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Weekly Newsletter – Volume 1, No. 1 – January 5, 2005

Highlights of the Week

1. IRS provides Guidance on Automatic Rollover of Mandatory Distributions from Qualified Plans
2. IRS Releases Comprehensive Final 401(k) and 401(m) Regulations
3. EBSA releases Field Assistance Bulletin (FAB) 2004-3 which Addresses Directed Trustee Responsibilities
4. IRS Sets Semiannual Regulatory Agenda
5. EBSA Sets Semiannual Regulatory Agenda
6. PBGC Sets Semiannual Regulatory Agenda
7. EBSA Releases 2004 Form M-1 for MEWA Reporting

IRS Guidance on Automatic Rollover of Mandatory Distributions from Qualified Plans

When a plan participant terminates employment with a company that maintains a tax qualified retirement plan, the retirement plan is allowed to cash out the participant's benefits without the participant's consent (and, if applicable, the consent of the participant's spouse), if the present value of the benefit does not exceed \$5,000. The plan administrator is required to provide the participant with a notice before making the distribution that describes the participant's ability to have the distribution rolled over to another qualified plan or an IRA and the related tax consequences.

In 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) modified this rule by adding a provision to the Internal Revenue Code (the "Code") which requires plans with mandatory cash-out provisions to transfer the cash-out distribution to an IRA of a designated trustee or issuer where:

1. the cash-out amount if more than \$1,000 but no more than \$5,000; and
2. the plan participant (or beneficiary) receiving the distribution does not elect to have the distribution paid directly to another qualified plan or IRA (a direct rollover), and does not elect to receive the distribution him/herself.

The plan administrator is also required to provide the distributee in writing, either separately or as part of the required distribution notice, that the distribution may be transferred without cost or penalty to another IRA.



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The EGTRRA provisions were scheduled to take effect when the Department of Labor (DOL) issued final safe harbor regulations under which the plan administrator's designation of an institution to receive the automatic rollover and the initial investment choice for the IRA would be deemed to satisfy the fiduciary responsibility requirements of ERISA. The DOL issued those regulations on September 28, 2004, and the regulations are effective March 28, 2005. Thus, the automatic rollover provisions apply to cash-out distributions made on or after March 28, 2005.

IRS has now provided guidance on automatic rollovers in Notice 2005-5, 2005-3 IRB, in the form of Q&As. The Q&As address the following topics:

- Definitions of
 - Applicable distributions
 - Mandatory distributions
- Satisfaction of the automatic rollover requirement
- Plan amendments
- Application to governmental plans – transitional rule
- Application to non-governmental 457(b) plans
- Application to church plans – transitional rule
- Transitional rule for all plans
- Creation of IRAs for plan participants
- IRA part of plan making distribution
- Elimination of mandatory distributions
- Application of joint and survivor annuity requirement
- Rollover contributions exceeding \$5,000
- Notification requirements

The IRS Notice also contains sample plan amendment language.

IRS Releases Comprehensive Final 401(k) and 401(m) Regulations

IRS issued a huge set of comprehensive final regulations setting out the nondiscrimination and other requirements for Code Section 401(k) cash or deferred arrangements (CODA), and for matching contributions and employee contributions under Code Section 401(m). The final regulations reflect the relevant tax law changes and the IRS rulings that have become effective since 1994, and modify and finalize the proposed regulations that were issued on July 17, 2003.

The final regulations retain the definition of a CODA from the proposed regulations, with some minor modifications. The first modification relates to the participant's ability to make "designated Roth IRA contributions" even though these contributions will be made



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on an after-tax basis. The second modification clarifies that compliance with the provisions of Code Section 402(e)(3) is the only means by which an employer can provide a cash or deferred election to an employee, without violating the constructive receipt rules, is through a tax qualified plan or trust.

The following areas are also addressed in the final regulations:

- Automatic enrollment
- One-time irrevocable elections
- Timing of elective contributions
- Anti-abuse rule
- One CODA treatment
- Aggregation of plans with ESOPs
- When different testing methods can be used
- Immediate nonforfeitability of elective contributions

The following actual deferral percentage (ADP) and actual contribution percentage (ACP) issues are addressed in the final regulations:

- ADP testing issues
 - Designating a nondiscrimination alternative
 - Special rule for early participation
 - Elective contributions used in the ADP test
 - QNECs and QMACs under the ADP test
 - Net income on excess contributions
 - Safe harbor 401(k) plans
- ACP testing issues (matching and employee contributions)
 - ACP test is parallel to ADP test for elective contributions
 - Similar plan aggregation and disaggregation rules
 - QNECs

The regulations also addressed restrictions on withdrawals. The final regulations generally adopt the rules in the proposed regulations, which incorporated guidance on various statutory changes, such as the elimination of the “same desk rule” by replacing “separation from service” with “severance from employment” as one of the events that allow a distribution from a CODA.

The final regulations also require that an employee must show that a hardship distribution is necessary to satisfy an immediate and heavy financial need, and that the need cannot be reasonably relieved by any available distribution from the plan, including a distribution of ESOP dividends or proceeds from a nontaxable loan. Items that have been added to the list of permissible events for a hardship distribution include funeral expenses and certain expenses relating to the repair of damage to the employee’s principal residence.



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Other changes in the final regulations permit medical expenses and post-secondary education expenses for an employee, spouse, or dependent (without regard to the 2004 statutory change in definition of Code Section 152) to be treated as a heavy financial need. Also, the definition of dependent for medical expenses is expanded to include a non-custodial child who is subject to the Code Section 152(e) support test for a child of divorced parents. However, nonprescription drugs or medicine (other than insulin) are excluded from the definition of medical expenses.

In addition, the final regulations provide that an employee's change of status from a common law employee to a leased employee is not an event that would allow CODA distributions.

These final regulations apply for plan years that begin on or after January 1, 2006. However, plan sponsors are permitted to apply these final regulations to any plan year that ends after December 29, 2004, provided that the plan applies all of the rules contained in the final regulations, to the extent applicable, for that plan year and all subsequent plan years. However, the implementation of these rules in the middle of a plan year can only be successful if the plan has been operated in accordance with the regulations for the entire plan year.

EBSA releases Field Assistance Bulletin (FAB) 2004-3 which Addresses Directed Trustee Responsibilities

On December 17, 2004 the DOL's Employee Benefits Security Administration (EBSA) provided guidance to its field investigators on the fiduciary responsibilities of directed trustees under ERISA with respect to publicly traded securities purchased or held in qualified retirement plans. DOL reiterated its position that directed trustees are fiduciaries under ERISA and as such are required to exercise their duties prudently. However, the FAB indicated that a directed trustee would rarely need to question the directing fiduciary's instructions regarding transactions involving publicly traded securities.

The FAB makes clear that the named fiduciary, not the directed trustee, has the primary responsibility for determining whether an investment in employer stock is prudent and the directed trustee can generally rely on the directions of the named fiduciary. However, the FAB does provide that if the directed trustee "knows or should know" that the direction is either not made in accordance with the terms of the plan or is contrary to ERISA, the directed trustee should not follow the direction.



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In the FAB the DOL clarified that a direction is consistent with the terms of the plan if the documents do not prohibit the direction. (It should be noted that the directed trustee has an obligation to request and review the plan documents.) With respect to the “contrary to ERISA” standard, the DOL made clear that the directed trustee does not have an obligation to determine the prudence of every transaction and does not have to duplicate or second-guess the work of plan fiduciaries that have discretionary authority over the management of plan assets.

The FAB further provides that if the directed trustee has material, non-public information on the employer stock that would be necessary for a prudent decision, the directed trustee has an obligation to inquire about the named fiduciary’s knowledge and consideration of the information in making the direction. However, the possession of non-public information by one part of an organization is not imputed to personnel providing directed trustee services as long as the organization maintains procedures designed to prevent the illegal disclosure under securities, banking or other laws (and the individuals responsible for performing directed trustee services do not have actual knowledge).

DOL further indicated that the directed trustee will rarely have an obligation to question the prudence of a direction to purchase publicly traded securities at the market price based solely on the basis of publicly available information. In addition, the FAB further stated that a steep drop in a stock’s price, by itself, would not indicate that a named fiduciary’s direction to purchase or hold stock is imprudent and not a proper direction. Also, the DOL stated that the nature of a directed trustee’s responsibility does not change because the directed trustee questions whether the direction is proper or declines to follow a direction while carrying out its duties.

IRS Sets Semiannual Regulatory Agenda

IRS issued its semiannual regulatory agenda, which lists mandatory priorities for the next 12 months, including projects involving pension and benefit plans. (Regulatory Agenda, 69 Fed. Reg. 73610, 12/13/2004)

Highlights of some of the proposed regulations that are on the agenda include:

- Update and revise regulations for cash or deferred compensation
- Provide the definition of highly compensated employee
- Update and clarify the general rules for deductibility of employer contributions to tax qualified retirement plans and other deferred compensation arrangements
- Numerous regulations regarding tax sheltered annuities or 403(b) plans
- Modify the rules for determination of minimum single-sum distributions from cash balance plans



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- Provide rules regarding the interest rate used to calculate the current liability under Code Section 412(b)(5)
- Rules for providing a bona fide phased retirement program
- Enhancement of the existing HIPAA portability regulations by tolling the running of certain time periods in certain circumstances, clarifying the procedures for requesting special enrollment, addressing how the HIPAA portability requirements apply to individuals taking leave under the Family Medical Leave Act of 1993, and prescribing how to count the number of employees an employer has.

In addition, the IRS has several pension and benefit regulations that will be finalized in the next 12 months. These regulations include:

- Guidance to group health plans regarding the limitations on imposing pre-existing condition exclusions and the special enrollment rules. These regulations will also provide guidance regarding plans and benefits that are not subject to these rules.
- Guidance regarding the requirements imposed on group health plans not to discriminate in rules for eligibility under the plan on the basis of any health factor, and not to require any individual to pay a higher premium or contribution for coverage under the plan than any similarly situated individual based on any health factor
- Information about the tax treatment of cafeteria plans
- Cash balance plan nondiscrimination rules prohibiting discrimination in favor of highly compensated individuals
- Income inclusion rules relating to the distribution of certain life insurance and annuity contracts by a tax qualified retirement plan
- Guidance on the anti-cutback provisions of Code section 411(d)(6) regarding the elimination of certain early retirement benefits, retirement-type subsidies, and optional forms of benefits
- Regulations to conform amendments made by EGTRRA relating to the elimination of forms of distribution in defined contribution plans

For other areas on the regulatory agenda please see the IRS Regulatory Agenda as published in the Federal Register.



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EBSA Sets Semiannual Regulatory Agenda

EBSA has also issued its semiannual regulatory agenda which lists priorities for the next 12 months. (Regulatory Agenda, 69 Fed. Reg. 73450, 12/13/2004)

In the pre-rule stage arena, EBSA has stated that it is conducting a review of the prohibited transaction exemption procedures and the participant loan rules. For each of these reviews, EBSA will address:

- the continued need for the rules
- the nature of complaints or comments received from the public regarding the rules
- the rules' complexity
- the extent to which the rules overlap, duplicate, or conflict with other federal, state and local rules
- the degree to which technology, economic conditions, or other factors have changed industries affected by the rules.

EBSA has five proposed regulations.

- Regulations addressing the ERISA and Public Health Service Act (PHSA) amendments that were made by the Women's Health and Cancer Rights Act of 1998 regarding protection for patients who elect breast reconstruction in connection with a mastectomy. Scheduled release date is June 2005.
- Regulations that establish procedures and standards for distributing benefits of individual account plans that have been abandoned by their sponsoring employers or plan administrators. Scheduled release date is January 2005.
- Regulations implementing the provisions of the Pension Funding Equity Act of 2004 (PFEA) which requires the administrator of a defined benefit multiemployer plan to provide participants, beneficiaries, and other parties with an annual funding notice indicating, among other things, whether the plan's current funded liability percentage is at least 100%. Scheduled release date is January 2005.
- Regulations that define when participant monies paid to or withheld by an employer for contribution to an employee benefit plan constitute "plan assets" for purposes of Title I of ERISA and the related prohibited transaction provisions of the Code. The regulations would establish a safe harbor period of specified number of business days during which certain monies that a participant pays to, or has withheld by, an employer for contribution to an employee benefit plan would not constitute "plan assets." Scheduled release date is December 2004.



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- Amendments to DOL's Voluntary Fiduciary Correction (VFC) program to add to additional transactions that are eligible for the program and by clarifying certain other operational requirements. EBSA will issue a restatement of the VFC program in its entirety and request public comments on the included amendments. Scheduled release date is December 2004.

In addition to the proposed rules/regulations, EBSA has four regulations that are in the final rule stage and will be finalized in the next 12 months.

- HIPAA regulations providing regulatory guidance to implement the provisions of HIPAA that were designed to improve health care access, portability, and renewability.
- ERISA section 702 established that a group health plan or health insurance issuer may not establish rules for eligibility (including continued eligibility) of any individual to enroll under the terms of the health plan based on any health status-related factor. These provisions are also contained in the Code and PHSA. DOL, IRS and the Department of Health and Human Services (HHS) published final interim regulations in April 1997 implementing the nondiscrimination provisions of HIPAA. The new final regulations will contain additional interim guidance under HIPAA's nondiscrimination provisions, and proposed guidance on bona fide wellness programs.
- Regulations with regard to the provisions of the Newborns' and Mothers' Health Protection Act of 1996 which amended ERISA and PHSA to provide protection for mothers and their newborn children with regard to the length of hospital stays following the birth of a child.
- The Mental Health Parity Act of 1996 (MHPA) amended the PHSA and ERISA to provide for parity in the application of limits on certain mental health benefits with limits on medical and surgical limits. DOL has amended the interim final regulations, in consultation with the Departments of Treasury and HHS, conforming the regulatory sunset date to the new statutory sunset date of December 31, 2004.

EBSA also has two items on its long-term agenda. The first is the issuance of regulations that set standards for determining "adequate consideration" under ERISA section 3(18). The second is the issuance of regulations that implement the civil penalty provisions of the PFEA that permit DOL to assess a civil penalty of not more than \$1,000 per day for each violation by any person of the notice requirement in ERISA relating to an election for deferral of charge for portion of net experience loss.



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PBGC Sets Semiannual Regulatory Agenda

PBGC also issued its semiannual regulatory agenda, which lists regulatory priorities for the next 12 months. (Regulatory Agenda, 69 Fed. Reg. 74036, 12/13/2004)

PBGC currently has five proposed regulation projects which are:

- The proposed regulations that amend the required reporting or disclosure of certain plan actuarial and employer financial information, participant notices, and reportable events to improve disclosure and provide for electronic filing of certain information were issued in December 2004.
- Regulations requiring electronic filing of premium declarations. Scheduled release date is February 2005.
- Regulations that amend the current regulations that provide a rule for computing liability under ERISA section 4063(b) when there is a substantial cessation of operations by an employer described by ERISA section 4062(e). Scheduled release date is February 2005.
- Regulations amending its benefit valuation and asset allocation regulations by adopting more current mortality tables and otherwise simplifying and improving its valuation assumptions and methods. Scheduled release date is February 2005.
- PBGC plans on issuing regulations that will improve its benefit payment rules. These regulations will fill in the gaps in the current rules, clarify matters that have been handled on a case-by-case basis in the past, and otherwise address issues relating to the determination of guarantee limits and the time, form and manner of payment. Scheduled release date is May 2005.

PBGC only has one regulation that is scheduled to be finalized during the next 12 months. PBGC plans to replace the numerous policy statements about penalties that it has issued over the last few years with an updated and expanded set of penalty policies codified in its regulations.

EBSA Releases 2004 Form M-1 for MEWA Reporting

A copy of the 2004 Form M-1 for MEWA reporting can be found at *69 Fed. Reg. 76548, 12/21/2004*. The Form M-1 is utilized by multiple employer welfare arrangements (MEWAs) to report compliance with the HIPAA reporting requirements. Certain entities claiming an exemption from the HIPAA reporting requirements also use Form M-1.



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The 2004 form is substantively identical to the 2003 form and like the 2003 form can be filed electronically over the internet. However, the 2004 form requests the filer's email address. The 2004 filing package also includes EBSA's Self-Compliance Tool which is a set of worksheets that a filer can use to determine compliance with the MEWA requirements.

The 2004 Form M-1 is March 1, 2005. Administrators can request an automatic 60-day extension to May 1, 2005.

Because of the increased use of computer generated forms, EBSA will not mail 2004 Form M-1 packages to filers on record. Copies of the form and filing instructions are available on the EBSA website at <http://dol.gov/ebsa>, by clicking on "Forms/Doc Request," and by mail after contacting EBSA at 866-444-3272. Electronic filers access, complete, and submit their returns online via a secure website at <http://www.askebsa.dol.gov/mewa>. The electronic filing is free and the users can complete the return in multiple sessions and print a copy of the return for their records. This website also includes a user manual, frequently asked questions, and a link to submit questions electronically. All forms submitted are subject to computerized review, regardless of the method of submission.