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Monthly Newsletter – Volume 2, No. 3 – March 6, 2006

Highlights of the Month

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2. Reminder: Employers Must Send Prescription Drug Information to CMS by March 31st
3. Why Benefit Issues Should be addressed in Mergers and Acquisitions before the Deal Closes
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5. IRS Proposes Distribution Rules for Roth 401(k)s
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President Signs the Deficit Reduction Act

On February 8, 2006 the President signed into law the Deficit Reduction Act of 2005 (DRA). For sponsors of defined benefit pension plans, this means that the flat-rate premiums paid to the PBGC have increased from \$19 to \$30 per participant. In addition to the flat-rate premium, plan sponsors of underfunded defined benefit pension plans pay an additional \$9 per \$1,000 of unfunded vested benefits. The variable rate premium was not changed by DRA. The new premiums are effective for plan years beginning on or after January 1, 2006.

The 2006 Form 1-ES that was issued by the PBGC contains the old premium rate since it was issued prior to DRA being signed into law. PBGC recommends that filers using those forms cross out the old premium rate and write in the new premium rate on the form. Also, any filer that had already submitted the Form 1-ES using the old rate must make an amended filing to bring the estimated payment up to the new premium level.

Reminder: Employers Must Send Prescription Drug Information to CMS by March 31st

The next deadline for Medicare Part D compliance is fast approaching. Employers who sponsor group health plans that cover any prescription drugs must file with the Centers



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for Medicare and Medicaid Services (CMS) by March 31, 2006, whether your drug coverage is creditable or noncreditable. As you will recall these rules apply whether your group health plans cover only active employees and/or retirees. In order to comply with the rules, you must complete an electronic disclosure form that is available on CMS's web site at <http://www.cms.hhs.gov/CreditableCoverage>. You should complete the form as soon as possible since the web site may become unavailable due to heavy usage close to the March 31st deadline.

You should also remember that if you currently provide prescription drug coverage but terminate that coverage later or change the coverage from creditable to noncreditable or vice versa, you must complete a new electronic disclosure within 30 days of the change. In addition to completing the new electronic disclosure, you must provide an updated notice to the plan participants in your plan. Beginning in 2007, you are required to submit the electronic disclosure form every year within 60 days after the first day of the plan year.

Why Benefit Issues should be addressed in Mergers and Acquisitions before the Deal Closes

Historically, companies have failed to integrate their human resource departments into their merger team. In many instances this has resulted in increased deal expenses that could have been either avoided or accounted for in the purchase price with proper planning. Prior to a deal closing, the buyer should have an integration plan that quantifies the costs relating to issues, such as severance payments, pension funding, healthcare costs, raises, new hiring, relocations, etc., budget for those costs, and tie the cost back into the deal price.

Hidden Liabilities

The failure to uncover hidden liabilities with respect to pension plan funding can cause the price of a deal to increase exponentially. For example, an acquisition of a global company that sponsors various defined benefit pension plans around the world without having an actuary quantify the outstanding liabilities could result in underrecognized or unrecognized liabilities because of different standards that apply to the calculation of the liabilities. Also, the acquisition of a company that participates in a multiemployer plan may result in significant withdrawal liabilities if the buyer decides to withdraw from the multiemployer plan.

Another area where there may be hidden liabilities is in the operation of the retirement plans that are sponsored by the target. The rules that govern the operation of tax



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qualified retirement plans are complex and change on a regular basis. Failure to inquire as to the operation of the plans can result in significant fines and penalties if the plans are audited by the U.S. Department of Labor, the Internal Revenue Service and/or the Pension Benefit Guaranty Corporation. If this audit occurs several years after the deal is closed, any indemnifications in the merger agreement may have expired and the buyer is left to pay the fines and penalties.

Failure to properly review the target's healthcare plans can result in significant liability for incurred but not reported claims and unrecognized liabilities for post-retirement benefits. For example, the target company promised employee lifetime health benefits in employee communications but this information is not recorded in the company's financial statements.

In most cases, the benefits offered by the two companies are dissimilar which means that decisions must be made as to what benefits will be offered by the combined company. In cases where the target is small and will be integrated into the buyer's existing benefit plans and programs, one issue may revolve around what types of unrecognized liabilities exist for accrued vacation time. If the target had a generous vacation policy or allowed employees to accumulate vacation time without a cap over several years, the cost of paying the acquired employees for their accrued vacation could be significant and not be readily apparent in the target's financial statements.

Other issues that are more difficult to quantify involve discrimination issues and sexual harassment claims. Asking questions of human resource personnel on these types of issues does not guarantee that these claims will be uncovered but it does increase the likelihood.

Another issue that is evident in mergers is matching salaries. Rarely do two companies have the same salary structure. By reviewing the salary structure of the target you are able to account for any salary increases in how the deal is valued. If the pay inequity is not dealt with in the beginning, it can only cause problems.

The buyer's shareholders expect a return on their investment in the target and identifying and dealing with human resource issues in structuring the deal will assist the company in meeting the expectations of the shareholders by realizing any synergies of the combined companies' workforce.



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EBSA Investigating Conflicts of Interest in the Pension Consulting Industry

In May 2005 the SEC issued a report on its examination of select pension consultants. Following the release of the SEC staff report, Congressmen Ed Markey and George Miller requested specific information about pension consultants found in the SEC report to have conflicts of interest. In addition, they requested that the SEC, EBSA, and PBGC explain the steps that are being taken to detect and deter conflicts of interest and hidden financial arrangements that threaten the financial health of workers' pension plans.

Assistant Secretary of EBSA, Ann Combs, stated in her February 1, 2006 letter to the Congressmen that "EBSA enforcement officials are currently reviewing the documents to determine what DOL investigative action may be necessary. Based on this review, several matters have been referred to EBSA regional offices for investigation." EBSA has a standing policy to not comment on ongoing investigations until public action is taken or the investigation is closed. Therefore, she would not provide further substantive investigative information.

Assistant Secretary Combs further stated that EBSA is reviewing existing regulations that relate to the disclosure of fees by service providers to employee benefit plans. This review includes revenue sharing arrangements. The letter also stated that fee disclosure is important in two respects. First, the plan fiduciaries have a duty under ERISA to determine whether the fees being paid for services are reasonable. Second, plan fiduciaries need to be able to assess whether revenue sharing arrangements might affect the recommendations that are made by a service provider, e.g., a pension consultant.

EBSA and the SEC worked together to create a Fact Sheet that can be used by plan fiduciaries to select and monitor pension consultants. This Fact Sheet has a series of questions that can assist plan fiduciaries in evaluating the objectivity of the recommendations that are made by pension consultants. This Fact Sheet can be accessed on the EBSA website (<http://www.dol.gov/ebsa/newsroom/fs053105.html>).

IRS Proposes Distribution Rules for Roth 401(k) s

IRS recently issued proposed regulations that deal with distributions from Roth 401(k) plans. The addition of the Roth 401(k) to an existing 401(k) plan presents many new and highly technical administrative issues. If you are thinking of implementing a Roth 401(k), then you need to understand the new administrative challenges that are associated with this type of account.



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Qualified versus non-qualified distributions

If a distribution from a Roth 401(k) is a qualified distribution, then the distribution is non-taxable. Generally, a distribution from a Roth 401(k) is qualified if the monies have been in the plan for 5 taxable years and the distribution is made after the earlier of death, disability, or age 59 ½.

Therefore, it is important to determine when the 5-year holding period begins. Under the proposed regulations, the 5-year holding period begins at the start of the tax year in which the first Roth 401(k) contribution is made to the plan and ends at the end of the fifth tax year.

In the case of a direct rollover from one Roth 401(k) plan to another, the holding period from the distributing plan is “tacked on”, i.e., it is taken into account under the recipient plan. The proposed regulations state that a participant will only have one 5-year holding period which is the longer of either the “tacked on” holding period or the “new contribution” holding period.

If a participant does an indirect rollover from one Roth 401(k) to another, the holding period is not “tacked on.” An indirect rollover is one where the participant receives a distribution and rolls the money over within a 60-day period.

Taxation of nonqualified distributions

A taxable Roth 401(k) distribution which is not rolled over is generally taxed in proportion to the participant’s basis and earnings in the account.

Rollovers

Both qualified and nonqualified Roth 401(k) distributions may be rolled over to another qualified plan that accepts Roth 401(k) distributions. A participant may also rollover distributions to a Roth IRA. The proposed regulations impose a number of administrative requirements on the plan administrator. These requirements are:

- ◆ The plan administrator must track the 5-year holding period on a per participant basis.
- ◆ When there is a direct rollover, the administrator of the distributing plan must provide the administrator of the recipient plan with a statement that identifies the first year of the 5-year holding period applicable to the distribution and portion of the distribution attributable to basis or state that the distribution is a qualified



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distribution. The administrator of the recipient plan is entitled to rely on this statement.

- ◆ If the distribution is made to the participant, the administrator of the distributing plan must provide the same information in b above to the participant with the exception of the requirement to provide the first year of the 5-year holding period.
- ◆ If a participant receives a distribution and then rolls the taxable portion into another Roth 401(k), the administrator of the recipient plan must report receipt to the IRS.

Special treatment distributions

Three types of distributions receive special tax treatment under the proposed regulations even if the Roth account is qualified, i.e., the 5-year holding period has been met and the participant is over age 59 ½. These distributions are:

- ◆ Distributions that relate to contributions that exceed the limits under Code section 415, 402(g) or 401(k) ADP testing limits.
- ◆ Deemed distributions of defaulted participant loans.
- ◆ Dividends on ESOP stock that meet the requirements of Code section 404(k).

Distributions of 404(k) dividends and deemed distributions relating to defaulted participant loans are taxed even though the Roth account is qualified and a regular distribution from the account would not be taxed.

Loans and hardship withdrawals

The entire value of the participant's account, i.e., both the Roth 401(k) and non-Roth 401(k) portions, may be taken into account in determining the amount available for participant loans. This rule is important since one of the rules that applies to participant loans is that the loan is limited to 50 percent of the participant's account. However, the participant loan should be funded out of the non-Roth 401(k) portion of the plan since a defaulted loan that has been taken from the Roth 401(k) portion of the plan is taxed even if the Roth 401(k) account is qualified.

The rules governing hardship distributions provide that only a participant's contributions and not earnings are eligible for hardship withdrawals. However, in determining the taxation of hardship distributions, these distributions are deemed to come proportionately from basis and earnings. This creates an issue with Roth 401(k) accounts in that the amount of contributions that remain in the account that are eligible for hardship withdrawals are reduced by the full amount of the hardship distribution.



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Taxation of stock distributions

Special taxation rules apply to in-kind distributions of employer securities from 401(k) plans. Basically, the employee is taxed on the historical cost of the stock to the plan when the stock is distributed. When the employee sells the stock the gain that is realized is taxed as a capital gain. This tax treatment is referred to as “net unrealized appreciation” or NUA. When employer securities are distributed from a Roth 401(k) account and the distribution is from a qualified account, then no tax is paid on the distribution and the participant’s basis in the stock is fair market value as of the date of distribution. When the participant disposes of the employer stock, any gain realized on the sale over the participant’s basis is taxed at capital gains rates. However, if the distribution of employer securities from a Roth 401(k) account is nonqualified, then the participant’s basis in the stock is based on historical cost rather than fair market value at the date of distribution. Because the stock in the Roth 401(k) account is purchased with after-tax dollars, the participant does not pay any tax on distribution. However, the participant would be required to pay capital gains tax on any gains when the stock is sold.

Prohibition on manipulation of accounting

Because the Roth distributions are nontaxable when distributed as long as the account is qualified, there is a potential for abuse. The IRS recognized this potential and included a general rule that prohibits any transaction or accounting methodology that has the effect of “directly or indirectly transferring value from another account into the designated Roth account.

Generally the proposed regulations are effective January 1, 2007. However, the rollover rules and the prohibition on manipulation of accounting are effective as of January 1, 2006.

Final HIPAA Enforcement Rules are issued

The final enforcement rules under HIPAA take effect on March 16, 2006 and were issued by the Department of Health and Human Services (HHS) on February 16th. These enforcement provisions deal with HIPAA’s administrative simplification provisions which include privacy, security, unique identifiers, and transactions and code sets. These final rules give HIPAA enforcers more latitude in defining the scope of violations and in calculating the related fines.



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Amount of Penalty; Number of Violations

The final enforcement rules change the methodology for calculating the number of violations. The final rule retains the proposed rule's provision imposing a penalty if a covered entity violates an "administrative simplification provision," which is defined as "any requirement or prohibition established by" the statute or regulations. The proposed rule stated that HIPAA enforcers would look at the number of times the covered entity engaged in a particular conduct or the number of times it failed to engage in required conduct, the number of people involved in the violation, and the duration of the violation. The language in the final rule is a more open-ended standard. The final rule states that "the number of violations of an identical provision or requirement will be determined based on the covered entity's obligation to act or not act under the provision violated." In terms of continuing violations, HHS has stated that the violations will be deemed to occur on each day the violation continues. The final rule also provides that an act that violates one provision in a subpart and another more general provision in the same subpart will not be counted as more than one violation. However, if a single act violates multiple subparts it may result in multiple penalties.

In addition, the final rules state that HHS has the right to use statistical sampling to calculate fines. The following example was used by HHS for illustration purposes.

A dentist has 3000 patients, 210 of whom did not receive a notice of privacy practices (NPP), according to the lack of signed acknowledgements. When a complaint is filed with HHS, HHS reviews a random sample of 100 patients, and finds that 15, i.e., 15%, did not receive the NPP. Even though 210 out of 3000 is a lower figure than 15%, HHS sticks to that percentage and fines the dentist \$600.

Based on this example, it is possible to have a violation rate that is much higher than the actual violation rate which results in higher fines.

Liability for Acts of Agents

The provisions in the proposed rules that make a covered entity liable for the violations committed by one of its agents, as long as the agent was acting within the scope of its authority, was retained in the final rule. However, if a covered entity has complied with the business associate provisions of the security and privacy rules, the covered entity is not liable for the actions of the business associate. In order to not be liable for any security and/or privacy violations by a business associate, the covered entity's contract with the business associate must contain specific terms relating to these issues. In addition, the covered entity must take reasonable steps to cure a breach or end a violation



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that is known to the covered entity. The final rule clarifies that the federal law of agency will be used to determine whether a principal-agent relationship exists and whether the agent acted outside its scope of authority. It should also be noted that the final rule presumes that workforce independent contractors are a covered entity's agents.

Violations of Addressable Security Implementation Specifications

The preamble to the final rule illustrates what would constitute a violation of an addressable security implementation specification. The preamble makes it clear that “addressable” does not mean optional and that if implementation of an addressable implementation specification is reasonable and appropriate, then the addressable implementation specification is a requirement. However, if the implementation of the addressable implementation specification is not reasonable and appropriate, the covered entity is required to document why implementation is not reasonable and appropriate and is required to implement an equivalent alternative measure if reasonable and appropriate. A covered entity's failure to document why implementation is not reasonable and appropriate, as well as the implementation of an equivalent measure if reasonable and appropriate, would violate the security rule.

Other topics covered in the final rule include hearings, appeals, waiver of penalties, public notice of imposition of penalties, and collection of penalties.