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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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RECENT JUDICIAL ACTIVITY

Court Rules Against Company in 401(k) Company Stock Investment Case

On August 19, the U.S. Court of Appeals for the Third Circuit reversed an earlier *ruling In re Schering-Plough Corporation ERISA Litigation*, finding for the plaintiff. The Court found that the District Court for the District of New Jersey improperly dismissed the appellants' claim for breach of fiduciary duty by the plan sponsor.

In this case, the plan assigned responsibility for selecting plan investment options to an investment committee and authorized the committee to designate a fund investing in the company's common stock as an option. The plan did not require participants to invest any portion of their account balances in this or any other investment choice and, in fact, prohibited participants from investing more than 50 percent of their account balances in the employer stock fund. The appellants contended that the plan fiduciaries should accept responsibility for a period of lower market performance of the company's stock because the fiduciaries imprudently offered the stock fund as an investment choice.

The district court dismissed the appellants' claim, but the appeals court concluded that the plaintiffs may seek money damages on behalf of the plan, notwithstanding the fact that the alleged fiduciary violations affected only a subset of the plan's participants. The American Benefits Council filed an amicus (friend of the court) brief on November 24, 2004, arguing that a fiduciary's compliance with the plan's terms by permitting investment in employer stock is consistent with ERISA's fiduciary requirements. Based upon previous case law, plan participants must prove that an extreme decline in a company stock's value occurred with the plan fiduciary knowing the true financial condition of the company in order for it to be a breach of an ERISA duty. In addition, any weakening of previous case law would undermine Congress' current policy of favoring employee stock ownership, expose plan fiduciaries to constant litigation, and would inhibit the continued growth of 401(k) plans.

The Council has also argued that the recent wave of company stock fund ERISA litigation is discouraging plan sponsors from making company stock an available investment option and thus discourages broad based equity ownership in a company by employees of that company.

RECENT REGULATIONS AND GUIDANCE

New HSA Proposed Regulations and 2006 Indexed Amounts

The Department of Treasury and Internal Revenue Service have issued proposed regulations with respect to the comparability rules for Health Savings Accounts (HSAs). In general, employer contributions are comparable if they are either the same amount or the same percentage of the deductible for employees who are eligible individuals with the same category of coverage. As the press release notes, "The proposed regulations generally follow the previously issued guidance on comparability rules. The rules also provide additional clarification with respect to a few issues not previously addressed." One item not previously addressed relates to what it means to offer an HSA through a cafeteria plan. Such HSAs will need to comply with the cafeteria plan nondiscrimination rules, but not the comparability rules.

Companies have already begun to raise concerns about the rigid comparability rules and the new complexity that appears to exist if an employer wants to qualify for the cafeteria plan exception.

In addition, 2006 HSA amounts adjusted for inflation are being circulated. These are based on the procedure detailed in the statue and are considered final, but will not actually be published until November 2005 by the Treasury Department:

- Maximum contributions: $2,700 for individual coverage, $5,450 for family coverage.
- Minimum deductibles: $1,050 for individual coverage and $2,100 for family coverage.
- Maximum out-of-pocket: $5,250 for individual coverage and $10,500 for family coverage.
- The catch-up amount for participants over 55 is fixed by statute and will be $700 per eligible account in 2006.

Council Testifies Before IRS on Proposed Relative Value Regulations
At an Internal Revenue Service (IRS) hearing on August 24, Kent Mason, an attorney with the Benefits Group of Davis & Harman, LLP, testified on behalf of the Council regarding the proposed relative value regulations published in January 2005. The Council's testimony focused on the effect of the proposed regulations on social security level income (SSLI) payment options. SSLI payments are expected to provide the participant with a level income before and after Social Security payments begin when Social Security is taken into account. Typically, payments before Social Security retirement age are higher but then reduced once Social Security payments begin. The Council argued that SSLI payments should not be subject to the assumption requirements under Code Section 417(e)(3) (which are applied to immediate payments of benefits such as lump sums), an argument also made by the Council in a comment letter filed in April.

The proposed regulations would revise the December 2003 final regulations concerning disclosure of the relative values of optional forms of benefit. The proposed regulations, consistent with an earlier announcement, 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. However, the original effective date of October 1, 2004, was retained for comparing optional forms of benefit that are subject to the assumption requirements under Code Section 417(e)(3). The proposed regulations included a parenthetical reference to the types of benefits that would be subject to 417(e)(3) and, for the first time, the reference included SSLI payments (the December 2003 final regulations included a parenthetical reference that did not include SSLI payments).

Mason argued that SSLI payments should not be subject to the 417(e)(3) requirements because, when combined with Social Security, they are nondecreasing payments and certainly not immediate payments. Mason pointed out the parenthetical reference was a surprise and added that if the IRS and Treasury wanted to make changes to 417(e)(3), a separate regulatory project should be opened to address the issues.

John Vine of Covington & Burling, testifying on behalf of the ERISA Industry Committee, also focused his testimony on the effect of the regulations on SSLI payments. Others testifying included Don Segal, representing the American Academy of Actuaries, Judy Mazo on behalf of the National Coordinating Committee for Multiemployer Plans, and Debbie Chalfie for the National Women's Law Center.

IRS Issues Final Regulations on Eliminating Forms of Distribution in Defined Benefit Plans

As previously reported, the U.S. Treasury Department and the Internal Revenue Service (collectively, the IRS) published final and proposed regulations on August 12 regarding the types of optional forms of benefit that can be eliminated from defined benefit plans without violating the anti-cutback rules of Section 411(d)(6) of the Internal Revenue Code. The final regulations adopt the proposed regulations published on March 24, 2004, with some revisions. Some of these changes are discussed in more detail below. The final regulations are generally effective with respect to amendments adopted and effective after August 12, 2005 (see discussion of contingent event amendments below).

The proposed regulations address two topics reserved for later guidance in the final regulations — the interaction of the permitted forfeiture rules under Code Section 411(a) with the anti-cutback rules under Code Section 411(d)(6) (to reflect the holding in *Central Laborers' Pension Fund v. Heinz* (541 U.S. 739, June 7, 2004)), and a new utilization test method under which a plan amendment is permitted to eliminate an optional form of benefit that has not been utilized during a look-back period. The Council has prepared a summary of the 411(d)(6) proposed regulations.

Like the proposed regulations, the final regulations provide plans with two methods of potentially eliminating optional forms. Under the first option, plans could eliminate options that are redundant (provided they are not "core" options described below). The proposed regulations required a waiting period of 90 days before such amendments could be effective. The final regulations changed the waiting period to the maximum notice period under the Qualified Joint and Survivor Annuity (QJSA) rules that is currently 90 days (there are legislative proposals to extend that period to 180 days). Options are redundant if they fall within the same "family" of optional forms—the regulations designate six option "families":

- 50 percent or more joint and survivor annuity
- Less than 50 percent joint and survivor annuity
- 10 years or less term certain annuity
- Greater than 10 years term certain annuity
- 10 years or less of installment payments
- Greater than 10 years installment payments

As an alternative, plans can generally eliminate other optional forms of benefit, four years after the amendment is adopted, if the plan provides the following four "core" benefit options:

- Straight life annuity
- 50, 75 or 100 percent QJSA
- 10 year certain annuity
- Most valuable option for participant with a short life expectancy

The proposed regulations had limited the second core option to a 75 percent QJSA but the IRS extended the option to 50 or 100 percent provided other requirements are met.

The final regulations also provide that, effective for amendments adopted after December 31, 2005, benefits that are contingent on the occurrence of certain events, such as a plant shutdown or involuntary separation, and that continue after retirement are protected retirement-type subsidies that cannot be eliminated, both before and after the occurrence of the contingency. The rule is limited to benefits that are permitted to be in a qualified defined benefit plan. However, an amendment eliminating an "unpredictable" contingent event benefit (within the meaning of Code Section 412(l)) can be adopted prior to January 1, 2006, so long as the contingent event has not occurred..

IRS Proposes Rules Affecting ESOP Dividend Deduction
On August 25, the U.S. Department of Treasury and the Internal Revenue Service (collectively, the IRS) published proposed rules that would (1) limit the dividend deduction to the issuing corporation when the employer securities held in an employee stock ownership plan (ESOP) are not securities of the corporation maintaining the plan, and (2) eliminate deductions for payments in redemption of stock held by an ESOP.

The first rule may come as a surprise to companies in which the dividend is paid on company stock of a foreign parent company. The proposed regulations provide that the foreign parent is entitled to the deduction rather than the U.S. subsidiary maintaining the plan. Generally, basic tax principles in the compensation area assign deductions to the service recipient.

The IRS's reasoning for the second rule was previously discussed in Rev. Rul. 2001-6. They rejected the reasoning in a more recent case that held the payments were deductible (*Boise Cascade Corporation v. United States*, 329 F.3d 751 (9th Cir. 2003)). The IRS believes that allowing the deduction would constitute, in substance, an avoidance or evasion of taxation because it would allow a corporation to claim two deductions for the same economic cost—once for the value of the stock contributed to the ESOP and again for the amount paid to redeem the stock.

Although the regulations are proposed to be effective on the date of issuance of the final regulations, the IRS indicated it will continue to assert (outside of the 9th Circuit) that no deduction is allowed for payments made to reacquire employer securities held by an ESOP. Comments on the proposed regulation are due November 23, 2005, and the Council will likely file a comment letter. If your corporation is affected by either of these two changes, the Council would like to hear from you in order to incorporate our members' concerns into the comment letter.

Council Testifies Before IRS on Proposed Section 415 Regulations
At an Internal Revenue Service (IRS) hearing on August 17, Davis & Harman attorney Jason Bortz testified on behalf of the American Benefits Council with regard to recently proposed Section 415 regulations. These rules address contributions made to qualified retirement plans.

Bortz applauded the IRS for their action on this topic and took the opportunity to voice some of the remaining concerns for employer plan sponsors, many of which were communicated in a formal comment letter from the Council to the IRS on July 25, 2005.

The Council has recommended that the proposed regulations be amended so that:

- All payments to a participant be treated as compensation under section 415 if made (1) during the limitation year including the participant's severance from employment or (2) within 2½ months of severance of employment, if later;
- Non-elective post-termination contributions are not precluded by the special rules in section 415 for post-termination compensation;
- Excess contributions should be distributed first from the qualified plan when aggregating contributions for an employee who participates in an employer-sponsored 403(b) arrangement and is also a sponsor of an individualized 401(a) qualified plan;
- Changes be dropped from the regulations concerning how a participant's average salary for his or her highest three consecutive years is calculated (each year's compensation would be limited under the annual compensation limit found in section 401(a)(17)); and
- Several adjustments are made to the proposed multiple annuity starting date calculations for defined benefit plan disbursements so that the age-adjusted dollar limit for any benefit commencement age will not decrease on account of increasing age or service accruals and the rules will not preclude many cost-of-living adjustments.

Treasury and IRS Issues Priority Guidance for 2005-2006
The U.S. Department of Treasury and Internal Revenue Service (IRS) have released their 2005-2006 Priority Guidance Plan listing those issues that will be the subject of formal guidance during the next year. In a joint statement issued with the plan, the agencies' representatives noted that they are "committed to increased and more timely published guidance." They also state that "the published guidance process can only be fully successful if [the agencies] have the benefit of the insight and experience of taxpayers and practitioners who must apply the rules." Individuals are encouraged to provide comments and suggestions throughout the year as the agencies work on their guidance.

The plan includes 254 projects dealing with tax topics that affect individuals, corporations, charities, international transactions, and employee benefit plans. The following are a few of the projects affecting retirement, health, and executive compensation programs:

- Guidance on the tax treatment of distributions from Roth 401(k) plans and final Roth 401(k) regulations;
- Final regulations concerning in-service distributions under phased retirement arrangements;
- Final regulations on electronic notices;
- Regulations under Section 411(d)(6) regarding elimination of optional forms of benefit in defined benefit plans (see story above);
- Proposed regulations updating mortality tables;
- Final regulations regarding limitations on benefits and contributions under Section 415;
- Final regulations under Section 417 on the relative value of optional forms of benefit;

- Guidance under Section 420 on the impact of the Medicare prescription drug subsidy on the minimum cost requirement;
- Additional guidance on debit cards in employer-provided medical reimbursement arrangements;
- Guidance on the impact of providing a two-and-a-half month grace period for dependent care assistance plans and health flexible spending arrangements;
- Proposed regulations on cafeteria plans;
- Proposed regulations addressing numerous issues with respect to the taxation of nonqualified deferred compensation under Section 409A; and
- Final regulations on a flat rate supplemental wage withholding.

CMS Announces Prescription Drug Premium

On August 9, the Centers for Medicare & Medicaid Services (CMS), announced that Medicare prescription drug coverage will carry an average monthly premium of $32.20. According to CMS, this figure is approximately $5 less per month than previously estimated, because the weighted average of the actual bids from stand-alone prescription drug plans, on which the Medicare premium was based, are lower than had been predicted. The premium goes into effect on January 1, 2005 and beneficiaries may begin signing up for coverage on November 15. Individual premiums will vary with the plan chosen by the participant.

CMS also announced the low-income premium benchmark amounts for each region. If participants enroll in a plan with the premium below the benchmark, they will be eligible for additional help in paying for their premiums.

RECENT LEGISLATIVE ACTIVITY

Funding Reform Efforts Continue Through August Recess;
Side-by-Side Chart, Hybrid Provision Analysis Now Available

Funding reform efforts on Capitol Hill continued through the August recess. As previously reported, The House Education and the Workforce reported out the Pension Protection Act (H.R. 2831) on June 30 and the Senate Finance Committee reported out the National Employee Savings and Trust Equity Guarantee Act (NESTEG) on July 26. H.R. 2830, sponsored by Education and the Workforce chairman John Boehner (R-OH) and cosponsored by House Ways and Means Chairman Bill Thomas (R-CA), was referred to the House Ways and Means Committee and could be considered as part of the larger Social Security and retirement policy debate by that committee this fall.

A side-by-side chart comparing the pending bills, current law and the administrations proposals, prepared by the Benefits Group of Davis and Harman LLP, is now available for your information.

With regard to hybrid pension plans, the NESTEG bill contains a provision regarding their treatment under age discrimination law. The provision clarifies the age-appropriateness of the hybrid pension designs on a prospective-only basis and includes language stating that "no inference" one way or the other is to be drawn as to the legal treatment of hybrid plans under present law. The law firm of Ivins, Phillips & Barker has prepared a detailed memo analyzing the legal ramifications of this provision that may be helpful to you in your review of the bill.

Council Urges Support of FSA Rollover Bill in House, Senate
Use Capitol Connection Feature of Council's Web Site Today

The American Benefits Council has urged employers and employees to write their Senators and urge co-sponsorship of legislation regarding flexible spending arrangements (FSA). S. 309, sponsored by Senators Jim DeMint (R-SC), Ken Salazar (D-CO) and John Ensign (R-NV), would permit up to $500 in unused FSA funds to be carried forward to the following year's FSA or transferred to a health savings account (HSA). The Council has strongly supported modifying or eliminating the use-it-or-lose-it rule as a way to encourage increased enrollment in (FSAs) and greater employee control over health spending.

An identical companion bill has now been introduced in the House of Representatives. H.R. 1998 is sponsored by Jim McCrery (R-LA), Bobby Jindal (R-LA) and Marilyn Musgrave (R-CO).

With the introduction of this House bill, the Council has modified the ready-to-use letters on the Capitol Connection section of their Web site. To access the Capitol Connection Center, click on one of the following links and enter the appropriate zip code:

Letter from Employer: http://snipurl.com/s309employer

Letter from Employee: http://snipurl.com/s309employee

It is important to have solid support for this legislation since the prospects for congressional action on the issue have increased — largely because House Ways and Means Committee Chairman Bill Thomas (R-CA) has mentioned FSAs when discussing Social Security reform and the need to expand options to help individuals save for retiree health. Please contact your Senators and Representatives today and urge your employees to send a message as well. This is a great way for companies to get employees engaged on a public policy issue that is obviously of great value to employees and their families.