

Employee Benefits Law Update

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What Do You Need to Do Between Now and December 31st?

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Plan or Program	Action	Deadline
Nonqualified Deferred Compensation Plans	Code Section 409A: Participant deferral elections for compensation for services performed during 2006. (Deferral elections for performance-based compensation may have a later deadline.)	December 31, 2005
	If plan sponsor wishes: (1) amend plans to allow participants to cancel deferral elections; (2) terminate plans by amendment; (3) cash out NSO discounts.	December 31, 2005
Qualified Retirement Plans	Automatic Rollovers: Amend plans to eliminate mandatory cashouts above \$1000 or to implement automatic default rollover to an IRA.	End of first plan year ending on or after March 28, 2005
	Anti-cutback rules: Amend plans to eliminate contingent benefits.	December 31, 2005
Defined Benefit Plans	Relative Value Disclosure: Revise QJSA notice and election forms.	November 1, 2005, as applicable
	Comply with second round relative value disclosure requirements.	February 1, 2006
	Minimum Required Distributions: Operate in compliance with new rules.	January 1, 2006
	Section 415 Interest Rate: Apply interest rate for lump sum and other optional forms at pre - 2004 level.	January 1, 2006
	Benefit Suspension & Corrections: Correct any plan amendments with invalid benefit suspension provisions; notify participants.	December 31, 2005
	RASDs: If you wish to add RASDs, amend plan document.	December 31, 2005 (amendment deadline still uncertain).
Defined Contribution Plans	401(k) and 401(m) Regulations: Review plans to ensure operational compliance. If plan uses prior year data, amend plan to comply with new testing rules.	December 31, 2005, if plan uses prior year data to comply with new testing rule
	Roth 401(k) Contributions: Contributions may begin in 2006.	First plan year beginning on or after January 1, 2006. Amend plan by end of plan year.
Section 125 Plans	Extended Grace Period: If new 2 1/2 month grace period observed for health care reimbursement and dependent care accounts, amend plan document.	End of applicable plan year.

In the past 12 to 14 months, Congress, the Internal Revenue Service (the “Service”), the Department of Labor (the “DOL”) and various other federal agencies have adopted rules and issued a particularly large number of regulations and proposed regulations and various other items of guidance affecting almost all types of employee benefit and compensation plans: nonqualified deferred compensation plans, qualified retirement plans, and health and welfare plans. Much of the guidance will require changes either in plan documents or in plan operation or in both. The table above sets forth some of the most important actions you should take between now and the beginning of next year as you review your benefits and compensation programs in order to comply with the new requirements. This article discusses some of the major recent changes in qualified and nonqualified plans. The article also raises a number of design and development issues which you may wish to consider in dealing with these changes.

Nonqualified Deferred Compensation Plans

American Jobs Creation Act and New Code Section 409A

Perhaps the most significant (and certainly the most publicized) development in the benefits and compensation field was the enactment of new Section 409A of the Internal Revenue Code (the “Code”) under the American Jobs Creation Act. As we discussed in an earlier newsletter, Section 409A establishes a new regime for the governance of nonqualified deferred compensation plans which is basically designed to restrict the ability of executives to access the funds in their deferred compensation plans until the occurrence of a specified distribution event. The rules under Section 409A are far-reaching and affect not only distributions, but also initial deferral elections, subsequent changes to deferral elections, acceleration of distributions and the use of trust vehicles. In addition to traditional nonqualified and supplemental retirement plans, these rules apply to a wide variety of arrangements, including certain types of severance payments or plans, discounted nonstatutory options, deferrals of restricted stock or restricted stock units and 457(f) plans sponsored by tax-exempt employers including certain grandfathered 457(f) plans.

The Service released initial guidance under Section 409A in January and released proposed regulations on September

29, 2005. We will discuss the proposed regulations in greater detail in an upcoming newsletter. One major change in the proposed regulations from the earlier guidance that we would like to draw your attention to now is that the deadline for amending nonqualified deferred compensation plans to comply with Section 409A has been extended from December 31, 2005 to December 31, 2006. (All deferred compensation plans have had to operate in accordance with Section 409A since January 1, 2005.)

Three end of 2005 deadlines, however, remain that are important to some plan sponsors. Participants who no longer wish to participate in a nonqualified deferred compensation plan must cancel their 2005 deferral elections by December 31, 2005. The compensation affected must be reported in the 2005 tax year of participants. Plan sponsors who wish to allow such an election must amend their plans by December 31, 2005. Similarly, plan sponsors who no longer wish to sponsor nonqualified deferred compensation plans must terminate their plans by December 31, 2005. Finally, if an employer has outstanding nonstatutory options issued at a discount, the discount can be cashed out before December 31, 2005 and the option will remain as excepted from Section 409A.

Both plan sponsors and participants should be aware that an amendment to a grandfathered plan that allows participants either to cancel their deferral elections or continue them will be a material modification and will result in the plan and all amounts deferred under the plan being subject to Section 409A.

Qualified Retirement Plans

Automatic Rollovers

Effective March 28, 2005, if a qualified retirement plan contains provisions for the mandatory distribution of benefits of more than \$1,000, the plan has to roll over the distribution into an individual retirement account (an “IRA”) which meets certain specific requirements set forth by the DOL, including selection by plan fiduciaries. The only exceptions to this rule are if the participant affirmatively elects either to roll over the distribution into another qualified plan or IRA or to accept a cash distribution subject to applicable taxes

and penalties. The rule applies to all defined contribution and defined benefit plans and to Section 403(b) plans and governmental Section 457(b) plans.

In order to comply with the automatic rollover rules, most plan sponsors have chosen to amend their plans to lower the mandatory distribution amount to \$1,000 or less. Plan sponsors could, however, have chosen to retain current mandatory distribution levels and follow Service and DOL guidance on automatic rollovers. This guidance includes a safe harbor for fiduciary responsibility regarding the selection of appropriate IRA vendors and advance written disclosures to participants. Whichever option the plan sponsor has chosen, plan operation must reflect the change as of March 28 and the sponsor must adopt a good faith amendment which reflects plan operation since March 28 by the end of the first plan year ending on or after March 28, 2005.

Governmental plans must comply with the new rules as of the close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after January 1, 2006.¹ Church plans must comply with the new rules no later than 60 days after the close of the earliest church convention that occurs on or after January 1, 2006.

Anti-cutback Rules

The Service has issued final and proposed regulations under Code Section 411(d)(6) to allow plan sponsors to eliminate certain optional forms of benefit, including early retirement and retirement-type subsidies. This guidance allows plan sponsors to eliminate certain benefit options which place undue burdens on sponsors or create inappropriate complexities or are of *de minimis* value to participants. The general effective date of the regulations is August 12, 2005. Special relief applies to amendments which a plan sponsor adopts prior to January 1, 2006 to eliminate benefits contingent on certain events.

The regulations and the relief they provide will be of particular interest to sponsors of defined benefit plans and to plan sponsors whose plans have become overburdened with numerous special options and subsidies as a result of

corporate acquisitions and mergers. The proposed regulations add a utilization test as a means of eliminating various benefit forms covered under the regulations. Specifically, a plan sponsor may eliminate a benefit form if it was available to at least 100 participants during a relevant time period and no participant elected that benefit form during the time period.

Defined Benefit Plans

Relative Value Disclosure

For sponsors of defined benefit plans, a continuing top priority will be preparing for required disclosure to participants of the relative economic values of optional forms of benefits available under their plans. The disclosures apply to all defined benefit plans. The first round of disclosures applied to lump sums or other benefit forms that are less valuable than the qualified joint survivor annuity (“QJSA”) and was effective in July 2004. The second round of disclosures, which applies to all other optional forms, is effective for benefits beginning on or after February 1, 2006. Please note that compliance date may necessitate revisions of the QJSA notice and applicable election forms by November 1, 2005, for distributions 90 days later, or on February 1, 2006.

Required Minimum Distributions

Another top year-end priority for sponsors of defined benefit plans is compliance with the minimum required distribution (“MRD”) rules. The final regulations, which the Service issued in 2004, generally require that an employee’s entire benefit must be distributed in a series of periodic annuity payments over the life of the participant or his or her beneficiary or over a comparable period certain, generally with no increasing payments. Prior to 2006, a “good faith” transition period has been in place for 2003 through 2005. Note, however, that governmental plans may retain any distribution option in effect on April 17, 2002, provided that the option is consistent with a “good faith” interpretation of the regulations.

The date by which defined benefit plan sponsors must amend their plans to reflect the MRD requirements is the

end of the remedial amendment period (“RAP”) under the Economic Growth Tax Relief and Reconciliation Act (“EGTRRA”).² The Service has published model “snap on” amendments that plan sponsors may use, with appropriate individualized adjustments, to amend their plans.

Retroactive Annuity Starting Dates

Plan sponsors now have some design flexibility in their plans by adding retroactive annuity starting dates (“RASDs”). A RASD is an annuity starting date elected by the participant which begins on or before the date the plan sponsor delivers the required QJSA notice to the participant. The Service issued regulations which allow pension plans to use a retroactive annuity starting date effective generally as of January 2004. The regulations do not require that your pension plan offer RASDs, but it may be a useful feature to add to your plan; for example, if a participant retires and for some reason the QJSA notice is delayed, the plan can still, if the participant so elects, pay benefits effective to a date prior to the date of delivery of the QJSA notice. The deadline for amending plans to allow for RASDs is somewhat uncertain. Unofficial guidance suggests it may be by the end of the 2005 plan year. On the other hand, amendments to eliminate RASDs may now be possible under the anti-cutback relief discussed above.

Benefit Suspension Provisions

Another area in which plan sponsors have a degree of flexibility in defined benefit plan design involves benefit suspension rules. In a landmark decision issued in 2005, *Central Laborers Pension Fund v. Heinz*, the Supreme Court prohibited a plan’s adoption of new or broader benefit suspension provisions which affected participants’ previously accrued benefits. (Suspension of benefit payments typically occurs when a retiree rejoins the active workforce and recommences benefit accruals.) This decision, although it involved a multiemployer plan, has potentially broad effects, especially in view of the fact that the Service had previously approved a number of benefit suspension provisions. As a result, the Service has published guidance which provides relief from retroactive plan disqualification under *Heinz* provided that employers send out participant notices and make required retroactive payments by January

1, 2006. Generally, it appears that plan sponsors may adopt formal plan amendments by the end of the EGTRRA RAP. The relief is only under the tax code and does not include relief under ERISA.

Interest Rates Used in Determining Section 415 Limits

In 2004, the Pension Funding Equity Act changed the interest rate used to adjust the limit under Section 415 for lump sum payments and certain other optional forms of benefit for the 2004 and 2005 plan years (and only for those years) to the greater of 5.5% or the rate specified in the plan. For plan years beginning in 2006, the rate returns to the greater of the applicable interest rate (as defined in Section 417(e)(3)) or the rate specified in the plan. In terms of plan operation, plan sponsors must be certain to revert to the previous rate as of the first day of any plan year beginning in 2006. In terms of plan amendment, however, plan sponsors have until the end of the 2006 plan year.

Another feature of the Pension Funding Equity Act allowed plan sponsors to determine the Section 415 limit during the 2004 calendar year by using the applicable interest rate in effect on the last day of the plan year prior to January 1, 2004. If a plan used this rate, the plan sponsor must amend the plan prior to the end of the 2006 plan year.

Defined Contribution Plans

Final 401(k) and (m) Regulations

In late 2004, the Service, for the first time in over a decade, issued comprehensive final regulations on 401(k) and 401(m) plans. The new rules address a number of issues including treatment of the gap period for purpose of returning excess contributions when a plan fails nondiscrimination tests; limits on the use of certain sorts of qualified nonelective contributions (“QNECs”) in order to satisfy nondiscrimination tests; the addition of new types of “hardship” events; and, changes in the vesting rules for breaks in service. The regulations also provide substantial guidance on so-called “safe-harbor” plans.

The new regulations make it essential for plan sponsors to review plan provisions to ensure both plan operational

and plan document compliance with the new regulations. Some items, such as the expanded category of hardship events will, require plan design decisions. Plans must comply operationally with the new regulations for plan years beginning on and after January 1, 2006. The Service does not appear to have provided definitive guidance on when plan sponsors must amend plan documents, though certain changes relating to testing may be necessary by the end of 2005 (if your plan uses prior year data). (The deadline for amendments will depend to some degree on the type of amendment and whether the amendment may have the effect of reducing benefits for affected participants.)

Roth 401(k) Contributions

A potentially significant new benefit which employers may make available under 401(k) plans would allow participants to make Roth 401(k) contributions to their plans. Such Roth contributions can be made only on an after-tax basis and must meet certain specific requirements. Roth contributions are treated like 401(k) salary deferrals for purposes of the annual maximum contribution limit and nondiscrimination testing. Unfortunately, Roth 401(k) accounts appear to entail a number of significant administrative requirements, including maintenance of a separate trust. Despite this fact, plan sponsors may wish to offer Roth 401(k) accounts because of their potential attractiveness to employees.

Plans may offer Roth 401(k) accounts starting in 2006. Plan sponsors must amend plan documents by the last day of the plan year in which Roth 401(k) accounts are permitted. Many vendors or third party administrators will not be ready to administer Roth IRAs on January 1, 2006.

Health and Welfare Plans

Cafeteria Plan Rules

In the area of health and welfare plans, the Service issued guidance which would permit participants in certain flexible spending accounts for health and dependant care to receive reimbursement for expenses incurred as long as two and one half months after the end of relevant plan

year. The effect of the change will be to give participants as long as 14 1/2 months to use amounts contributed to a spending account for a single plan year. The purpose of this extended grace period is to reduce forfeitures from these accounts and, thus, make them more attractive to employees. On the administrative side, plan sponsors will need to develop procedures for tracking expenditures from prior year accounts for account expenses incurred after the new plan year begins. Plan sponsors should amend their cafeteria plans by the end of the applicable plan year if they wish to include the extended grace periods.

Medicare Part D

Early in 2005, the Center for Medicare and Medical Services ("CMS") published final regulations on Medicare prescription drug coverage ("Medicare Part D"). Under the regulations, every plan which provides prescription drug coverage to any participant who is eligible for Medicare must affirm whether or not it is a "qualified retiree prescription drug plan." This requirement applies even to those plans which do not offer retiree benefits and is designed to establish a basis for claiming "creditable coverage" for those participants who are Medicare eligible. In order to encourage plan sponsors to offer coverage which is equivalent to Medicare Part D to their retirees, the government offers a direct subsidy provided that certain conditions are met. The deadline for a plan sponsor to apply for the 2006 subsidy was October 31, 2005. For future years, the application deadline will be September 30 of the preceding year. The application requires certification from an actuary and is quite complicated.

In addition, the regulations require that all plans must provide notice to those individuals who are eligible for Medicare about their prescription drug coverage and whether it meets the requirements for creditable coverage. For 2006 participants, plan sponsors were required to supply the notices by November 15, 2005.

Summary

This article has only attempted to highlight some of the more significant issues affecting benefit and compensation plans. Please contact us if you have any questions.

ENDNOTES

- 1 Fiduciaries for government plans (and church plans exempt from ERISA) cannot rely on the DOL guidance for nongovernmental plans and have no “safe harbor” for the fiduciary act of selecting a default IRA provider.
- 2 The Service has published guidance presenting a new staggered cycle for plan sponsor submissions for determination letters. The

EGTRRA RAP will coincide with the submission cycle. Individually designed plans will be subject to a five-year staggered cycle determined by the plan sponsor’s employer identification number. Governmental plans, multiemployer plans, and prototype plans are subject to separate cycles.

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