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Newsletter – Volume 1, No. 3 – March 3, 2005

Highlights

1. National Employee Savings and Trust Equity Guarantee (NESTEG) Act reintroduced in Senate
2. IRS Publication 969 Sheds New Light on Health Savings Accounts
3. IRS Finalizes Regulations Allowing Defined Contribution Plans to Eliminate Optional Forms of Distribution without Advance Notice
4. Merrill Lynch Successfully Defends Directed Trustee Role in WorldCom ERISA Case

National Employee Savings and Trust Equity Guarantee (NESTEG) Act reintroduced in Senate

The NESTEG bill would provide the following expanded protections for retirement plan participants, require companies to allow employees to diversify out of company stock, adopt a permanent yield curve replacement for the 30-year Treasury rate, expand the portability of retirement plan assets, and simplify pension laws and regulations.

The following summarizes the major provisions of the bill:

- ***Provisions relating to funding, deductions and PBGC***
 - Replacement of the 30-year Treasury rate with a yield curve based on corporate bonds of various durations.
 - Provision that would fix the interest rate at 5.5% in calculating the maximum benefit payment.
 - New reduced PBGC premiums for new small employer plans (100 or fewer employees) of \$5 per person for the first 5 years of the plan's life.
 - Increased tax deduction limits for employers that sponsor both a defined benefit and defined contribution plan that would permit an employer to contribute up to 6% of an employee's compensation to the defined contribution plan in addition to the amount the employer contributes to the defined benefit plan.
 - Increased tax deduction for contributions to defined benefit plans that would permit the employer to contribute up to 130% of current liability rather than the current 100%.
 - PBGC would pay interest on premium overpayment refunds at the same rate it charges for underpayments.



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- Guaranteed benefit amounts for majority owners would be phased in over 10 years.
- PBGC would be permitted to estimate the amount of benefit payable to participants in PBGC-trusted plans.
- ***Provisions relating to the investment of participant accounts***
 - Accelerated diversification of employer stock accounts
 - Immediate for amounts attributable to employee contributions
 - After 3 years of service for amounts attributable to employer contributions
 - 30-day advance notice to participant regarding diversification eligibility.
 - Provision of benefit statements according to the following schedule:
 - Quarterly for defined contribution plans that allow workers to direct the investment of their plan accounts.
 - Annual for plans that do not allow workers to direct the investment of their plan accounts.
 - Once every 3 years for workers in defined benefit pension plans.
 - Disclosure of annual investment guidelines and retirement planning information to workers.
 - Defined contribution plans with employer stock funds would be required to provide the same information to plan participants as it discloses to investors under the securities laws.
 - Amendment to ERISA that would eliminate liability for a plan sponsor relating to investment advice given to plan participants by a qualified investment adviser in a self-directed individual account plan.
 - Addition of a provision that would permit the employer to offer qualified retirement planning services to employees on a salary reduction basis, with an annual limit of \$1,000.
 - New excise tax penalty for a plan sponsor's failure to provide blackout notices.
 - Increased IRA contribution limits
 - Additional contribution of \$1,500 for 2005
 - Additional contributions of \$3,000 per year for years 2006 through 2009.
- ***Improvements in portability and distribution rules***
 - Provision that allows the rollover of after-tax amounts in annuity contracts.
 - Rollovers by non-spouse beneficiaries from a tax-qualified retirement plan, 457(b) plan, or tax sheltered annuity, i.e., 403(b) plan.
 - Requirement that employer non-elective contributions be vested according to either a 6-year graded vesting schedule or 3-year cliff vesting schedule.



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- Provision that permits a direct rollover from a retirement plan to a Roth IRA.
- Early distribution penalty for SIMPLE plans would be reduced from 20% to 10% for an initial 2-year period.
- Allow distributions from SIMPLE plans to be rolled over to other tax-favored arrangements within the first 2 years of participation.
- Automatic rollovers of involuntary distributions to be transferred to the PBGC instead of to an IRA.
- Extension of the PBGC's "Missing Participant Program" to terminated plans of private employers not covered by PBGC, including defined contribution plans.

The bill also contains the following administrative provisions:

- An update and improvement of the Employee Plans Compliance Resolution System (EPCRS) as it relates to small business plan sponsors.
- Extension of the benefits election period from 90 days to 180 days.
- Increase the asset limit for Form 5500-EZ to \$250,000.
- Provision that would prohibit states from treating qualified plan rollovers as income in determining unemployment compensation.

In addition, the bill would add the following provisions relating to spousal protection.

- Clarification that a domestic relations order issued after a divorce can be a Qualified Domestic Relations Order (QDRO).
- Extension of tier II railroad retirement benefits to surviving former spouses under divorce agreements.
- Requirement that pension plans that do not fully subsidize the qualified joint and survivor annuity provide an alternative joint and survivor annuity option.

IRS Publication 969 Sheds New Light on Health Savings Accounts

The IRS has released a revised version of Publication 969, "Health Savings Accounts and Other Tax-Favored Health Plans," for use in preparing 2004 tax returns. This publication formerly only covered medical savings accounts but now also covers other topics such as health savings accounts (HSAs), flexible spending arrangements (FSAs), and health reimbursement arrangements (HRAs).

For 2004 and later tax years, eligible individuals may set up HSAs if they are covered under high deductible health plans (HDHPs) and not covered under any other non-HDHPs (except for certain permitted insurance or coverage). Eligible individuals may, subject to statutory limits, contribute to HSAs, and so may employers, as well as other persons on behalf of eligible individuals. An HSA account holder may deduct contributions to his HSA even if someone else makes the contributions. This deduction



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is taken in calculating the individual's adjusted gross income, i.e. above-the-line, rather than on Schedule A. Employer contributions to an HSA are excludable from the employee's income, and distributions for qualifying medical expenses are tax-free.

Deductible Limits

For 2004, an HDHP is defined as a health plan with an annual deductible of at least \$1,000 for individual coverage and maximum out-of-pocket expenses of \$5,000. These amounts are increased to \$2,000 and \$10,000, respectively, for family coverage. Subject to certain exceptions, an eligible individual must have an HDHP that does not provide benefits for any year until the annual minimum deductible for the year is satisfied.

The maximum annual deductible contribution to an HSA is the sum of the limits determined separately for each month, based on status, eligibility, and health plan coverage as of the first day of the month. For 2004, the maximum monthly contribution for eligible individuals with self-only coverage under an HDHP is 1/12 of the lesser of (1) the annual deductible under the HDHP (minimum of \$1,000) or (2) \$2,600. For family coverage, the maximum monthly contribution is 1/12 of the lesser of (1) the annual deductible under the HDHP (minimum of \$2,000), or (2) \$5,150. For individuals and their spouses between the ages of 55 and 65, the HSA contribution limit is increased by \$500 in calendar year 2004. The catch-up contribution amount increases annually in \$100 increments until it reaches \$1,000 in calendar year 2009.

Family Plan Issues

Joint HSAs are prohibited. Therefore, each spouse who is an eligible individual that wants an HSA must open a separate HSA. If married individuals, who have family HDHP coverage, establish separate HSAs they are generally permitted to divide the annual HSA contribution limit for family coverage between themselves as they wish. However, if they each have self-only HDHP coverage, they are subject to separate annual contribution limits.

Many family plans have varying deductibles. Some plans have deductibles for both the family as a whole (umbrella deductibles) and for individual family members (embedded deductibles). Under these plans, if an individual meets the individual deductible for one family member, he doesn't have to meet the higher annual deductible amount for the entire family. However, if the deductible for an individual family member is below the minimum annual deductible for family coverage, the plan does not qualify as an HDHP. For example, the family coverage under the health insurance plan provides for an annual deductible of \$3,500. The plan also has an individual deductible of \$1,500 for each family member. The plan does not meet the requirements for an HDHP since the individual family member deductible is below the \$2,000 minimum annual deductible for family coverage.



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For a family HDHP that has an umbrella deductible and embedded deductibles, the HSA limit for contributions is the least of: (1) the maximum annual contribution limit for family coverage; (2) the umbrella deductible; or (3) the embedded deductible multiplied by the number of family members covered by the plan.

Filing Requirements

In order for an individual to make the maximum HSA contribution for a tax year, they must be an eligible individual and have the same coverage throughout the year. Otherwise individuals are required to prorate the contribution by using the worksheet for line 3 in the instructions for Form 8889, “Health Savings Accounts.”

If individuals have contributions to or distributions from their HSAs during 2004, they must file Form 8889 with their individual returns. Form 8889 and its instructions are not yet available on the IRS website.

Comparability Requirements for Employer Contributions to HSAs

If an employer decides to fund HSAs, it must make comparable contributions to all comparable participating employees’ HSAs. Publication 969 clarifies that in order for contributions to be comparable, they must either be:

1. the same amount; or
2. the same percentage of the annual deductible limit under the HDHP covering the employees.

Comparable participating employees are defined as:

1. Employees who are covered by the employer’s HDHP and are eligible to establish an HSA.
2. Employees who have the same category of coverage (either self-only or family).
and
3. Employees who have the same category of employment (either part-time or full-time).

Medicare Issues

In addition, individuals who are *enrolled* in Medicare are not eligible individuals for HSAs and, therefore, can not make contributions to an HSA. However, if an individual is eligible for Medicare but has not enrolled in Medicare, he/she can still make contributions to an HSA.



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IRS Finalizes Regulations Allowing Defined Contribution Plans to Eliminate Optional Forms of Distribution without Advance Notice

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) eliminated the advance notice requirement that was applicable to eliminating optional forms of distribution under defined contribution plans. Prior to EGTRRA, a defined contribution plan amendment that eliminated an optional form of distribution could not have applied to a participant for any distribution without meeting an advance notice requirement.

The Internal Revenue Code provides that a tax qualified retirement plan can not be amended to reduce benefits that have already accrued, i.e., would result in a decrease of benefits. This provision is also known as the anti-cutback rule. Generally, amending a plan to eliminate an optional form of benefit is treated as reducing accrued benefits.

However, a defined contribution plan may be amended to eliminate or restrict a participant's right to receive payment of accrued benefits under a particular optional form of benefit without jeopardizing the plan's tax-exempt status, if once the plan amendments are effective, the alternative forms of distribution that remain available to a participant include payment of a single-sum distribution form that is "otherwise identical" to the eliminated or restricted optional form of benefit.

In order for a single-sum distribution to be considered "otherwise identical" to the optional form of benefit that is being eliminated or restricted, it must be identical in all respects (unless it provides greater rights to the participant), except for the timing of payments after commencement. A single-sum distribution form is not "otherwise identical" to a specified installment form of benefit if the single-sum form:

1. is not available for distribution on any date on which the installment form could have begun;
2. is not available in the same medium as the installment form; or
3. imposes any additional eligibility conditions.

Pre-EGTRRA, the optional form of benefit could only be eliminated with an advance notice to the participants. EGTRRA eliminated the advance notice requirement if:

1. a single-sum payment is available to the participant at the same time(s) as the form of distribution being eliminated, and
2. the single-sum payment is based on the same or greater portion of the participant's account as the form of distribution being eliminated.

The final regulations retain most of the provisions of the 2003 proposed regulations which were issued in response to the legislative changes enacted as part of EGTRRA.



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Many comments were received with respect to the proposed regulations that expressed concern over the elimination of the advance notice requirement. IRS declined to adopt the advance notice requirement saying that the legislative history to Section 645(a)(1) of EGTRRA shows that Congress was aware of the existing advance notice requirement. Therefore, IRS inferred that Congress's omission of the notice condition was deliberate.

IRS further stated that the elimination of an optional form of benefit if prospective in nature since a plan amendment eliminating an optional form of distribution can only apply to distributions with annuity starting dates after the amendment is adopted.

Merrill Lynch Successfully Defends Role as Directed Trustee in WorldCom ERISA Case

The Federal District Court for the Southern District of New York has summarily held that Merrill Lynch did not have a duty to investigate whether continuing to invest plan assets in WorldCom stock was prudent. (*In Re WorldCom, Inc. ERISA Litigation*, (2005, SDNY) 2005 WL 221263).

Background

In 1994 Merrill Lynch began acting as the directed trustee of the WorldCom 401(k) Savings Plan (the "Plan"). The Plan offered participants the ability to invest their accounts in several different investment options including a WorldCom stock fund. Under the agreement between Merrill Lynch and WorldCom, WorldCom was the plan sponsor, investment fiduciary, and plan administrator. This agreement also provided that Merrill Lynch was a directed trustee that was **required** to follow the directions of the plan participants regarding the investment of their accounts. In addition, this agreement specifically stated that the plan administrator and the investment fiduciary, i.e., WorldCom, was the named fiduciary of the Plan.

The subject litigation is a class action lawsuit brought by plan participants who had invested in the WorldCom stock fund. The plaintiffs alleged that Merrill Lynch had violated its fiduciary duties by continuing to allow investments in WorldCom stock fund when it knew, or should have known, that this investment was imprudent.

Most of the other defendants in the suit settled, but Merrill Lynch sought summary judgment on the grounds that it was a directed trustee under Section 403(a) of ERISA and that as such, it owed no fiduciary duty of prudence to the plan participants. Merrill Lynch's alternative argument was that if it did have a fiduciary duty of prudence, the duty was not triggered.



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The plan participants claimed that Merrill Lynch was not a directed trustee, because it took investment directions from the plan participants, instead of from a named plan fiduciary, as required under Section 403(a) of ERISA. In addition, the plan participants claimed that the agreement between Merrill Lynch and WorldCom gave Merrill Lynch more discretion in fulfilling its duties than was appropriate for a directed trustee.

Court Ruling

The district court disagreed with the plan participants and held that Merrill Lynch was indeed a directed trustee and that the level of discretion given to Merrill Lynch was consistent with its status as a directed trustee. The court held that even though Merrill Lynch was subject to the instructions provided by the plan participants for the allocation of funds among the various investment options both the Plan document and the agreement required Merrill Lynch to follow WorldCom's instructions in every material way. Therefore, the court held that Merrill Lynch was subject to the directions of WorldCom in every aspect of the relationship that was relevant under Section 403(a) of ERISA.

The plan participants had also argued that Merrill Lynch, as a directed trustee, breached its fiduciary duty by not acting when it knew, or should have known that WorldCom's directions to it were imprudent and violated ERISA, or that WorldCom, as a co-fiduciary, was violating its own fiduciary duty to the Plan. The plan participants argued that Merrill Lynch should have:

- Suspended the acquisitions of WorldCom stock by the Plan no later than March 13, 2002;
- Required WorldCom to immediately begin a review of the prudence of continuing to hold WorldCom stock by the Plan; and
- Started liquidating WorldCom stock no later than April 24, 2002.

In reviewing the scope of Merrill Lynch's fiduciary duty as directed trustee, the court gave substantial weight to the Employee Benefits Security Administration Field Assistance Bulletin (FAB) 2004-3 which provides guidance on directed trustees' fiduciary responsibilities involving publicly traded securities.

According to the court, FAB 2004-3 provides that when a directed trustee doesn't have material non-public information regarding a company, the trustee will rarely have a duty to question the prudence of a direction to buy publicly traded securities solely on the basis of publicly available information. In fact, as noted by the court, FAB 2004-3 provides that only in "limited, extraordinary circumstances, where there are clear and compelling public indicators....[such as] a bankruptcy filing or similar public indicator, that call into question a company's viability as a going concern," may a directed trustee



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have a duty not to follow the named fiduciary's instructions without making a further inquiry.

In the court's opinion, the plan participants had not presented sufficient evidence that were questions of fact as to whether reliable public information existed that called into serious question the continued short-term viability of WorldCom as a going concern. Although WorldCom's fortunes were declining, its decline generally was not out-of-step with its competitors in the telecommunications industry. Thus, the court granted Merrill Lynch's request for summary judgment.