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Newsletter – Volume 1, No. 8 – August 3, 2005

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Highlights

1. Proposed IRS Guidance on Use of Electronic Media for Employee Benefit Plan Notices, Elections and Consents
2. IRS to Scrutinize Fringe Benefits for Departing and Retiring Executives
3. 2005 Form 5500 Instructions and Separate Schedule P Instructions
4. Insurer Required to Provide COBRA Coverage Because Insurance Contract Did Not Limit Election Period

Proposed IRS Guidance on Use of Electronic Media for Employee Benefit Plan Notices, Elections and Consents

IRS issued proposed regulations that contain the requirements for the use of electronic media to provide notices to plan participants and beneficiaries or to transmit elections or consents relating to employee benefit plans. The proposed regulations are not effective until finalized. These regulations coordinate the rules in the existing guidance for the requirements of the E—SIGN statute (the Electronic Signatures in Global and National Commerce Act).

Background

The rules under the Internal Revenue Code (the “Code”) and ERISA require certain retirement plan notices, elections or consents to be in writing. For example:

- The requirement that a terminated participant must be provided with a tax notice (“402(f) notice”) within a reasonable period of time before an eligible rollover distribution is made, a written explanation of his/her rollover rights and the tax and other consequences of the distribution or rollover.
- A written notice to participants that receive periodic distributions from retirement plans to elect out of income tax withholding.
- A written election by a participant to receive a distribution from his/her retirement plan prior to the later of normal retirement age or age 62 when the value of his/her account exceeds \$5,000.



Let us help you manage your benefits cost and risk.

Newsletter – Volume 1, No. 8 – August 3, 2005

- A written notice that the plan is being amended to significantly reduce the rate of future benefit accrual or that eliminates or significantly reduces early retirement benefits or retirement type subsidies (“204(h) notice”).

The Taxpayer Relief Act of 1997 required the IRS to issue guidance designed to interpret the notice, election, consent, disclosure, and timing requirements (including recordkeeping requirements) under the Code and ERISA relating to retirement plans as applied to the use of new technologies by plan sponsors and administrators. IRS complied by issuing several items of guidance relating to the use of electronic media with respect to employee benefit plan arrangements. The IRS guidance included:

- Notice 99-1, 1999-1 CB 269, permitting the use of electronic media for plan transactions that do not require a written election, e.g., plan enrollments, direct rollover elections, beneficiary designations, investment election changes, elective and after-tax contribution designations, and general or specific account inquiries.
- Final regulations in 2000 that relate to the use of electronic media for transmission of notices and consents required to be in writing, i.e., 402(f) notice, election to receive distribution in excess of \$5,000, election out of withholding on periodic payments.
- Final regulations in 2003 relating to the 204(h) notice.

The proposed regulations coordinate the existing notice and election rules under the Code and the regulations relating to certain employee benefit plan arrangements with the requirements of E—SIGN. In addition, the proposed regulations set forth the exclusive rules relating to the use of electronic media to satisfy any Code requirement that a communication to or from a participant, with respect to the participant’s rights under the employee benefit plan arrangement be in writing or in written form. The proposed regulations also provide that the rules contained therein apply regardless of whether the other Code requirement cross-references the finalized regulations.

Highlights of the Proposed Regulations

The scope of the proposed regulations applies to any notice, election or similar communication provided to, or made by, a participant or beneficiary under:

1. Retirement Plans. This includes tax qualified retirement plans, 403(a) or 403(b) annuity contracts, simplified employee pensions (SEPs), savings match incentive plans (SIMPLE plans), or 457(b) governmental plans.



Let us help you manage your benefits cost and risk.

Newsletter – Volume 1, No. 8 – August 3, 2005

2. Accident and health plans. This includes health plans under Code sections 104(a)(3) or 105, cafeteria plans under Code section 125, educational assistance plans under Code section 127, qualified transportation fringe benefit plans under Code section 132, Archer medical savings accounts under Code section 220, and health savings accounts under Code section 223.

The proposed regulations do not apply to the following:

1. Notices required by Titles I or IV of ERISA. The notices, consents, elections, or disclosures over which DOL or PBGC have interpretative and regulatory authorities, e.g., summary plan descriptions, summary annual reports.
2. Notices Where Interpretative Authority is Vested in DOL or PBGC. Suspension of benefit notices and COBRA notices or any other notices where interpretative authority rests with DOL or PBGC even though the Code contains the notice requirements.
3. Other Code Requirements. The regulations do not apply to other required notices such as tax reporting, tax records, or substantiation of expenses.

Requirements for Use of Electronic Media

The proposed regulations contain several requirements relating to the use of electronic media. Any notice that is provided via electronic media must meet all of the otherwise applicable requirements which include the applicable timing and content rules relating to the communication. The regulations require that the content of the notices and the medium through which it is delivered be reasonably designed to provide the information to a participant in a manner no less understandable to the participant than if provided on a written paper document.

Consent Requirement

The proposed regulations provide that a participant must consent to receiving notices electronically before such notices can be provided electronically. The participant's consent to the receipt of the electronic notice must demonstrate that the participant can access the electronic media that will be used to provide the applicable notices.

Qualified Joint and Survivor Annuity (QJSA) Elections

The proposed regulations extend the use of electronic media to the notice and electronic rules applicable to plans subject to the QJSA rules which include all defined benefit and money purchase pension plans. While the proposed regulations permit the use of



Let us help you manage your benefits cost and risk.

Newsletter – Volume 1, No. 8 – August 3, 2005

electronic acknowledgement or notarization of a signature, they would require the signature of the individual be witnessed in the physical presence of the plan representative or notary public, regardless of whether the signature is provided on paper or through an electronic medium.

IRS to Scrutinize Fringe Benefits for Departing and Retiring Executives

IRS issued a Market Segment Specialization (MSSP) Audit Technique Guide (ATG) on executive fringe benefits. This audit guide provides guidance to IRS auditors on the treatment of payments and perks that are given to departing or retiring executives for club memberships, qualified employee discounts, home improvements, personal use of a company's aircraft, and qualified retirement planning.

Property or services that are provided to an executive in lieu of or in addition to regular taxable wages are taxable unless there is a statutory exemption that applies to the property or services. The IRS has recognized that many times employers classify fringe benefits under expense accounts as something other than compensation, in order to escape income and employment taxes. In addition, more corporations are providing non-cash awards and bonuses to executives making the compensation harder for the IRS to identify.

The areas addressed in the ATG are:

1. Club Memberships. Generally, an employer cannot deduct club dues for social, athletic, sporting, luncheon, airline, hotel and so-called "business" clubs unless the employer includes the value of the club membership in the employee's income as compensation. However, if the cost of the club membership would qualify as a deductible business expense if included in the income of the employee, and the employee substantiates the expense, the portion of the membership dues that is used for business purposes may be excluded as a working condition fringe.
2. Qualified Employee Discounts. An employer is allowed to exclude from an employee's taxable income employer provided price reductions on qualified property or services offered to the employer's customers in ordinary course of business as long as the employee performs substantial services. This income exclusion does not apply to company directors and independent consultants. In addition, the employee discount must be provided on a nondiscriminatory basis. In recent years, it has become common practice for former corporate officers to be retained as an independent consultant after retirement and continue to receive discounts that are incorrectly treated as excludible employee discounts.



Let us help you manage your benefits cost and risk.

Newsletter – Volume 1, No. 8 – August 3, 2005

3. Housing Issues. In many situations corporations purchase homes for relocating corporate executives or provide low or no interest loans for a home purchase. Also, the corporation may furnish an executive's home office. In many instances, the employee's contract specifies that upon termination of employment, the furnishings and equipment are transferred to the executive as part of his/her severance package. In these types of situations, the transfer of personal tangible property is taxable to the departing executive. The amount of income inclusion must be determined based on one of the methods prescribed in Treasury Regulations section 1.482-3.
4. Non-Commercial Air Travel. The value of air transportation provided by an employer on corporate aircraft for an employee's personal purposes is includible in his/her income as a taxable fringe benefit. The amount of income is based on the Standard Industry Fare Level (SIFL) formula (plus a terminal charge). If the individual is a control employee, i.e., director, certain officers, highly compensated employee, and shareholder, and some former control employees there is a higher SIFL inclusion amount. In many instances, departing executives are provided the same travel status and privileges as other senior corporate executives in their consulting/severance packages. IRS has stated that most corporations include a portion of the imputed amount in wages. However, in many instances the amount included in income is calculated incorrectly.
5. Qualified Retirement Planning. The cost of qualified retirement planning services is excludable from the taxable income of highly compensated employees as long as the services are available on substantially the same terms to each member of the group of employees normally provided with education and information on the company's qualified employer plan.

IRS has instructed its auditors to look for information regarding additional sources of taxable income on SEC filings and the company's income tax return. IRS instructed its auditors to select a representative group of company executives for an in-depth examination. The IRS said that at a minimum the selection should include the SEC Section 16b executives.

The IRS auditors have been told to perform the following actions:

- Identify all payments to, or on behalf of, the executives/officers
- Inspect employment contracts and/or severance agreements to identify salaries and benefits paid to the executives



Let us help you manage your benefits cost and risk.

Newsletter – Volume 1, No. 8 – August 3, 2005

- Sample executives' monthly expense reports
- Search for the executive's name, social security number or title in accounts payable
- Request a listing of specific payroll codes or other accounting codes that relate to executive's expenses/expenditures.

2005 Form 5500 Instructions and Separate Schedule P Instructions

Both the IRS and EBSA have posted advance copies of the 2005 Form 5500, related schedules, and instructions. EBSA posted the advance copies on ERISA Filing Acceptance System (EFAST) webpage on July 15, 2005. IRS posted advance copies of the same forms, schedules and instructions plus separate Schedules B and P instructions on July 27, 2005.

Schedule T has been eliminated for 2005. Instead filers are required to report their compliance with the minimum coverage rules in Code section 410(b) in a new section IV on Schedule R, Retirement Information. In addition, the 2005 minimum coverage reporting requirements are significantly reduced. Filers that are required to file Schedule R need only note whether the plan satisfies either the ratio percentage test or the average benefits test instead of completing a two-page Schedule T. Therefore, a filer is not required to provide information about qualified separate lines of business and the exceptions to the coverage testing rules, or the provision of data to demonstrate compliance with the minimum coverage testing rules of Code section 410(b).

Insurer Required to Provide COBRA Coverage Because Insurance Contract Did Not Limit Election Period

A recent appeals court decision (*Lifecare Hospitals, Inc. v. Health Plus of La., Inc.*, 2005 U.S. App. LEXIS 14640 (5th Cir. 2005)) reminds employers and administrators that COBRA provides for a minimum 60 day election period but does not set a maximum. Based on this ruling, employers, plan administrators, and insurers should review their governing plan documents to ensure that the COBRA election period is specifically limited to 60 days.

In July 2001 an employee's wife met a representative of his employer shortly after the employee became seriously ill. The employer informed her about the employee's COBRA rights and handed her a COBRA election form. The employee was subsequently terminated and his health coverage expired on August 31st. In late November 2001 the employer provided the employee with written information regarding COBRA. The employee elected COBRA in mid-December.



Let us help you manage your benefits cost and risk.

Newsletter – Volume 1, No. 8 – August 3, 2005

The insurer denied the employee's claims for medical expenses after August 31st for failure to make a timely COBRA election. The hospital sued the insurer. The trial court held that:

1. The oral information provided to the employee's wife in July 2001 did not contain sufficient information to constitute a COBRA notice.
2. The employee received an adequate COBRA notice in November 2001 and
3. The employee timely elected COBRA since it was made within 60 days after an adequate COBRA election notice was provided and that the employee's election was effective.

The trial court ordered the insurer to pay the claimed hospital expenses pursuant to the agreement between the hospital and the insurer. The trial court also ordered the employer to reimburse the insurer for these expenses because the employer, as plan administrator, had failed to satisfy its statutory and contractual obligations to provide timely COBRA notices.

Both the insurer and employer appealed the trial court decision. The appeals court affirmed the order requiring the insurer to pay the employee's hospital expenses. However, the appeals court reversed the trial court's order requiring the employer to reimburse the insurer. The reversal was based on the fact that the insurer's contract with the hospital would obligate the insurer to pay the employee's hospital expenses regardless of whether the employer's COBRA notice obligations were fulfilled. The appeals court reasoned that COBRA requires a minimum election period of 60 days but does not mandate a maximum or default election period. Therefore, the appeals court found that the 18-month maximum COBRA coverage period specified in the plan was also the election period. Whether or not the oral COBRA notification given to the employee's wife in July was adequate, the December COBRA election was valid because there was no 60-day deadline.