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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.

Articles in this Edition

RECENT REGULATORY ACTIVITY

IRS/Treasury Release Final Roth 401(k) Regulations

On December 30, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) released final regulations on designated Roth contributions under Sections 401(k) and (m) of the Internal Revenue Code (Code). Designated Roth contributions (referred to in the general media as Roth 401(k) contributions) are elective contributions that are included in gross income. A subsequent distribution of Roth contributions is excludable from gross income (along with the earnings on the contributions, if the distribution is a qualified distribution).

The final regulations, which were published in the Federal Register on January 3, 2006, were effective January 1, 2006. The regulations address a number of outstanding issues, but indicate that guidance relating to the taxation of distributions will be provided in proposed regulations that were expected to be issued in the near future.

Some of the highlights of the final regulations are:

- Code Section 72 will apply to determine the character of distributions from designated Roth accounts so that any distribution will include a pro rata portion of the earnings from the account. This characterization is different than the one applied to Roth IRAs which provides that distributions are first considered to be made from contributions (making even non-qualified Roth IRA distributions non-taxable until all contributions are distributed).
- Plans that allow designated Roth contributions must also offer pre-tax elective contributions.
- No other contributions, such as forfeitures and matching contributions, can be allocated to the designated Roth account.
- Designated Roth contributions are subject to the minimum required distribution rules (another difference from Roth IRAs).
- Plans can use automatic enrollment in conjunction with designated Roth contributions but the plans must specify the extent to which contributions made in the absence of an affirmative election are designated Roth contributions or pre-tax elective contributions.
- The direct rollover rules apply as if the designated Roth contributions and pre-tax elective contributions are coming from two separate plans for the $200 limitation on notice and withholding requirements, but the $1,000 limitation on automatic rollover requirements would not apply separately.
- For distributions of excess contributions by highly compensated employees (HCEs) (in order to pass non-discrimination testing), a plan can permit HCEs to elect whether excess contributions are to be attributed to pre-tax elective contributions or designated Roth contributions. However, a plan is not required to provide this option, implying that a plan can specify the order of the type of contribution that will be distributed.

The regulations indicate there are many other aspects of designated Roth contributions that would be reflected in plan terms but are not addressed in the regulations.

IRS Provides Relief for Relative Value Disclosures

In the Winter 2006 Employee Plans Newsletter, published by the Internal Revenue Service (IRS) in late December, the IRS announced that it would not finalize the 2005 proposed relative value regulations before the end of 2005. The newsletter also indicated the IRS expects the final regulations to provide that reasonable, good faith compliance (including substantial compliance with the 2003 regulations) will be deemed to satisfy the regulatory requirements during 2006 (for explanations provided before January 1, 2007). The relative value regulatory requirements apply to the written explanation that must be provided to each participant 30 to 90 days before his or her annuity starting date. Generally, the regulations require specific disclosures comparing the relative value of optional forms of benefit that may be elected by a participant. The regulatory requirements (or good faith compliance with the regulatory requirements) are effective for annuity starting dates on or after October 1, 2004, for certain distributions, and for annuity starting dates on or after February 1, 2006, for other distributions.

Medicare Retiree Drug Subsidy Program Estimated to Support Coverage for 6.5 Million Retirees

In a December 22 announcement, the U.S. Department of Health and Human Services (HHS) and the Centers for Medicare and Medicaid Services (CMS) estimated that, as of December 13, 2005, they had approved applications for the new Medicare retiree drug subsidy (RDS) program which covered 5.9 million Medicare-eligible retirees and had applications covering another 600,000 retirees still in process. Combined, this results in a total of 6.5 million retirees whose employer-sponsored retiree prescription drug coverage is expected to be supported by Medicare's 28 percent, tax-free subsidy (for drug expenses between $500 and $5,000) in 2006. In addition, CMS Administrator, Mark McClellan, said that about 1 million more retirees are estimated to be receiving prescription drug coverage from an employer-sponsored health plan that either supplements Medicare's new drug coverage or, in some cases, has entered into a direct contract with Medicare to sponsor an approved drug plan for its own retirees.

CMS reported that 3.1 million seniors are expected to obtain drug coverage through the federal employees' health benefits program or TRICARE, a program available to military retirees. CMS also estimated that more than 11 million additional Medicare beneficiaries will have drug coverage as of January 1, 2006, when the new Medicare drug benefit begins: some by enrolling in private health plans or other entities that have begun offering the Medicare drug benefit and some who are low-income beneficiaries who also qualify for assistance under state-administered Medicaid programs. In total, from all sources of coverage, CMS estimates that 21 million Medicare beneficiaries will start the year with prescription drug coverage, toward an agency goal of covering 28-30 million beneficiaries within the first year of the program.

HHS Secretary Mike Leavitt told reporters today that the enrollment figures demonstrate that most employers are continuing their retiree health plans and maintaining prescription drug coverage for their retirees. "Employers are, in fact, making use of the subsidy to keep providing, and in some cases enhancing, drug coverage for retirees," Leavitt said. "There had been predictions that employers would drop retiree drug coverage, but that's proven wrong," he added.

The official announcement, complete with statistics and data tables, is available on the HHS Web site.

CMS officials said they plan on releasing enrollment information on the new drug benefit each month. CMS officials have further indicated that they expect another spike in enrollment to occur toward the end of the enrollment period in May 2006 as Medicare beneficiaries make decisions to elect the benefit before a late penalty premium surcharge applies.

DOL Releases Final USERRA Regulations

The U.S. Department of Labor (DOL) has released final regulations implementing the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), which establishes certain rights and benefits for employees that serve or have served in the uniformed services, and prescribes certain duties for their employers.

The preamble to the final regulations notes that while the terms of USERRA may conflict with the Internal Revenue Code (Code), the Internal Revenue Service and Treasury Department have indicated that a health or pension plan will not violate Code requirements merely because of compliance with USERRA or its regulations. The regulations, which are effective on January 18, 2006, contain two sections applicable to health plan and pension plan coverage.

Treasury/IRS Release Code Section 409A Reporting Relief

On December 8, the U.S. Treasury Department (Treasury) and the Internal Revenue Service (IRS) released Notice 2005-94 which provides for suspension of employer and payer reporting and wage withholding requirements under Internal Revenue Code (Code) Section 409A with respect to compensation deferred for calendar year 2005.

The American Benefits Council had sent a letter to the Department of Treasury and IRS on November 9 strongly urging such relief. The Council asked the agency to "relieve or delay until a later year the reporting obligation for 2005 amounts so that employers and recordkeepers can expend their compliance and information systems resources on systems that are consistent with final rules."

Treasury/IRS Issue Updated Mortality Tables

The U.S. Treasury Department (Treasury) and the Internal Revenue Service (IRS) have issued updated mortality tables, based on the RP-2000 Mortality Tables Report, to be used for calculation of pension plans' current liability. The new tables, which apply to plan years beginning on or after January 1, 2007, generally assume that most pension plan participants will live longer, generating longer annuity payout periods, thereby making those pension plans less well-funded. The tables are now posted on the American Benefits Council's Web site.

Other items of note:

- The IRS and the Treasury considered and rejected the creation of separate mortality tables based on differences in job classification (i.e., blue-collar vs. white-collar), annuity size, employment status and industry.
- The proposed regulations would provide for separate sets of tables for annuitants and nonannuitants, reflecting the fact that nonannuitants tend to live longer.
- Changes in mortality tables for disabled participants are being separately reviewed.

- The mortality tables that would be established pursuant to this regulation would be based on mortality improvements through the year of the actuarial valuation and would reflect the impact of further expected improvements in mortality.
- A special simplified rule for small plans is provided.

Treasury/IRS Release Guidance on Amendment Timing Rules for Retirement Plans
On December 2, the U.S. Treasury Department (Treasury) and the Internal Revenue Service (IRS) issued Notice 2005-95 which clarifies and modifies the amendment timing rules for qualified plans. This guidance addresses the rules promulgated in IRS Revenue Procedure 2005-66 which established five-year staggered remedial amendment periods.

Notice 2005-95 provides specific timing rules for plan amendments made with respect to, among others, the following statutory provisions or IRS and Treasury guidance:

- The final regulations pertaining to retroactive annuity starting dates;
- EGTRRA's mandatory automatic rollover provisions;
- IRS and Treasury guidance regarding Professional Employer Organization plans;
- The final regulations pertaining to Code sections 401(k) and 401(m);
- IRS and Treasury guidance pertaining to required minimum distributions from defined benefit plans,
- New Code section 415 limits as provided for by the Pension Funding Equity Act of 2004; and
- Qualified Hurricane Katrina distributions and loans as provided for by the Katrina Emergency Tax Relief Act of 2005.

Notice 2005-95 also clarifies that, in general, the amendment timing deadlines of Rev. Proc. 2005-66 apply except where a statutory provision or guidance issued by the IRS sets forth an earlier deadline to adopt an amendment, or where a statutory provision or guidance issued by the IRS sets forth a specific deadline for the adoption of an amendment that is earlier or later than the deadlines set forth in Rev. Proc. 2005-66.

RECENT LEGISLATIVE ACTIVITY

House, Senate Approve One-Year Mental Health Parity Extension
The House of Representatives and the Senate have each approved a bill (H.R. 4579) providing a one-year extension of existing mental health parity law. The bill passed by voice vote in the House on December 17 and in the Senate on December 22.

Specifically, H.R. 4579 amends ERISA, the tax code and the Public Health Services Act to extend for one year the current law prohibition on employer-sponsored group health plans and health insurers from applying an annual or lifetime dollar limit on mental health benefits which are lower than any comparable dollar limits on benefits for other illnesses or medical care. The current law, established in 1996, was scheduled to expire at the end of 2005. The bill was sponsored by House Committee on Education and the Workforce Chairman John Boehner (R-OH).

The bill will now be signed by President Bush.

House, Senate Approve Budget Bill Conference Report; House Must Vote Again
On December 19, the House of Representatives approved the conference report of the FY 2006 budget reconciliation bill (Deficit Reduction Act, H.R. 4241/S. 1932) by a vote of 212-206; on December 21, the Senate approved the legislation by a vote of 51-50, with Vice President Dick Cheney casting the deciding vote. Normally, the bill would now be presented to the President for his signature and enactment. However, during the Senate vote, a technical point of order – unrelated to benefits policy – was raised and the conference agreement needed to be modified. Since the legislation has been changed, the bill as amended must now be considered again by the House.

The House has adjourned and is not scheduled to return to session until January 31, 2006. A spokesman for House Democratic Leader Nancy Pelosi (D-CA) is reported to have said that Pelosi may insist the House reconsider the conference agreement as modified by the Senate through a roll-call vote. House Speaker Dennis Hastert (R-IL) may therefore be forced to reconvene the House sooner than planned to vote once again on the budget reconciliation measure so that it can be sent to the President for his signature.

The conference agreement includes changes in pension insurance premiums to the Pension Benefit Guaranty Corporation and provisions to expand on hospital quality reporting under Medicare, establish a value-based purchasing program for hospital payments, modestly reduce funding for Medicare Advantage plans, and expand states' authority to obtain enrollment information from employers and insurers to determine if they have primary payment responsibility for low-income individuals who are covered under the Medicaid program.

A conference report summary, as well as a summary of the budget bill's Medicare provisions, is now available on the American Benefits Council's Web site.

House, Senate Approve KETRA Extension Legislation;
Includes Dependent Definition, Deferred Compensation Provisions
On December 16, the House of Representatives and Senate passed The Gulf Opportunity Zone Act (H.R. 4440), a package of tax incentives and relief measures for individuals and businesses in the Gulf region affected by hurricanes Rita and Wilma. H.R. 4440 includes an extension of the special distribution and loan provisions from the Katrina Emergency Tax Relief Act ("KETRA," H.R. 3768) – originally approved by both the House and the Senate on September 21 and finally enacted shortly thereafter – and includes:

- The exemption from the Internal Revenue Code (Code) Section 72(t) penalty tax for qualifying distributions from eligible retirement plans (along with corresponding three-year recontribution rights and income averaging);
- The mandatory one-year extension for outstanding loan repayments for affected individuals;
- The increase in the maximum plan loan limit (from $50,000 to $100,000) for affected individuals; and
- Recontribution rights for affected individuals that previously received a hardship distribution for the purchase or construction of a principal residence in an affected area.

H.R. 4440 also includes numerous changes with respect to other tax issues, including technical corrections to the Code Section 152 definition of "dependent," including for dependent participants in health savings accounts (HSAs) and dependent care spending arrangements.

The bill also contains revisions to certain of the rules pertaining to the taxation of foreign rabbi trusts under Code Section 409A – the section of the tax code regarding nonqualified deferred compensation. Code Section 409A(b) imposes immediate taxation, the 20 percent penalty and interest if deferred compensation accrues in a "foreign situs" trust or other arrangement that the U.S. Treasury Department deems equivalent to such a trust, even if the assets are subject to the claims of creditors of the employer. A statutory exception is provided if all employees perform "substantially all" services related to such deferred compensation in the jurisdiction of the trust. Under the statute, even if the underlying plan terms otherwise conform to the requirements of the Code, the dedication of assets in a foreign trust results in immediate taxation and penalties unless the statutory exception applies. The effect of the technical correction is to eliminate any grandfather relief for amounts accrued prior to December 31, 2004.

A Senate Finance Committee summary and Joint Tax Committee explanation of the bill are available on the American Benefits Council Web site.

President Bush signed the legislation into law shortly after its passage.

House Passes Pension Protection Act with Minor Changes, Conference Likely in Early 2006

On December 15, the House of Representatives passed a manager's substitute (updated version) of the Pension Protection Act (H.R. 2830) by a vote of 294-132. The approval followed a defeat of the Democratic leadership's motion to recommit the bill by a vote of 227-200. H.R. 2830, originally sponsored by House Education and the Workforce Committee Chairman John Boehner (R-OH), contains single- and multi-employer defined benefit plan funding reform provisions, defined contribution plan provisions, including those addressing automatic enrollment, and language intended to clarify the legal status of hybrid pension plans on a prospective basis. An official summary of the bill is available.

H.R. 2830 also includes several health care benefit provisions, allowing taxpayers to carry forward up to $500 of unused flexible spending account (FSA) balances each year and clarifying that health plans may recover benefits paid to a participant once the participant is reimbursed by a third party for the same expenses.

The Senate passed its pension reform legislation, the Pension Security and Transparency Act (S. 1783), on November 16. The two bills now need to be reconciled in a conference committee, expected to convene in early 2006. The same day, the White House released a Statement of Administration Policy (SAP) supporting the passage of H.R. 2830. The White House had previously issued an SAP threatening a veto of the Senate bill.

The manager's substitute reflects a number of changes from the bill as passed by the House Ways and Means Committee. Chairman Boehner and Ways and Means Chairman Bill Thomas (R-CA) reached an agreement with the United Auto Workers

(UAW) union to make some modest changes to the bill, including certain changes to the credit balance and shutdown benefits rules.

The updated bill also includes new provisions to encourage employers to implement automatic enrollment of new employees in defined contribution plans. These provisions include pre-emption of state wage withholding restrictions, relief from non-discrimination rules and direction to the U.S. Department of Labor to issue default investment guidance.

One important change contained in the manager's amendment significantly reduces the legislation's funding transition relief. Under the bills originally passed by the Education and the Workforce and the Ways and Means Committees, the increase in the funding target from 90 percent to 100 percent was effectively phased in over five years at two percent per year. In effect, the House-passed bill now provides as follows: the funding target is immediately increased to 100 percent in the first year that the bill is effective (i.e., 2007). However, there is a special rule under which a plan is deemed not to have a funding shortfall if it is funded at 92 percent in 2007, 94 percent in 2008, 96 percent in 2009, or 98 percent in 2010. Under the committee-passed bills, a plan that failed to reach these funding targets in the appropriate years would be charged with a shortfall equivalent to the difference between the funded level and the funding target. Under the House-passed bill, a plan that fails to reach the funding target would be charged with a shortfall equivalent to the difference between the funded level and the 100 percent level. We do not know yet whether this reduction in the transition relief was intentional or inadvertent. If this provision stays as it is, it would have a significant effect on many companies in 2007.

Hybrid Plan Issues to Be Discussed in Conference
The conference to reconcile the Pension Protection Act (H.R. 2830) and the Pension Security and Transparency Act (S. 1783) (see above story) will be particularly important for hybrid plan sponsors. House Education and the Workforce Committee Chairman John Boehner (R-OH), the original sponsor of H.R. 2830, committed his support for comprehensive legitimization of hybrid plans during debate of the bill in the House.

Prior to the House vote on H.R. 2830, a coalition of employee benefit consulting firms composed a letter to the House and Senate urging support for a comprehensive solution to the hybrid plan issue. According to the letter, "[h]ybrid plan provisions contained in H.R. 2830 provide that future benefits granted in typical hybrid plan designs satisfy age discrimination rules. However, as currently drafted, the legislation does not address benefits already earned by millions of workers in well over one thousand existing hybrid plans."

The letter also includes a copy of correspondence from the American Academy of Actuaries to the Government Accountability Office (GAO) identifying problems in the recent GAO report Private Pensions: Information on Cash Balance Pension Plans.

The letter is signed by executives from Aon Consulting, Buck Consultants (an ACS Company), Hewitt Associates, Mercer Human Resource Consulting LLC, Milliman Inc., Towers Perrin and Watson Wyatt Worldwide.

Rep. Cantor Introduces Bill to Improve HSAs

On December 13, the Chief Deputy Whip of the House of Representatives Eric Cantor (R-VA) introduced the Flex HSAs Act, a bill to expand the availability of Health Savings Accounts by allowing them to be coordinated with Flexible Spending Arrangements (FSAs) and/or Health Reimbursement Arrangements (HRAs). Under the Cantor bill, total combined annual contributions to HSAs, HRAs and FSAs could not exceed the out-of-pocket expense limits for high deductible health plans (HDHPs), currently $5,150 for individuals and $10,200 for families. The bill, which is co-sponsored by Rep. Michael Burgess (R-TX), would also increase the contribution limits for HSAs by eliminating the current law provision which restricts contributions to the lesser of the amount of the deductible for the HDHP offered in combination with Health Savings Accounts or a statutorily prescribed amount. By eliminating the “lesser of” restriction, the Cantor bill would make the maximum contribution amount to HSAs only subject to the statutory limit, currently $2,650 for individuals and $5,250 for families, amounts which are also indexed annually.

Cantor said his legislation is particularly aimed at giving mid-sized and large employers greater flexibility in designing HSAs so they are “more likely to get into the game." He also said that his bill is intended to “turn HSAs from short-term spending accounts to long-term savings accounts” for health care needs.

Also supporting the Cantor measure was House Speaker Dennis Hastert (R-IL). Hastert is not a co-sponsor of the legislation because his practice is not to co-sponsor bills introduced by other members; however, he urged that the legislation be enacted and said he has been a long-time supporter of HSAs and their predecessors, Medical Savings Accounts (MSAs), and views them as a good way to make health coverage more affordable for those who are now uninsured.

The Cantor measure was clearly aimed at setting the stage for consideration in improvements in HSAs in 2006. The Bush Administration is also reportedly considering proposing improvements in HSAs as part of its legislative agenda for 2006 and the Council continues to work to advance a wide range of legislative proposals to allow greater flexibility in the design of HSAs to encourage their expansion in the marketplace, including the improvements proposed today by Cantor.