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Highlights of the Month

1. Pension Reform Bill Passes Congress and Heads to the President for Signature
2. Labor Department Announces Final Rule on Electronic Filing and Proposes Improvements to Form 5500 Annual Reports
3. Recent Court Decision: ERISA Beats “Wal-Mart” Health Care Law
4. Internal Revenue Service Advises on Plan Excise Tax Calculations
5. Prescription Drug Re-importation Bills Making Way Through Congress
6. Update on Proposed Financial Accounting Standard: *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
7. IRS Issues Final Regulations on Health Savings Account (HSA) Comparability Rules

Pension Reform Bill Passes Congress and Heads to the President for Signature

Congress has passed HR4, the Pension Protection Act of 2006 (PPA), legislation aimed at reforming the funding of defined benefit pension plans, making permanent those provisions enacted in 2001 (EGTRRA) that were due to expire in 2010, and addressing investment education and diversification issues for participants in defined contribution plans.

The PPA also includes the following provisions:

- ❖ Provides a permanent interest rate based on a modified "yield curve," rather than a single rate for all plans;
- ❖ Prohibits employers from using credit balances if their plans are funded at less than 80%;
- ❖ Triggers accelerated contributions for “at-risk” plans. Plans are deemed “at risk” if the plan falls below 70% funded status using the worst-case scenario assumptions (i.e., employers cannot count credit balances and must assume employees take the most expensive benefits and retire at the earliest possible date). If an employer does not meet this test, it can forgo at-risk status only if it is 80% funded using standard assumptions (this test would be phased in over three years, starting at 65% in 2008 and rising to 70% in 2009, 75% in 2010, and 80% in 2011, according to a summary of

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- the provisions). If a company meets one of the two tests, it would avoid the at-risk designation; however, it would still be required to make up its overall funding shortfall over seven years like any other underfunded plan;
- ❖ Reduces the smoothing of interest rates to two years (instead of five for assets and four for liabilities under current law);
 - ❖ Prohibits employers and union leaders from increasing benefits if a plan is less than 80% funded, unless the benefits are paid for immediately;
 - ❖ Prohibits additional benefit accruals for lump sum distributions or shutdown benefits from plans funded at less than 60%;
 - ❖ Restricts the use of deferred executive compensation arrangements for employers with severely underfunded plans;
 - ❖ Permanently establishes an employer-paid termination premium of \$1,250 per participant if a plan sponsor terminates its employee pension plan upon entering bankruptcy. The plan sponsor would pay the premium after the company emerges from bankruptcy;
 - ❖ Requires employers to make sufficient contributions to plans in order to meet a 100% funding target and erase funding shortfalls over seven years;
 - ❖ Clarifies that all defined benefit plans (including cash balance and pension equity plans) are not inherently age discriminatory as long as benefits are fully vested after three years of service and interest credits do not exceed a market rate of return. The bill prohibits wear away of pre-conversion accrued benefits if conversion occurred after June 29, 2005. The provisions surrounding hybrid plans are prospective only and provide no clarification of the legal status of hybrid plans for past years.

The bill also includes provisions for the airline industry to opt for a “soft-freeze” or “hard-freeze” of their pension plans. Those that opt for a soft-freeze would receive an additional three years to meet their funding obligation, while an employer-paid termination premium of \$2,500 per plan participant also must be paid if they terminate their pension plan upon entering bankruptcy (with such premium to be paid upon emergence from bankruptcy.) Airlines choosing a hard-freeze of their pension plan would be given an additional 10 years to meet their funding obligations, with identical termination premium provisions as given above.

The bill increases disclosure requirements of pension plans, including more detailed information on Form 5500 filings, enhancing Form 4010 disclosure requirements (underfunded plans) and making available to the public all Form 4010 information filed with the PBGC, excluding corporate proprietary information. Also included are provisions prohibiting a company from forcing employees to invest any of their own retirement savings contributions in company stock and requiring companies to provide workers with quarterly benefit statements that include information about accounts, the



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value of their assets, their rights to diversify and the importance of portfolio diversification. To that end, the bill's provisions permit only qualified "fiduciary advisers" (those fully regulated by applicable banking, insurance and securities laws) to offer investment advice. Plan sponsors retain responsibility for selecting the advice providers while the providers will be personally liable for the advice they give. Advice providers may use computer models to tailor recommendations to a participant's individual situation but the model must be certified and audited by an independent party and may not favor investments offered by the advice provider.

Labor Department Announces Final Rule on Electronic Filing and Proposes Improvements to Form 5500 Annual Reports

The U.S. Department of Labor's Employee Benefits Security Administration (EBSA) announced a final regulation requiring plans to file Form 5500 annual reports electronically, beginning with 2008 plan year filings due in 2009. Simultaneously, EBSA, along with the Internal Revenue Service (IRS) and the Pension Benefit Guaranty Corporation (PBGC), proposed changes to the forms that will be processed under the new electronic system.

Under the final rule, the electronic filing requirement will be effective for plan years starting on or after January 1, 2008. Delinquent or amended filings for prior plan years for which paper filing options were available will be subject to the electronic filing requirement. The EBSA will provide instructions prior to the inauguration of the system on how those filings are to be made under the electronic filing system. In the preamble to the final regulations, EBSA noted that the requirement to file annual reports electronically does not affect the record retention or disclosure obligations under ERISA §107 and ERISA §209. Also, a plan administrator's obligation to make the latest annual report available for examination and to furnish copies upon request, under ERISA §104(b), are not affected by an electronic filing requirement.

As explained in the E-Filing Proposal, the EBSA anticipates that the new electronic filing system will incorporate the Internet as the sole medium for transmission of all filings, with this Internet-based transmission process superseding all of the other currently available methods of transmitting Form 5500 filings, including use of computer diskette, CD-ROM and magnetic tape. They plan for the system to incorporate immediate validity and accuracy checks that would reduce both the error and rejection rate of filings and would eliminate much of the costly post-filing paper correspondence and related potential penalties.



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The proposed revisions to the Form 5500 include:

- ❖ Creation of a new short form for small plans whose assets are held in easy to value investments with regulated financial institutions;
- ❖ Increased transparency of plan-related fees and expenses;
- ❖ Improved information on the funding of defined benefit plans;

Realignment of the reporting rules of 403(b) plans (subject to Title I) to be compatible with those of 401(k) plans. The new system will also customize the information required to be filed to the type of plan involved in each filing.

Recent Court Decision: ERISA Beats “Wal-Mart” Health Care Law

A U.S. District Court judge threw out the Maryland Fair Share Health Care Act that regulated the amount of health care coverage companies in the state were required to provide. The law required non-governmental employers of 10,000 or more people in the state of Maryland to spend at least 8% (6% for non-profit employers) of their payroll cost on health-care benefits or pay the difference into a state trust that would be used to offset the cost of providing Medicaid benefits. The judge ruled that the matters dealt with in the Maryland law were preempted by Section 514(a) of ERISA. His ruling also stated that the “act violates ERISA’s fundamental purpose of permitting multi-state employers to maintain nationwide health and welfare plans, providing uniform nationwide benefits and permitting uniform national administration.”

Two other states had imposed similarly-themed health care mandates this year. The Massachusetts Health Care Access and Affordability Act requires employers with at least 11 full-time employees to make a “fair share contribution” unless they offer health insurance for their employees and make a “fair and reasonable premium contribution” defined by regulation. Surcharges are also imposed under the Massachusetts law on employers who do not provide health insurance. Vermont has also enacted legislation applicable to employers with more than four employees.

Internal Revenue Service Advises on Plan Excise Tax Calculations

Failure to timely transmit participant contributions to a plan constitutes a prohibited transaction which is subject to an excise tax under Section 4975 of the Internal Revenue Code. In Revenue Ruling 2006-38, the IRS states that under Section 4975, the applicable excise tax is applied to the amount involved in the prohibited transaction. According to the ruling, the term “amount involved”, where the transaction involves the use of money



or other property, is the greater of the amount paid for such use or the fair market value of such use for the period in which the money or other property is used, and the amount involved is determined for the entire period that the money or other property is used. In addition, in the instance of a prohibited transaction that is a loan, an additional prohibited transaction is deemed to occur on the first day of each taxable year in the taxable period after the taxable year in which the use occurred. Section 4975(a) imposes a 15% excise tax (the first tier excise tax) on a prohibited transaction, and Section 4975(b) imposes a 100% tax on the amount involved if the transaction is not corrected during the taxable period. The taxable period is the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of the date of the mailing of a statutory notice of deficiency, the date on which the first tier excise tax is assessed or the date on which the correction of the prohibited transaction is corrected.

As an example, the ruling gave the following as a scenario for a calendar year profit sharing plan with a 401(k) arrangement. An employer failed to segregate \$100,000 in participant contributions from its assets and transmit them to the plan on December 8, 2004. The contributions were not segregated and transmitted until December 30, 2005. Under these circumstances, the delay would constitute a prohibited transaction for 2004 and 2005, and the amount involved would be subject to excise taxes for both 2004 and 2005. For purposes of calculating the Section 4975 excise tax on a timely filed Form 5330, the amount involved for 2004 would be the interest (using 5% for underpayments) on the \$100,000 from December 8 to December 31, 2004 (\$314). The amount involved for 2005 would be the interest on the 2004 amount (\$314) plus the \$100,000 from January 1 to December 30, 2005 (\$5,002). The 15% excise tax on the amount involved would be \$47 for the 2004 taxable year and \$797 for the 2005 taxable year, for a total excise tax of \$844.

Prescription Drug Reimportation Bills Making Way Through Congress

The Senate approved an amendment to the Homeland Security Appropriations bill that would prohibit seizures by U.S. Customs and Border Protection of prescription drugs purchased from Canadian pharmacies by U.S. residents. The House has approved two appropriations bills -- Homeland Security and Agriculture -- that include provisions to allow the purchase of prescription drugs from abroad. The provision included in the House Homeland Security Appropriations bill would allow the purchase of prescription drugs from any nation. The House Department of Agriculture Appropriations bill prohibits the Food and Drug Administration from preventing individuals, wholesalers, or pharmacists from importing FDA-approved drugs from other countries.



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Update on Proposed Financial Accounting Standard: Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)

In March 2006, the Financial Accounting Standards Board (FASB) issued the aforementioned proposal to amend Statements 87, 88, 106 and 132. Comments were accepted through May 2006 and the FASB has now started its re-deliberations of the proposed accounting standard in reaction to the comments received and the feedback at the June 27, 2006 public roundtable meetings. The FASB staff projects that re-deliberations will continue through August 9, 2006, and that a final Statement will be issued at the end of the third quarter of 2006.

At a meeting held on July 12, 2006 the FASB took the following actions:

- ❖ Affirmed its decision to require an employer that is a business entity to:
 1. Recognize in its statement of financial position the overfunded or underfunded status of a defined benefit postretirement plan measured as the difference between the fair value of plan assets and the benefit obligation. For a pension plan, the benefit obligation would be the projected benefit obligation; for any other postretirement benefit plan, such as a retiree health care plan, the benefit obligation would be the accumulated postretirement benefit obligation.
 2. Recognize as a component of other comprehensive income, net of tax, the actuarial gains and losses and the prior service costs and credits that arise during the period but pursuant to FASB Statements No. 87, *Employers' Accounting for Pensions*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, are not recognized as components of net periodic benefit cost. Amounts recognized in accumulated other comprehensive income would be adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of Statements 87 and 106.
- ❖ The Board decided that any transition asset or transition obligation remaining from the initial application of Statement 87 or 106 would be recognized as a component of other comprehensive income, net of tax, rather than as an adjustment to the opening balance of retained earnings (as was proposed in the Exposure Draft). Amounts recognized in accumulated other comprehensive income would be adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of Statements 87 and 106.
- ❖ The Board decided not to require retrospective application of the accounting change for all financial statements presented, deciding instead to require recognition of the



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funded status in the statement of financial position as of the effective date of the final Statement. The Board directed the staff to discuss with users and preparers of financial statements the benefits and costs of providing, in notes to the financial statements, the pro forma effect of the changes on the financial position of the entity as of the immediately preceding fiscal year end. The Board will decide whether to require such a disclosure at a future meeting.

IRS Issues Final Regulations on Health Savings Account (HSA) Comparability Rules

The IRS has issued final regulations (TD 9277) on the comparability rules for HSAs. The regulations apply to all employer contributions made on or after January 1, 2007. Under Code Section 223, eligible individuals may set up HSAs if they are covered by high deductible health plans and are not covered by any other non-high deductible plans. Subject to statutory limits, eligible individuals may contribute to HSAs as may their employers and other persons on their behalf. Any employer contributions are excludable from the employee's income and distributions made from the HSA for qualifying medical expenses are tax-free. HSAs are not subject to nondiscrimination rules restricting the amount of benefits provided to highly compensated employees. However, if an employer funds HSAs, "comparable" contributions must be made to all comparable participating employees' HSAs. Generally, all employer contributions to HSAs must be the same amount or the same percentage of the high deductible health plan's deductible for all employees who fall into the same coverage category. In addition, the comparability rules apply separately to each of three categories of employees: active full-time (30 or more hours per week), active part-time, and former employees (excluding those covered under COBRA).

Under the final regulations, several important changes/clarifications were made from the proposed regulations:

- ❖ The number of coverage categories was expanded from two, self-only and family, to four, self-only, self plus one, self plus two, and self plus three or more. The regulations also stipulate that the employer's contribution with respect to the self plus two category may not be less than that made to the self plus one category, and that the employer's contribution to the self plus three category cannot be less than that made to the self plus two category. This creates eight different categories of employees, each of which could have a different level or percentage of employer contributions.
- ❖ The comparability rules do not apply to collectively bargained employees if health benefits were the subject of good faith bargaining between the employee representatives and the employer.



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- ❖ Employer contributions to HSAs are made through the cafeteria plan if, under the written cafeteria plan agreement, employees have the right to elect to receive cash or other taxable benefits in lieu of all or a portion of an HSA contribution – that is, all or a portion of the HSA contributions are available as pre-tax salary reduction amounts – regardless of whether an employee actually elects to contribute any amount to the HSA by salary reduction.