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Highlights of the Month

1. FASB Issues Exposure Draft on Pension and Postretirement Reporting in Financial Statements
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3. EBSA Amends Class Exemption 80-26 to Eliminate the Three-Day Restriction on Interest-Free Loans to Plans by Parties in Interest
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5. EBSA Issues Technical Guidance on Plan Distribution of Settlement Proceeds Relating to Late Trading and Market Timing
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FASB Issues Exposure Draft on Pension and Postretirement Reporting in Financial Statements

The Financial Accounting Standards Board (FASB) issued an exposure draft on financial statement reporting for pensions and other postretirement benefits on March 31, 2006. The exposure draft requires employers to:

- ❖ Recognize the overfunded/underfunded positions of their defined benefit pension plans and postretirement benefit plans in their balance sheets and
- ❖ Measure plan assets and obligations as of the date of the financial statements.

The proposal amends FASB Statements No. 87, 88, 106 and 132(R). This is the first phase of a two phase project by FASB to improve the transparency and completeness of plan sponsor financial statements. Currently an employer is allowed to recognize an asset or liability in its balance sheet that in most instances differs from the overfunded/underfunded position of its postretirement benefit obligations including pensions. Under the current rules, the funded status of the employer's pension and postretirement benefit plans is reported in the footnotes to the employer's financial statements.



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Written comments on the exposure draft must be submitted by May 31, 2006. Comments should be submitted by email to File Reference No. 1025-300. For individuals/organizations who do not have access to email, written comments should be submitted to the “Technical Director – File Reference No. 1025-300, Financial Accounting Standards Board, 401 Merritt 7, PO Box 5116, Norwalk, CN 06856-5116. FASB intends to hold public roundtable meetings on June 27, 2006 in Norwalk, CN. The roundtable meetings will allow interested constituents to express their views about the Exposure Draft.

Current Status of Cash Balance Plan Legislation

On April 6, 2006 the House of Representatives voted to adopt the cash balance provisions in the Senate’s pension reform bill. This legislation would authorize the establishment of cash balance plans as well as provide certain protections where traditional defined benefit pension plans are converted to cash balance plans.

Background. Cash balance plans are defined benefit plans that in operation look like defined contribution plans. The participant’s benefit is determined by reference to the employee’s “cash balance” or hypothetical account. Under a cash balance plan, the balance in the employee’s hypothetical account is the sum of the hypothetical allocations for earlier plan years provided under a hypothetical formula resembling the allocation formula under a defined contribution plan, plus subsequent interest adjustments through normal retirement age.

The Internal Revenue Code (the Code) does not specifically authorize cash balance plans. However, the IRS laid the groundwork for cash balance plans in regulations and other releases. In 2002 the IRS issued proposed regulations dealing with cash balance plans and other topics. These regulations would have allowed the conversion of traditional pension plans into cash balance plans without violating the regulations’ age discrimination rules. These regulations drew sharp criticism since the conversion can effectively limit future accruals for older workers. The IRS withdrew the proposed regulations dealing with cash balance plans and stated that it would no longer consider technical advice requests dealing with cash balance plan conversions as long as there is pending legislation.

2006 Pension Act. The 2006 Pension Act would remove the statutory and regulatory concerns involving cash balance plans by amending Code section 411(b) and the parallel provisions in ERISA section 204(b) to provide special rules for these and other types of hybrid defined benefit plans. The current legislation would be effective for periods beginning after July 31, 2005.



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The 2006 Pension Act defines a cash balance plan as a defined benefit plan under which:

1. a participant's accrued benefit is determined by reference to the balance of a hypothetical accumulation account; and
2. pay credits and interest credits are credited to the hypothetical accumulation account.

The 2006 Pension Act provides that a cash balance plan will not be treated as violating the anti-cutback rules which guard against a reduction in the rate of benefit accrual under a defined benefit plan due to a participant's age or service merely because there is an expectation that a younger participant will have a longer period to accumulate interest credits. However, if the rate of any pay credit or interest credit to a participant's accumulation account decreases as a result of the participant's attainment of any age, the provision would violate the anti-cutback rules that deal with benefit accrual.

The current proposed legislation provides for the following protections relating to cash balance plans or other types of hybrid plans that are similar to cash balance plans:

1. **Accelerated vesting.** A cash balance must vest a participant's benefit over a 3 year period, i.e., the participant must have a nonforfeitable right to his/her benefit after 3 years of service.
2. **Establishment of Interest Credit Rate.** Interest credits must be made at a rate that is no lower than the applicable federal mid-term interest rate and no greater than (a) the applicable federal mid-term rate, or (b) a rate equal to the rate of interest on amounts invested conservatively in long-term investment grade corporate bonds. IRS will calculate the rate in (b) by reference to two or more indices that it selects periodically. IRS will make the indices and the methodology used to determine the rate publicly available.

If the cash balance plan uses a variable rate to credit interest, the plan must provide that upon plan termination, the rate of interest used to determine accrued benefits will be equal to the average of the rates of interest used under the plan during the five-year period ending on the termination date.

The legislation addresses conversions of traditional defined benefit pension plans to cash balance plans by providing a floor benefit to any employee who was a participant on the effective date that the plan was converted to a cash balance plan. The floor benefit is required to be calculated under one of the following 3 methodologies. The methodology



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for calculating the floor benefit must be specified in the plan document and applied uniformly to all plan participants. The three methods are:

1. No wear away method.
2. Greater of old, new or election of either method.
3. Method prescribed by the IRS in its regulations implementing the new legislation.

It is expected that Congress will pass pension reform legislation by end of May.

EBSA Amends Class Exemption 80-26 to Eliminate the Three-Day Restriction on Interest-Free Loans to Plans by Parties in Interest

The Employee Benefits Security Administration (EBSA) has finalized an amendment to Class Exemption 80-26 (71 Fed. Reg. 17917, 4/7/2006) which permits loans between an employee benefit plan and a party in interest if certain conditions are met. The original exemption provided for a 3 day limit on loans between plans and parties in interest.

The final amendment to PTCE 80-26 eliminates the three day requirement but does contain a provision that loans with durations in excess of sixty days must be made pursuant to a written loan agreement that contains all of the material terms that are applicable to the loan. The written loan requirement applies prospectively to loans that involve the payment of a plan's ordinary operating expenses. However, if the loan is made for a purpose that is incidental to the ordinary operation of the plan, the written loan requirement is effective December 15, 2004.

DOL Updates Voluntary Fiduciary Correction Program

EBSA updated its Voluntary Fiduciary Correction Program to include additional transactions, reduced documentation requirements, a simplified application form, a checklist and an online calculator for determining the amount to be restored to plans. EBSA expanded the scope of penalty relief to include welfare plans and nonqualified pension plans.

The following covered transactions were expanded:

- ❖ **Participant loans.** The 2005 revisions permitted a plan to correct participant loans that violated certain plan restrictions as to the amount of the loan or the duration of the loan (as incorporated from the Code's requirements, i.e., amount limited to \$50,000 and duration limited to 5 years unless for a mortgage on



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- principal residence). The final notice expands the covered transaction to include correction of participant loans that violate the plan's terms regarding level amortization or that result in loan defaults (also as incorporated from the Code's requirements). The final notice changed the procedure for correcting participant loan violations to require only that the correction be made under the IRS EPCRS procedure for participant loan corrections and that a copy of the EPCRS compliance statement, along with proof of any required payments be submitted to the DOL.
- ❖ **Settlor expenses.** The notice adds a new covered transaction for expenses that were improperly paid with plan assets. These expenses would include expenses that should have been paid by the plan sponsor because they involved settler functions or situations where the plan documents require the plan sponsor to pay the expenses. The corresponding Class Exemption 2002-51 has also been amended to include the improper payment of settler expenses, so long as the payment was not expressly prohibited by the plan document.
 - ❖ **Notice.** An amendment to Class Exemption 2002-51 that eliminates the requirement to provide notice to interested parties for certain corrections of delinquent contributions or loan repayments.
 - ❖ **Illiquid plan assets.** The 2005 revision provided that a plan could divest itself of an illiquid plan asset, e.g., a limited partnership interest, when the asset was purchased in three specific scenarios. The final notice adds a fourth purchase scenario. The fourth scenario is when the illiquid asset is purchased from a party in interest in accordance with the terms of a prohibited transaction exemption.

The final notice slightly narrowed the definition of “under investigation.” A party is not eligible to correct covered transactions under the VFC Program if the plan or the applicant are “under investigation.” The 2005 revisions broadened the definition of “under investigation” to include not only DOL civil and criminal investigations but also any other civil or criminal investigations by a federal agency, e.g., IRS or SEC, involving the plan, the applicant or a plan fiduciary and any federal agency's notice of intent to conduct an investigation. The final notice narrowed the definition to investigations either ongoing or for which notice has been given, that specifically involve the plan or specifically relate to the applicant or the plan sponsor in connection with an act or transaction directly related to the plan.

In addition, the final notice includes an optional disclosure provision under which eligibility is not barred if the investigation is a civil investigation by the PBGC or certain state agencies and the applicant discloses the investigation in writing when submitting the correction application.



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EBSA Issues Technical Guidance on Plan Distribution of Settlement Proceeds Relating to Late Trading and Market Timing

Much of the news involving mutual fund abuses dealt with late trading and market timing by certain individuals. The Securities & Exchange Commission (SEC) has entered into settlement agreements with certain mutual fund companies to correct these abuses. Since many retirement plans invest in mutual funds, they will be entitled to a portion of the settlement proceeds. Questions have arisen regarding the application of ERISA's fiduciary duties with respect to these proceeds. In response to these questions, EBSA issued Field Technical Assistance Bulletin (FTAB) 2006-01.

Each of the settlement agreements called for the establishment of a fund that would be administered by an independent distribution consultant (IDC). The IDC has the responsibility to distribute the monies in the settlement to affected shareholders of the relevant mutual fund. The FTAB sets out 2 methods for allocating the settlement fund proceeds among retirement plan participants. First, the FTAB states that if the IDC requires the plan fiduciaries to utilize a specific participant allocation method as a condition of receiving the distribution, then the fiduciary is deemed to have satisfied ERISA's fiduciary standards if it carefully follows the required allocation methodology. Second, if the IDC's distribution plan provides, but does not require the use of a methodology for allocating proceeds among plan participants, then EBSA views the careful use of the provided methodology as satisfying ERISA's fiduciary duty requirements.

In the event that the IDC distribution plan does not provide for an allocation methodology, then the plan fiduciaries must decide on an allocation methodology that is fair, reasonable, and objective for all participants. Items that the plan fiduciary can consider in establishing the allocation methodology include but are not limited to relative cost involved with potential allocation methods and the extent to which detailed plan records exist that are useful in identifying plan participants that should be compensated from the settlement proceeds. For example, the plan may not have records that would show what participants were invested in the fund during the relevant period and incurred a loss. In this case the plan fiduciary may decide to allocate the settlement proceeds to current participants invested in the mutual fund. The FTAB also states that it is possible that the plan fiduciaries could conclude that participant level allocations of the settlement proceeds are cost prohibitive because the amounts are de minimis. In this instance the settlement proceeds can be used to pay reasonable plan expenses if the plan permits the payment of plan expenses.



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The thrust of the FTAB is that the allocation of the settlement proceeds is a fiduciary act and that if the IDC does not specify a plan allocation method, the plan fiduciaries will need to develop a proper allocation method that meets the prudent and solely in the interest requirements of ERISA.

Medicare Part D Creditable Coverage Model Notices are Updated

The Centers for Medicare and Medicaid Services (CMS) published new model notices and guidance for use on or after May 15, 2006. The updated Model Creditable Coverage Notice and Model Non-Creditable Coverage Notice are substantively the same as last year's generic model notices. However, CMS made changes to the model notices to make them easier to understand.

CMS has also created a new Model Personalized Disclosure Notice on Creditable Coverage that may be used when Medicare beneficiaries request a copy of their creditable coverage notice. The personalized notice includes the following information:

- ❖ The Medicare beneficiary's first and last name, social security number, or health insurance claim number.
- ❖ The date ranges of creditable coverage.
- ❖ Statement that the health plan's drug coverage was determined to be creditable or non-creditable coverage.
- ❖ The health plan's name and contact information.

The personalized notices may be used by the employer in lieu of either the Model Creditable Coverage Notice or Model Non-Creditable Coverage Notice.

Medicare eligible individuals who do not enroll for Part D coverage when they initially become eligible will pay a penalty in the form of higher premiums when they enroll later unless they are covered by creditable coverage under their employer's plan. Therefore it is important that they retain copies of the creditable coverage notice provided to them by their employer as proof that they have maintained creditable coverage since the end of their Medicare Part D initial enrollment period.

The new CMS guidance did not change the simplified method for determining creditable coverage, but has clarified the definition of an integrated plan entitled to use the alternative simplified method of determining creditable coverage. If the employer's prescription drug coverage satisfies the four requirements under the simplified method, the employer will not need an actuarial determination that the expected amount of claims



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under the plan is at least as much as the expected amount of claims under a standard Medicare Part D plan.

Under the simplified method, prescription drug coverage is deemed creditable based on plan design if it:

1. is designed to pay, on average, at least 60% of participants' drug expenses;
2. covers both brand name and generic prescriptions;
3. provides reasonable access to retail providers and, optionally, to mail order coverage; and
4. has a maximum annual benefit for prescription drug coverage that is at least \$25,000 (or has an actuarial expectation that it will pay at least \$2,000 per Medicare eligible individual in 2006).

Health plans that integrate prescription drug coverage with other coverage, e.g., medical, dental, vision, etc. can meet the fourth requirement for the simplified method, if it has:

- ❖ no more than a \$250 deductible per year;
- ❖ maximum annual benefit of at least \$25,000; and
- ❖ no less than a \$1 million lifetime combined benefit maximum.

Under the new CMS guidance, an integrated health plan is defined as having a combined:

- ❖ plan year deductible for all benefits under the plan;
- ❖ annual maximum for benefits under the plan; and
- ❖ lifetime benefit maximum for all benefits under the plan.

The new CMS guidance, model personalized disclosure notice, and model generic notices are posted on CMS' website at

http://www.cms.hhs.gov/CreditableCoverage/02_CCafterMay15.asp#TopOfPage.

CMS Announces Indexed Medicare Part D Limits for 2007

On April 5, 2006 CMS announced the indexed Medicare Part D amounts for 2007. CMS' Office of the Actuary estimates that this year's 6.88% increase reflects both higher drug utilization among seniors and reduced prices in prescription drug costs that have been negotiated by Part D prescription drug plans.



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The following table compares the 2006 and 2007 indexed amounts.

	2006	2007
Retiree Drug Subsidy (RDS) Amounts		
Cost Threshold	\$250	\$265
Cost Limit	\$5,000	\$5,350
Standard Benefit Design Parameters		
Deductible	\$250	\$265
Initial Coverage Limit	\$2,250	\$2,400
Out of Pocket Threshold	\$3,600	\$3,850
Total Covered Part D Drug Spending before Catastrophic Coverage	\$5,100	\$5,451.25

For calendar year plans, the new limits apply as of January 1, 2007 and the new application for RDS must be filed by September 30, 2006.

If you have a non-calendar year plan, you should review the Medicare amounts with your actuary to determine whether to use the 2006 or 2007 numbers for your next application for the RDS subsidy. Any RDS application filed after June 6, 2006 must use the new 2007 numbers for calculating actuarial equivalence. The CMS regulations permit plans that file applications between April 5th and June 6, 2006 to file attestations based on the 2006 Medicare amounts.

Healthcare Continuation Coverage under COBRA and USERRA

When the DOL issued the final regulations under the Uniformed Services Employment and Reemployment Rights Act (USERRA), it did not provide detailed rules governing the election of continuation coverage, preferring instead to allow employers to adopt their own reasonable procedures for electing continuation coverage. While an employer may use procedures that are similar to its COBRA procedures, there are differences between COBRA and USERRA. Therefore, it is important that the employer focus on the differences between the two laws. The major differences are:

1. **Application.** Continuation rights under USERRA are available regardless of the size of the employer’s workforce.
2. **Maximum coverage period.** The maximum coverage period under COBRA may be 18, 29, or 36 months depending on the qualifying event. The maximum coverage period under USERRA is 24 months.



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3. **Premiums.** The calculation of premiums during the USERRA period are similar to the calculation of premiums under COBRA in that plans are permitted to charge covered individuals up to 102% of the full coverage premium. However, under USERRA, a service member who is on military duty for less than 31 days cannot be required to pay more than the employee share if any for the healthcare coverage.
4. **Termination of continuation coverage.** Unlike COBRA, an employer cannot terminate continuation coverage under USERRA when an individual obtains alternative coverage.
5. **Notice, election and payment procedures.** As stated at the beginning of this article, COBRA has very detailed procedures for providing notice, electing coverage and payment of premiums. USERRA does not provide any such procedures. Therefore, it is the employer's responsibility to adopt reasonable requirements and procedures for the administration of continuation coverage under USERRA.

It is important that all employers establish an action plan for compliance with the USERRA continuation procedures. The employer has the flexibility to adopt procedures that are similar in most respects to their COBRA procedures. To take advantage of this opportunity, employers must act to amend their COBRA notices and summary plan descriptions, and/or create additional USERRA-specific notices. If an employer decides to establish separate USERRA continuation procedures, there are additional administrative burdens and that any subsequent violations of those procedures could result in a fiduciary breach and related ERISA penalties.