator), and
- covering new transactions.

Transactions newly covered by the program include:

- sale of illiquid assets to a party in interest,
- plan loans that exceed amount or duration limitations, and
- plan loan repayments that are not transmitted to the plan within a reasonable time after withholding or receipt by the employer.

The expanded program is effective April 6, 2005, and (except for the sale of illiquid assets provision) can be used during the comment period that ends on June 6, 2005.

Treasury Clarifies HSA Issue

The Internal Revenue Service and the U.S. Department of Treasury issued on April 13 Revenue Ruling 2005-25 clarifying that a taxpayer with self-only high deductible health plan coverage may contribute to a Health Savings Account (HSA) even if the taxpayer's spouse has nonqualifying family coverage, so long as the spouse's plan does not cover the taxpayer. The ruling also clarifies how much the eligible individual in such a situation may contribute to the HSA. This reverses an informal position Treasury has held. This rule was likely to disqualify many individuals who were otherwise eligible to participate in HSAs.

IRS Issues Corrected HRA Guidance

The Internal Revenue Service (IRS) issued on April 14 a corrected version of Revenue Ruling 2005-24. The original guidance clarified that an HRA was qualified to reimburse medical expenses on a tax-free basis only if the plan was designed so that a participant could never receive the unused funds. The corrected version includes several references that medical expenses must be substantiated before a reimbursement is made. However, IRS staff notes that this correction was not intended to modify any of the substantiation rules related to debit cards in Revenue Ruling 2003-43 or Notice 2004-16. (Debit cards typically provide reimbursement at the time of payment for a health care service with substantiation requirements met at a later time.) The correction also clarified that Revenue Ruling 2005-24 has no impact on salary reduction plans under Internal Revenue Code Section 125. None of the conclusions drawn in the original Revenue Ruling about the qualified status of certain HRA plan designs were changed by these corrections.

CMS Issues Revised Application Instructions for Medicare Waivers

The Centers for Medicare and Medicaid Services (CMS) on April 28 issued revised application instructions for waivers for employer retiree plans offering the Medicare prescription drug benefits. These instructions outline when applications are due to CMS for employer group waivers along with other requirements accompanying the submission of an application.

RECENT LEGISLATION AND ACTIVITY

Congress Passes Bankruptcy Reform Legislation Affecting Retirement Plans

On April 14, the House of Representatives passed significant bankruptcy reform legislation, The Bankruptcy Abuse Prevention and Consumer Protection Act (H.R. 685), after several attempts over the past several years. Though the bill would 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. The Senate passed a

companion bill (S. 256), on March 10. President Bush was expected to sign the bill into law on April 20.

This legislation 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) Individual Retirement Accounts (IRA) 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.

In a related matter, the U.S. Supreme Court recently ruled in the case of *Rousey v. Jacoway* that assets from an IRA are exempt from bankruptcy if the amount is "reasonably necessary to support the accountholder and his dependents." The court did not elaborate further on what dollar level would be considered "reasonable," and did not distinguish between contributory IRAs and rollover IRAs. This decision could create confusion, even after the bill is enacted, about whether an amount below $1 million is "reasonable."

Budget Conference Includes Proposed PBGC Premium Increase

House Budget Committee staff will develop the final reconciliation bill. The House passed its version of the budget resolution on March 17 by a vote of 218-214. The Senate passed its version on March 17 by a vote of 51-49.

Both bills include proposals that would result in significant increases in premiums paid by defined benefit plan sponsors to the Pension Benefit Guaranty Corporation. Under the House budget resolution, $18.1 billion over five years would be raised from Pension Benefit Guaranty Corporation (PBGC) premiums. The Senate resolution, however, would raise a total of $5.3 billion over five years. Clearly, if the final measure more closely resembles the House provision, PBGC premiums will be increased more dramatically.

If the PBGC premium increase remains in the budget, and it likely will, it poses some greater challenges to the ultimate passage of funding reform legislation this year. In particular, the revenue raised by increasing PBGC premiums is used for the federal budget deficit purposes; it will not be available to pay for needed strengthening of the pension funding rules (which costs federal revenue).

With respect to its advocacy for funding reform – in particular, the permanent replacement of the 30-year Treasury rate with the four year weighted average of the long-term corporate bond rate and the retention of the current rules structure for valuations – to access a briefing paper click on the link. It provides a more thorough explanation of the importance of smoothing liability and valuation calculations and highlighting the difference between smoothing those calculations as opposed to "spreading out" the amount of contributions due so that contributions will be less volatile (often referred to as "back-end smoothing").

In addition, the PBGC issued a paper on April 6 entitled "Impact on Contributions, Funded Ratios and Claims Against the Pension Insurance Program of the

Administration's Pension Reform Proposal." The paper further supports the Bush Administration's funding proposals through a series of simulations using three key variables: required minimum contributions, plan funding levels and claims against the pension insurance program.

Congress Passes Budget Resolution Suggesting PBGC Premium Increase

On April 29, Congress passed a final budget resolution that would require $6.6 billion over five years to be raised through increases in premiums to the Pension Benefit Guaranty Corporation (PBGC). The House agreed to the resolution on April 28 by a vote of 214-211, while the Senate passed the resolution by a vote of 52-47 on April 29. A summary of the final resolution, a fact sheet, talking points, and the joint manager's statement are now available.

Unlike the original Senate resolution, in which the savings were divided between the Senate Health, Education, Labor and Pensions (HELP) Committee and the Senate Finance Committee, the final resolution allocates the entire $6.6 billion to the HELP committee. The budget resolution will now be followed by substantive legislation that will provide the measures to actually achieve the savings reflected in the budget resolution.

House and Senate Leaders Preparing Pension Reform Legislation

Representative John Boehner (R-OH), chairman of the House Education and the Workforce Committee, is expected later this spring to introduce comprehensive pension reform legislation with regard to the recently passed Fiscal Year 06 budget and its $6.6 billion over five years increase in Pension Benefit Guaranty Corporation (PBGC) premiums. Boehner and the staff of the Education and Workforce Committee are working closely with Representative Bill Thomas (R-CA), chairman of the House Ways and Means Committee, and his staff on the reform package. Both committees have jurisdiction over pension issues.

The proposed reform package may contain elements from the Administration's proposal while addressing issues raised by the business community. These concerns include the increased unpredictability of the use of a spot rate for asset valuations, a near-spot rate interest rate for determining funding obligations, the complexity of a yield curve, loss of the use of credit balances and the use of a company's credit rating to determine funding and premium obligations. Members of Congress remain worried about the PBGC deficit, the need for greater transparency with respect to funding status and the need to employ a better system for addressing underfunding earlier and more quickly. In addition, the comprehensive reform measure will likely include hybrid plan provisions and multiemployer plan provisions. It may also include some provisions affecting defined contribution plans, such as investment advice.

Boehner's bill may not contain any airline-specific relief, though this issue is addressed in the Employee Pension Preservation Act (H.R. 861), introduced April 20 by Senators Johnny Isakson (R-GA) and David Rockefeller (D-WV). The bill would allow airlines to make up the shortfall in their pension funds over 25 years instead of the current four years. The bill would also require airlines to agree to limit their pension liability by partially or totally freezing current benefits. It would cap the per-employee liability of the PBGC at current levels, helping to reduce the likelihood that the PBGC would have to borrow from the Treasury to meet its obligations to airline employees.

Pension reform legislation is also expected to proceed in the Senate as well. The National Employee Savings and Trust Equity Guarantee Act of 2005 (NESTEG) (S. 219, sponsored by Senate Finance Committee Chairman Charles Grassley (R-IA) and Ranking Member Max Baucus (D-MT)) has already been reintroduced, but is expected to be revised when taken up by the Committee. Currently, NESTEG does not contain hybrid-specific legislation.

In a related development, the Senate Republican Policy Committee recently released a report, Retirement Income Security: The Status of Hybrid-Pension Plans, recommending a legislative clarification that hybrid plans are not inherently age discriminatory and that conversions should be permitted as long as participants' accrued benefits are protected.

Portman, Cardin Introduce Pension Reform Bills

On April 28, Representatives Rob Portman (R-OH) and Ben Cardin (D-MD) introduced separate versions of pension reform legislation that focus primarily on defined contribution plan and IRA issues. Unlike with prior collaborations, such as the Comprehensive Retirement Security and Pension Reform Act of 2001, Portman and Cardin sponsored separate bills. Portman's Individual and Workplace Retirement Savings Promotion Act (H.R. 1960) and Cardin's Pension Preservation and Savings Expansion Act (H.R. 1961) contain many identical provisions (see below). Portman's bill, however, eliminates the income limits on Roth IRAs (renamed RSAs) with respect to both contributions and conversions while the Cardin bill does not modify the income limits, and repeals Roth 401(k)s entirely.

Summaries of Portman's Individual and Workplace Retirement Savings Promotion Act (H.R. 1960) and Cardin's Pension Preservation and Savings Expansion Act (H.R. 1961) are available on the Council Web site at http://www.americanbenefitscouncil.org.

Both bills contain provisions that would:

- make the EGTRRA changes (including the Saver's Credit) permanent;
- expand the Saver's Credit, make it refundable, and require that it be transferred directly to a plan or RSA;
- provide a tax incentive for qualified and nonqualified annuities (other than defined benefit plan annuities), subject to income limits;
- provide incentives for automatic enrollment;
- provide minimum distribution relief for longevity insurance;
- repeal the combined defined benefit/defined contribution plan deduction limit applicable to employer contributions;
- permit additional nonelective contributions to SIMPLE plans;
- index age 70 1/2 for purposes of the minimum distribution rules;
- provide a workable automatic rollover alternative and a solution to the problems attributable to lost participants;
- provide an exception from the minimum distribution rules for individuals with less than $100,000 in their IRAs and 403(b)s;
- address problems with respect to differential pay issues;
- direct the U.S. Treasury Department to facilitate the grandfathering of participants under a prior defined benefit formula (which can affect a cash balance plan conversion);

- direct Treasury not to finalize regulations that would increase administrative burdens on employers that maintain 403(b) plans
- apply certain defined contribution plan reforms, including rules regarding participants' right to diversify out of employer stock; and
- provide Form 5500 simplification for small employers.

Following the introduction of his bill, Portman officially resigned from the House of Representatives to take his position as United States Trade Representative. Cardin has also announced his candidacy for the Maryland Senate seat in 2006.

401(k) Automatic Enrollment Bills Introduced in Congress

April saw two members of Congress introduce legislation intended to facilitate employers' ability to automatically enroll their participants in their defined contribution retirement plans and to automatically increase the level of these participants' contributions to the plans over the years. Several other members of Congress are considering introducing similar legislation. On April 21, Senator Jeff Bingaman (D-NM) introduced the Save More for Retirement Act of 2005 (S. 875). A number of provisions in this legislation are encouraging, including direction to the Department of Labor to provide guidance on default investments and the preemption of automatic enrollment deferrals from individual state wage withholding laws. A summary of the proposal is available. On April 6, Representative Rahm Emanuel (D-IL) introduced the 401(k) Automatic Enrollment Act of 2005 (H.R. 1508). There are a number of concerns with this proposal as it would require any plan sponsor wishing to use the current 401(k) safe harbor provisions to add an automatic enrollment provision in order to qualify for the safe harbor and does little to encourage implementation of new automatic enrollment arrangements. Recently posted on the Council's Web site is a set of talking points on the automatic enrollment and automatic increase issues.

Senate Aging Panel Hears of the Importance of Employer-Sponsored Retirement Plans in Overall National Savings

On April 12, American Benefits Council President James Klein testified before the Senate Special Committee on Aging in a hearing on the role of employer-sponsored retirement plans in increasing national savings, calling employer-sponsored retirement plans "the one bright light" in an overall dismal picture of current U.S. savings levels.

With the use of charts illustrating the robust levels of contributions made by employers to U.S. retirement plans, the historical levels of U.S. pension fund assets, and also the decline of PBGC-insured pension plans, Klein urged the panel to help enact pension funding reform legislation and to validate the legitimacy and legality of cash balance and other hybrid plans. He also enumerated several Council proposals for improving defined contribution plans and boosting retirement savings rates. He said that one of the greatest challenges to retirement income security is the continued rising cost of health care coverage that absorbs available resources for employers, workers and retirees. Controlling costs and aligning expenditures with good quality outcomes Klein noted is essential to ensuring that there are ample resources to provide for retirement plans.

Joining Klein as witnesses were J. Mark Iwry, non-resident senior fellow, economic studies, The Brookings Institution; C. Eugene Steuerle, senior fellow, The Urban Institute; and John Kimpel, senior vice president and deputy general counsel, Fidelity Investments. All four witnesses generally echoed the sentiment that a healthy employer-

sponsored retirement system is critical for improving Americans' savings. Appearing earlier in the hearing was Mark Warshawsky, assistant secretary for economic policy for the U.S. Department of Treasury, who took the opportunity to promote the Bush Administration's pension funding reform proposals.

Senate Finance Committee Holds Hearing on Social Security Reform

On April 26, the Senate Finance Committee held a hearing on Social Security entitled "Proposals to Achieve Sustainable Solvency, With and Without Personal Accounts." Witness testimony and committee member statements are available on the hearing's Web site.

The reform ideas of several of the hearing speakers have been influential in the current Social Security reform debate. Peter Ferrara, a senior fellow with the Institute for Policy Innovation and director of the Social Security Project, Free Enterprise Fund, favors (and worked on) the Social Security Personal Savings Guarantee and Prosperity Act recently introduced by Senator John Sununu (R-NH) (S. 857) and Representative Paul Ryan (R-WI) (H.R. 1776). Once fully implemented, the Sununu/Ryan proposal would allow workers to invest in a personal account 10 percent of the first $10,000 in wages each year and 5 percent of wages in excess of $10,000 up to the Social Security wage base (currently $90,000). Under the legislation, if certain requirements are met, workers would receive the greater of the current law scheduled benefit or the benefit provided by the personal account.

Michael Tanner, director of the Project on Social Security Choice at the Cato Institute, spoke about the Institute's proposal, which forms the basis for legislation introduced by Rep. Sam Johnson (R-TX) (H.R. 530). Under this proposal, workers could invest 6.2 percent of payroll taxes in a personal account and workers choosing to remain in the traditional systems would receive a price-indexed initial benefit level.

President Bush spoke favorably about the idea of progressive indexing during his April 28 news conference, as proposed by hearing witness Robert Pozen, chairman of MFS Investment Management. Currently, wage indexing is used to calculate initial Social Security benefits and provides a higher level of initial benefits than would be provided if price indexing were used. Progressive indexing maintains wage indexing for lower wage workers (those with career average earnings of less than $25,000 per year) but moves to price indexing for high income worker (average earnings of more than $113,000 per year). A proportional mix of wage and price indexing would be used for those in the middle.

Peter R. Orszag, the Joseph A. Pechman senior fellow of Economic Studies at the Brookings Institution, who is not in favor of personal accounts, began by suggesting that Congress focus on ways to make 401(k)s and IRAs work more efficiently. He argued that common sense reforms, such as automatic enrollment and allowing tax refunds to be deposited directly into IRAs, should be implemented to bolster retirement security. While Joan Entmacher, vice president for family economic security at the National Women's Law Center, focused on Social Security benefits paid to disabled workers, children, spouses and surviving spouses.

House Subcommittee Holds Hearing on Retiree Health Issues for Employers

On April 29, the House Education and the Workforce Subcommittee on Employer-Employee Relations held a hearing to examine Challenges to Employer Efforts to Preserve Retiree Health Care Benefits. Witnesses testified from the Equal Employment Opportunity Commission (EEOC), National Education Association, AARP, and the U.S. Chamber of Commerce. Witnesses and subcommittee members focused on the recent activity related to the *Erie County* issue and the effect on employers if EEOC continues to be prevented from publishing its rule that would allow employers to offer different benefits to pre- and post-Medicare eligible retirees. A comprehensive summary of the hearing is available and details the issues and testimony presented by the witnesses.

2005 LITIGATION UPDATE

IRS and Treasury Provide *Heinz* Case Suspension-of-Benefits Guidance

On April 18, the Internal Revenue Service (IRS) and U.S. Treasury Department released Rev. Proc. 2005-23 which provides guidance to plans affected by a U.S. Supreme Court decision regarding plan amendments that add or expand a suspension of benefits provision. In *Central Laborers' Pension Fund v. Heinz*, 124 S.Ct. 2230 (June 7, 2004), the Supreme Court held that a plan amendment that expanded the reasons for suspension-of-benefit payments retirees had already accrued could not be enforced because it violated anti-cutback rules under Internal Revenue Code Section 411(d)(6) and ERISA Section 204(g). The revenue procedure provides guidance to plan sponsors that adopted similar amendments prior to the court's June 7, 2004, decision.