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Newsletter – Volume 1, No. 9 – September 7, 2005

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Highlights

1. IRS Changes Rules Relating to Qualified Plan Determination and Opinion Letters
2. IRS Issues Proposed Regulations Regarding ESOP Dividend Deductions
3. New IRS Rules will Impact the Transfer of Monies between 403(b) Vendors
4. Medicare Part D Subsidies for Prescription Drug Coverage for Retirees
5. Employer's Access to Private Health Information for Medicare Part D

IRS Changes Rules Relating to Qualified Plan Determination and Opinion Letters

IRS issued Revenue Procedure 2005-66 on August 26, 2005 which changes the deadlines for submitting tax-qualified retirement plans to the IRS for review of their tax-qualified status. Under the new Revenue Procedure, plan sponsors with individually designed plans will need to submit determination letter requests regularly once every five years to ensure that their plans continue to comply with all of the relevant tax qualification rules. Sponsors of master and prototype plans as well as volume submitter plans will need to submit applications once every six years.

An employer is not required to obtain a favorable determination letter from the IRS. However, most employers seek a favorable determination letter for protection if the plan is audited by the IRS and the IRS finds a problem with the form of the plan documents. If the plan has a favorable determination letter, the IRS cannot disqualify the plan on the basis that the terms of the plan do not comply with the requirements of Code section 401(a) as long as the plan has received a favorable determination letter. Therefore, most employers will request a favorable determination letter from the IRS.

Background

All tax-qualified retirement plans are required to comply in form with the requirements of Internal Revenue Code (IRC) section 401(a). Employers that sponsor individually designed plans obtain assurance that their plans meet the requirements of IRC Section 401(a) by submitting a determination letter application to the IRS. If the IRS determines that the plan meets all the requirements of IRC Section 401(a), the IRS issues a favorable determination letter to the plan sponsor.



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Many small employers adopt master, prototype or volume submitter plans (pre-approved plans). Employers that adopt pre-approved plans are allowed to rely on the favorable determination letter that is issued to the sponsor of the pre-approved plan. The sponsor of the pre-approved plan must periodically submit the pre-approved plan to the IRS for a favorable determination letter. However, in most instances the plan sponsor that adopts a pre-approved plan does not need to obtain an individual determination letter from the IRS.

All tax qualified plans need to be updated as regulatory and legislative changes are made to IRC Section 401(a). Thereby requiring plan sponsors to amend and update their plan documents in order to maintain the tax qualified status of their retirement plans. When the plans are amended, the plan sponsor or pre-approved plan sponsor applies for and obtains a new favorable determination letter from the IRS. If the IRS determines that the plan amendments do not adequately reflect the required changes during its review of the determination letter application, the IRS permits the plan sponsor to amend the plan retroactively to the effective date of the plan amendment or change as long as the plan was submitted to the IRS for a determination letter by the deadline applicable for the applicable change or amendment.

The determination letter application must be filed with the IRS by the end of the plan's remedial amendment period. A plan's remedial amendment period, generally, ends on the due date (including extensions) of the employer's tax return in the later of the year following the year in which the amendment or change is adopted or effective. If a plan sponsor fails to submit its determination letter application during this period, the plan sponsor cannot retroactively amend the plan to correct any defects that the IRS may discover as part of its review of the determination letter application or audit.

The IRS has the ability to extend the remedial amendment period deadline and has in many instances imposed a single deadline with respect to a number of legislative and regulatory changes that became effective over a period of several years.

Individually Designed Plans

Under the Revenue Procedure the IRS will begin to accept determination letter applications for individually designed plans that take into account the requirements of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) on February 1, 2006. The plan sponsors that are required to submit their applications beginning February 1, 2006 are the Cycle A employers as defined in the Revenue Procedure. Cycle A employers are those whose Employer Identification Number (EIN) ends in 1 or 6. The



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Cycle A employers will be required to submit their next determination letter application on January 31, 2012 and every fifth year thereafter. Here are the five-year cycles for plan sponsors of individually designed plans:

If the last digit of the plan sponsor's EIN is	The plan's cycle is	The last day of the EGTRRA remedial amendment period is	The next five-year remedial amendment cycle ends on
1 or 6	Cycle A	January 31, 2007	January 31, 2012
2 or 7	Cycle B	January 31, 2008	January 31, 2013
3 or 8	Cycle C	January 31, 2009	January 31, 2014
4 or 9	Cycle D	January 31, 2010	January 31, 2015
5 or 0	Cycle E	January 31, 2011	January 31, 2016

In mid-November of each year, the IRS will publish an annual Cumulative List of Changes in Plan Qualification Requirements (Cumulative List). The list will specify the changes in plan qualification requirements that the IRS will consider in its review of plans submitted for determination letters on and after January 31st of the calendar year following the publication of the list. The IRS will only consider in its review of any application of any qualification requirements in effect and any guidance issued before the issuance of the applicable Cumulative List, whether or not included in that Cumulative List.

Employers are discouraged from filing off cycle. Employers who file off cycle will be given secondary priority, i.e., their applications will only be reviewed after all of the on cycle employers have been reviewed and processed. In addition, if an employer files during a premature February to January 31st period, the employer is still required to file on the next regularly scheduled cycle to ensure that it has a letter covering all of the changes reflected in the Cumulative List that applies to its cycle.

Expiration Dates

Prior to the issuance of the Revenue Procedure, determination letters did not expire. Under the new procedures, every determination letter will have an expiration date which is the last day of the first five-year cycle that ends more than twelve months after the date on which the letter is issued. However, the IRS may through published guidance extend the expiration dates of determination letters for a particular cycle year or years.



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Plan Terminations

Determination letter requests for terminating plans fall out of the five-year cycle. An application for a terminated plan will be considered timely filed only if it is filed no later than the later of:

1. one year from the effective date of the termination
2. one year from the date the termination was authorized but no later than twelve months after the date of distribution of substantially all of the plan's assets.

Pre-Approved Plans

Pre-approved plans are required to file on a six-year cycle. Pre-approved defined contribution plans, e.g., profit sharing, 401(k), will be on a different cycle than defined benefit plans.

The review period for pre-approved plans will last approximately two years. Near the end of the review period, the IRS will publish an announcement notifying adopting employers of the date by which they must adopt the pre-approved plans. The announced deadline will mark the end of the plan's remedial amendment cycle. If the employer adopts the pre-approved plan by the announced deadline date, the employer will have adopted the plan within the employer's six-year remedial amendment period.

IRS Issues Proposed Regulations Regarding ESOP Dividend Deductions

On August 25th the IRS issued proposed regulations that clarified which entities are entitled to a deduction for dividends paid to an ESOP. The proposed regulations provide that when a subsidiary maintains an ESOP that holds securities of a parent or other corporation, only the parent corporation paying the dividend is entitled to the dividend deduction. If finalized, this regulation would have an adverse impact on ESOPs maintained by U.S. subsidiaries of a foreign corporation.

The proposed regulations also reiterate the IRS' disagreement with the 9th Circuit's *Boise Cascade* decision. In the *Boise Cascade Corporation v. United States*, 329 F. 3d 751 (9th Cir. 2003), the employer was entitled to a tax deduction for amounts it paid to reacquire stock from terminated participants. The 9th Circuit reasoned that distribution by the ESOP of the redemption proceeds to the participants was a transaction separate from the redemption transaction. Therefore, the 9th Circuit concluded that the distribution did not constitute a payment in connection with the corporation's reacquisition of its stock, and that Code section 162(k) did not bar the deduction of such payments.



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In 2001, the IRS issued Revenue Ruling 2001-6 (2001-1 C.B. 491), which held that Code section 162(k) barred a deduction for payments made in redemption of stock from an ESOP. In this Revenue Ruling the IRS also concluded that such payments were not applicable dividends under Code section 404(k)(1). In reaching the conclusions in the Revenue Ruling the IRS stated that allowing a dividend deduction for redemption of the ESOP stock would prevent the ESOP participants from availing themselves of certain tax benefits including the right to reduce taxes by utilizing the return of basis provisions under Code section 72, the right to make rollovers of ESOP distributions received upon separation from service, and the protection against involuntary cash-outs.

For the reasons stated in the Revenue Ruling, the IRS decided to issue new regulations under Code section 404(k) that would bar a company from taking a dividend deduction for amounts that it paid to redeem its stock from terminated ESOP participants. The proposed regulations state that payments made to redeem stock from terminated ESOP participants are not applicable dividends under Code section 404(k)(2) and a deduction of such amounts as ESOP dividends constitutes an avoidance and evasion of tax within the meaning of Code section 404(k)(5).

These regulations will be effective on the date of the issuance of the final regulations. However, the IRS will continue to assert that amounts paid to an ESOP to reacquire employer securities are not deductible by the employer under Code section 404(k) prior to the issuance of the final regulations (other than in the 9th Circuit).

New IRS Rules will Impact the Transfer of Monies between 403(b) Vendors

New IRS rules on 403(b) plans will *eliminate* the 90-24 transfer which permits participants in 403(b) plans to transfer their monies between different vendors. When 403(b) arrangements were first made available, the funding arrangement was through insurance contracts which carried higher fees. In recent years, many quality providers have made mutual fund options available for 403(b) arrangements which charge lower fees. These providers include Fidelity, Charles Schwab, TIAA-CREF, T. Rowe Price and Vanguard. The IRS currently permits the holder of a 403(b) contract to transfer monies between different 403(b) providers as long as your employer's plan and the vendor permit the transfers. If either your employer's plan or vendor does not permit transfers, then you are unable to transfer the monies between the different 403(b) vendors.



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There are a couple of important points to keep in mind when completing a 90-24 transfer:

1. The monies must be moved from trustee to trustee. If you take possession of the funds, the transfer is not tax free to you.
2. Many 403(b) investments, e.g., annuity and variable annuity products, charge significant penalties for a period of time. These charges are normally called surrender charges and can last for up to seven years after the investment is made in the contract. You need to carefully review your documents to determine what, if any, surrender charges may apply before transferring your monies.

When the decision has been made to initiate a transfer, a participant needs to make sure their employer allows transfers and then initial contact needs to be made to the participant's financial institution where their 403(b) is currently active. The participant needs to find out what charges exist and how much money they can transfer without being penalized. All these steps are necessary for a smooth and unambiguous transition.

Medicare Part D Subsidies for Prescription Drug Coverage for Retirees

Medicare Part D is effective January 1, 2006. The Centers for Medicare and Medicaid Services (CMS) have issued guidance for employers and plan sponsors during 2005. Specifically, CMS has issued additional guidance regarding:

1. The employer's obligation to send certificates of creditable coverage to all plan participants who are eligible for Part D coverage. ***This rule applies to all employers who provide a health plan for their employees, even though the employer does not provide retiree health benefits.***
2. How the tax-free retiree drug subsidy works.
3. Rules regarding the application of the retiree drug subsidy to account-based health plans, e.g., health flexible spending accounts, health reimbursement arrangements, and health savings accounts. These rules were covered in our July newsletter.

Certificates of Creditable Coverage

Any employer sponsored health plan that is subject to ERISA must provide a Certificate of Creditable Coverage to Part D eligible individuals. The requirement is imposed on the plan sponsor regardless of whether the plan is insured or self-insured. However, the plan sponsor can contract with the plan's insurer or third party administrator to provide the certificate as well as assistance in determining whether the coverage is creditable coverage. This certificate is required whether the individual's health plan coverage is primary or secondary to Medicare.



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The certificate must be provided to all Part D eligible individuals who are covered under or who apply for a group health plan's prescription drug coverage. Individuals eligible for Part D include individuals who are entitled to Medicare Part A and/or enrolled in Medicare Part B. Generally, individuals are entitled to Medicare Part A if they are at least age 65 and have monthly social security benefits. Individuals under age 65 may also be eligible for Medicare Part A if they receive at least twenty four months of disability benefits from Social Security. Based on the broad definition of eligible employees, an employer who does not provide retiree health benefits will be required to send certificates to active employees who are age 65 and entitled to enroll in Part D. In addition, an employer who provides health coverage to disabled employees is required to provide certificates to those individuals who are eligible individuals. CMS realized that the identification of these individuals could be difficult and time consuming and, therefore, has provided that group health plans may send the certificate to all of their participants rather than attempt to determine who is a Part D eligible individual.

The employer only needs to provide a single certificate to the plan participant and all other Medicare eligible dependents covered under the same plan unless the plan administrator knows that a spouse or dependent has a different mailing address. The certificate can be incorporated into other plan informational materials as long as the certificate is prominent and conspicuous. If the certificate is part of the plan informational materials, a reference to the section or page number of the certificate must be prominently displayed on the first page of the informational materials.

The certificate must initially be provided prior to November 15, 2005. In addition, certificates must be provided at the following additional times:

1. Prior to the Part D annual coordinated election period (beginning November 15th of each year);
2. Prior to an individual's initial enrollment period for Part D;
3. Prior to the effective date of coverage for any Part D eligible individual that joins the plan;
4. Whenever the prescription drug coverage ends or changes so that it is no longer creditable or becomes creditable; and
5. At any time, upon request.

In the event that the employer automatically provides the certificate to all plan participants, CMS considers the first two items in the above list to be automatically satisfied. CMS clarified that the terms "prior to" means that a certificate must have been provided within the twelve months before the time that an individual is required to receive a certificate.



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CMS has provided sample language for a certificate that only applies to the first initial enrollment period (November 15, 2005 through May 15, 2006). CMS intends to provide sample language for use after May 16, 2006 and in future years but has not done so at this time.

Retiree Drug Subsidy

Employers are entitled to receive tax-free drug subsidy payments for a portion of their plan's prescription drug costs. In general, the subsidy for each qualifying covered retiree, an employer or sponsor is eligible to receive payments of 28% of allowable drug costs that are within a specified cost threshold. For 2006, the threshold is between \$250 and \$5,000. Employers and sponsors who desire to claim the tax-free subsidy must apply each year. ***For 2006, the application deadline is September 30, 2005.***

Employers and sponsors who claim the subsidy must provide to CMS with their application for the subsidy an actuarial attestation that the value of the prescription drug coverage under the plan is at least equal to the actuarial value of the standard Part D benefit. In general, the attestation must be signed by a qualified actuary, must be based upon generally acceptable actuarial principles and CMS actuarial guidelines and must include the following assurances:

1. Gross test. The actuarial gross value of the retiree prescription drug coverage under the plan for the plan year is at least equal to the actuarial gross value of the standard Part D drug benefit for the plan year.
2. Net test. The actuarial net value of the retiree drug coverage under the plan for the plan year is at least equal to the actuarial net value of the standard Part D benefit for the plan year.

Employer's Access to Private Health Information for Medicare Part D

On August 22, 2005 the Department of Health and Human Services (HHS) posted a new Frequently Asked Question (FAQ) that addressed the right of a health plan, or a health insurance issuer, to disclose protected health information (PHI) to a plan sponsor for use in the plan sponsor's attempt to obtain the retiree drug subsidy available under Medicare Part D. The FAQ states that PHI can be disclosed to the plan sponsor to allow the plan sponsor to apply for the drug subsidy under Medicare Part D as long as the health plan document has been amended to allow the sponsor to receive PHI when performing plan administrative functions.