

Alert

Significant Regulatory Developments in
Human Resources, Benefits and Compensation
UNITED STATES

November 8, 2007

Year-End Checkup for Benefit Plans

This *Alert* will help identify general year-end administrative and planning issues that could lead to compliance or employee relations problems if not addressed before, or early in, 2008. In addition, we have highlighted recent legislative or regulatory developments that may require plan design or documentation changes, particularly in response to the Pension Protection Act of 2006 (PPA), final Internal Revenue Code (IRC) §409A regulations, and the re-proposed IRC §125 regulations.

General Topics

Administrative Tasks

2008 Benefit Limits: Benefits, employee communication material, and administrative rules that are tied to annual cost-of-living adjustments should be modified to reflect recently announced changes. You'll find the 2008 figures in our October 19, 2007, *Alert*, "2008 Limits for Benefit Plans."

Salary Reduction Elections: Employees can save or defer taxes on salary reductions under 401(k), 403(b), and 125 plans, as well as under qualified transportation benefit plans and nonqualified deferred compensation arrangements. In addition, salary reductions under these programs may enhance the value of certain tax credits such as the SAVER and earned income tax credits. Before the end of 2007, employers should communicate election rights for 2008 and obtain elections for all calendar year plans or arrangements, particularly if arrangements do not permit changes in elections throughout the year.

Employee Contribution Deposits: Employers should confirm that employee contributions withheld from employee paychecks (and loan repayments) are deposited with the plan's trust or insurance contract as soon as administratively possible. [Note: Flexible spending accounts (FSAs) and qualified transportation benefits, are generally not subject to this deposit requirement.]

Beneficiary Designations: Beneficiary designations should be reviewed for accuracy and completeness to avoid confusion about the proper beneficiary of plan benefits. For qualified retirement plans, a notary seal or plan representative's witness must attest to all required spousal consent signatures. Participants whose marital status changed during the year should be reminded to review existing designations. Some qualified plans require new designations at age 35. If this requirement is in your plan, verify that affected employees are reminded of it.

Social Security Earnings Limit: Consider alerting employees who are Social Security recipients that they can forfeit a portion of their benefits if they earn wages exceeding an earnings limit. The earnings limit is \$3,010 per month for each month before a recipient attains the Social Security normal retirement age in 2008 (65 and 10 months for individuals born in 1942). The earnings limit is \$13,560 per year for recipients who are younger than their Social Security normal retirement age in 2008. The earnings limit

applies to compensation for current service, not compensation for past services. Thus, payments made from qualified and nonqualified retirement plans do not count as earnings.

Form 5500 Filing Requirement: Confirm that all plans for which an annual Form 5500 filing will be required in 2008 have been identified and formalized in a written plan document that validates the Form 5500 filing structure. This would include all ERISA retirement plans and most welfare plans (e.g., health, life, and disability benefits). Generally, only insured welfare plans covering fewer than 100 employees on the first day of the plan year, church plans, and government plans are exempt from Form 5500 filings. Thus, employers need to file Form 5500 for less typical ERISA benefits like employee assistance plans, some severance pay plans, and business travel accident plans.

While not mandated, retirement plan sponsors are encouraged to update Schedule SSA records when previously reported deferred vested participants are cashed out. This stops the Social Security Administration from sending notices to participants at retirement age about the availability of plan benefits that no longer exist.

Retirement plan sponsors should also be aware that while Form 5500 schedules now require significantly less information about nondiscrimination demonstrations, there has been no change in the requirements. Adequate records should be retained to demonstrate compliance in the event of an audit.

Accountant's Opinion: Employers sponsoring qualified plans and certain funded welfare plans need to engage an independent qualified accountant to audit plan financial statements and provide the accountant's opinion with the plan's Form 5500 if Schedule H is required. Most plans covering 100 or more participants, and some covering fewer than 100 participants, must file Schedule H. An accountant's opinion is not required for 403(b) plans or unfunded or fully insured welfare plans. In addition, most cafeteria plans (including FSAs) are not required to comply with the audit rules.

Fidelity Bond: ERISA requires a fidelity bond for every plan fiduciary and every person who handles funds or other property of a plan. The bonding requirements can apply to vendors who have access to the claims payment checking account (even if the account is non-trusted). The amount of the bond must be at least 10% of the funds handled, with the minimum coverage amount being \$1,000 and the maximum amount being \$500,000. Small plans may require additional coverage to avoid the obligation to obtain and file an accountant's opinion. Employers should confirm that fidelity bonds are up to date.

PPA: The maximum bond amount is raised to \$1 million for plans that hold employer stock or other employer securities. A plan would not be considered to hold employer securities for bonding purposes where the only employer securities held by the plan are part of a broadly diversified fund of assets such as a mutual fund. The bonding increase applies to plan years beginning after 2007.

Electronic Communications: Recently, IRS revised its existing electronic communication regulations to integrate them with the Electronic Signatures in Global and National Commerce Act. The revisions expand the scope of the use of electronic media to apply to (a) any notices or communications from plans to participants; or (b) elections or consents transmitted from participants to plans. For example, qualified joint and survivor annuity notices and elections could be provided electronically. The new rules also function as a safe harbor when an electronic medium is used for a communication that is not required to be in writing or in written form. The revised regulations generally apply to notices provided, and participant elections made, on or after January 1, 2007.

Fiduciary/Provider Review

Monitoring Responsibility: Plan fiduciaries have a responsibility to monitor plan operations as well as the investment and distribution of plan assets. Virtually all courts addressing the issue have imposed personal liability on corporate employees, officers, and board members for violating their fiduciary responsibilities to plan participants and beneficiaries. Corporate officials with monitoring responsibilities should consider how effectively they are documenting that they are acting prudently. When these corporate officials have access to inside information, they also need to resolve the conflict between their loyalty to the corporation's shareholders and their loyalty to the plan participants. This conflict is most common and can be particularly acute if plan assets are invested in employer stock. In 2006, a series of class actions were filed on behalf of 401(k) plan participants alleging that the plan sponsors failed to prudently manage fees charged by plan vendors. This litigation, as well as forthcoming DOL guidance on 401(k) fees and an expansion of fee information that must be reported on Form 5500, will continue to highlight the importance of a prudent monitoring process. Aon Consulting's *Outlook*, "Managing Mutual Fund Expenses: A Fiduciary Obligation," focuses on providing plan sponsors with a better understanding of the components underlying a mutual fund's expense structure.

Vendor Selection: DOL views the selection of a vendor for an employee benefit plan as a fiduciary decision. To comply with ERISA, a fiduciary must gather enough information to assess the fees charged by providers as well as their qualifications and quality of services. DOL says the lowest bidder need not always be selected. Key quality factors to consider include scope of choices, qualifications of providers and specialists, and participant satisfaction statistics. After SEC released a report on conflicts of interest in the investment consulting business serving the retirement plan community, both DOL and SEC publicized ten questions plan fiduciaries should ask investment advisers to evaluate the objectivity of their advice (e.g., Do you or a related company have a relationship with money managers that you recommend?). Find them all at <http://www.dol.gov/ebsa/newsroom/fs053105.html>.

Investment Monitoring and Rebalancing: Fiduciaries should periodically monitor investment results and reassess choices. For plans that allow participants to direct investments, prospectuses and other investment information should be provided to participants. Whether participants or trustees make investment decisions, periodic rebalancing of plan investments is necessary to stay the course with a selected asset allocation strategy. Plan trustees may wish to schedule a date for rebalancing. For participant-directed plans taking advantage of the fiduciary relief under ERISA §404(c), as well as other plans, plan trustees may wish to include a rebalancing message with participant statements for the fourth quarter. Details on fiduciary and investment issues may be found in our *Research Briefs*: "Fiduciary Fundamentals Under ERISA" and "Fiduciary and Investment Issues: Beyond the Basics."

PPA: To encourage more employers to provide investment advice to 401(k) plan participants, PPA amends ERISA's fiduciary rules to recognize "fiduciary advisers" and to clarify the role of plan sponsors that select and monitor them. In addition, PPA provides fiduciary protection in situations where the participants do not make an investment choice and the plan fiduciary makes a default investment consistent with DOL regulations. Both new rules are available for 2007. DOL's final regulation on default investment safe harbors (e.g., balanced funds, life-cycle or targeted-retirement-date funds, or professionally managed accounts—and stable value or money market funds for up to 120 days) can be used even by plans that do not comply with ERISA 404(c) or don't use automatic enrollment. Fiduciaries may wish to reaffirm the suitability of their current default or consider alternatives.

Design Changes

Dependent Definition: The Gulf Opportunity Zone Act has corrected problems with the definition of “dependent” in IRC §152 as it applies to employee benefit plans. The Act’s changes are retroactively effective as if included in the Working Families Tax Relief Act of 2004, the original legislation that created the problems with the dependent definition. If an employer chooses to provide coverage only to dependents who qualify for tax-favored treatment, or meet safe harbors such as the 401(k) hardship withdrawal rule, then incorporating IRC §152 is a good start, but is not sufficient. At a minimum, the plan language must incorporate by reference both IRC §152 and the other relevant IRC sections that affect the definition of dependent that applies to the plan. For example, a health plan would have to say something like: “dependent” shall mean any dependent as defined in IRC §152, as modified by IRC §105 and §106 and their accompanying regulations. In some cases, the new dependent definition could be more expansive than an employer intends to use. For example, the definition of “dependent” could cover certain children over age 18 even if they are not full time students. Plan changes may be needed to assure that coverage is restricted to the intended class of dependents. Plan documentation should be reviewed to assure that it accurately reflects these legislative changes and supports the plan sponsor’s intent.

Domestic Partners and Same-Sex Marriages: As more states and foreign jurisdictions expand the availability of same-sex marriages and civil unions, plan participants will want information on how their changed status affects their employee benefits and the related treatment of both benefits and contributions under federal and state income tax rules. If not previously addressed, an evaluation of plan documents, operations, and employee communications is in order. The Defense of Marriage Act (DOMA) says federal law only recognizes opposite-sex spouses. This can affect the level of favorable tax treatment available and the application of certain qualified retirement plan rules (e.g., joint and survivor annuity rules). While employers will embrace different approaches to address developments in this area, all need to assess their plans to determine whether current plan language conforms to their desired approach, determine what is and is not possible, and then appropriately implement changes.

Cafeteria, Health, and Welfare Plans

Administrative Tasks

Use It or Lose It: Employers need to remind employees to carefully budget health or dependent care expenses in making their elections under FSAs to avoid forfeiture under the “use it or lose it” rule. In 2005, IRS modified this rule to allow employers with FSAs to permit a grace period of up to 2½ months following the end of their plan year during which plan participants can incur expenses and be reimbursed from any unused account balances.

Women’s Health & Cancer Rights Act: Group health plans are required to notify employees about the availability of coverage for breast reconstructive surgery expenses (where the plan provides coverage for mastectomies) at the time of enrollment and annually thereafter. Many employers satisfy the annual notice requirement by communicating the breast reconstruction mandate each year in open enrollment materials.

HIPAA Privacy Notice: A health plan must remind their enrollees of the availability of its Notice of Privacy Practices at least every three years. Assuming compliance was aligned with the latest permitted deadline, for a small plan [i.e., less than \$5 million in “annual receipts” (e.g., premium payments)], the third anniversary of HIPAA Privacy compliance date was April 14, 2007. For larger plans, the next third anniversary will be April 14, 2009.

Medicare Part D Creditable Coverage: Employers offering prescription drug coverage to employees or retirees covered by Medicare Part A or B must give participants a “creditable coverage” notice every year before November 15, or within one year after the previous disclosure. This disclosure requirement applies not only to retirees over age 65, but also workers over age 65, workers with end-stage renal disease, and workers disabled two or more years. Because of the difficulty of isolating these plan participants, many employers have included the creditable coverage notice in their open enrollment material or similar communications. Model notices are available from the Centers for Medicare & Medicaid Services (CMS).

In addition to providing creditable coverage notice to plan participants, employers must also complete a CMS online disclosure form that describes their prescription drug coverage. The initial form should have been completed no later than March 31, 2006. Thereafter, the disclosure form must be completed within 60 days after the first day of the plan year. Additionally, the disclosure form must be completed within 30 days after the termination of a prescription drug plan and after the creditable coverage status of the employer’s drug coverage changes. The online disclosure form is located at the CMS website: <http://www.cms.hhs.gov/creditablecoverage>.

Medicare Secondary Payer: In 2006, CMS amended its regulations to confirm that employers are liable under the Medicare Secondary Payer (MSP) rules for claims mistakenly paid on a primary basis, regardless of whether the employer’s plan is insured or self-insured or whether the employer has any initial responsibility to pay Medicare. Therefore, even when a plan is fully insured, and the employer has no payment obligation, Medicare can collect its incorrect primary payment from the employer. An employer should take steps to assure that its health insurance contracts allow for reimbursement from insurers during the three-year period the government can assert MSP claims against the employer.

Disability Benefits: Short-term and long-term disability benefits provided by employer contributions are subject to federal income tax and, for a limited period, FICA and FUTA. However, if employees contribute to the cost of these plans after-tax, a portion of any benefit received is nontaxable based on the ratio of employee and employer contributions. If the ratio used to determine excludable benefit payments changes, employers need to calculate and communicate the new ratio to third-party payors before 2008 so that the correct amount of income tax withholding, FICA, and FUTA can be determined for 2008 benefit payments.

Group Term Life Benefits: The value of employer-paid group term life insurance in excess of \$50,000 generates income that must be included in W-2 earnings. The value of the first \$50,000 of coverage is also taxable for key employees covered by discriminatory plans. The value of this coverage is determined using IRS Table I rates. Although includable in income, these amounts are not subject to income tax withholding but are subject to FICA withholding. If employers are not withholding FICA on an ongoing basis, they should withhold the appropriate FICA amount from a terminated employee’s last paycheck. Note that employee-pay-all supplemental plans may generate taxable income for employees paying less than Table I rates for their coverage if other employees are paying more than Table I rates for their coverage. Also note that IRS recently changed how to calculate the cost of coverage for premiums that run through cafeteria plans effective for periods from August 6, 2007. For these plans, the taxable value of the coverage is based solely on the Table I rates without consideration of the actual premium paid with flex plan dollars.

Design Changes

IRC §125 Cafeteria Plans: Proposed changes to IRS regulations for cafeteria plans, which will impact essentially all cafeteria plans to one degree or another, are scheduled to go into effect on the first day of the first plan year on or after January 1, 2009. Meantime, plan sponsors may rely on the proposed

regulations until the new rules are finalized. Plan sponsors will need to review their existing cafeteria plan design and administration to identify any compliance gaps that will exist if the proposed regulations are finalized in their current form and review all cafeteria plan documentation to assure compliance with the new requirements. Information on the proposed regulation can be found in the August 17, 2007 Aon Alert “IRS Issues New Proposed Section 125 Cafeteria Plan Regulations.” Among the more significant changes are:

Choice: A cafeteria plan must offer a choice between certain specified taxable benefits (cash) and specified qualified (non-taxable) benefits. The proposed regulations also provide a list of nonqualified benefits that may not be offered under a cafeteria plan. Prior to the effective date, plan sponsors will need to confirm that their plan conforms to these requirements. In addition, plan sponsors with employees in Massachusetts (see “State Mandated Health Care Reform” later in this Alert) will need to modify their plan documents to allow pre-tax contributions for third-party medical coverage (a qualified benefit under the proposed regulations).

Documentation: Cafeteria plans must be documented in writing prior to the first day of the plan year to avoid plan disqualification—which would make participants subject to taxation of the greatest value of benefits that could have been elected. Plan documentation must describe: (i) the benefits offered through the plan, (ii) rules for participation, elections and contributions, (iii) special requirements for health care, dependent care and adoption assistance FSAs, and (iv) if applicable, contributions to and distributions from health saving accounts (HSAs).

Discrimination: Long an area of uncertainty, the proposed regulations provide significant new guidance on three nondiscrimination tests that apply to cafeteria plans: (i) the Eligibility Test, (ii) the Contributions and Benefits Test, and (iii) the Key Employee Concentration Test. In addition to clarifying definitions, the guidance provides a new objective test to determine when the actual election of benefits is discriminatory; clarifies the safe harbor for cafeteria plans offering medical benefits, and creates a new safe harbor for premium-only cafeteria plans that meet certain requirements.

Consumer-Driven Health Plans: Consumer-driven health (CDH) emerged six years ago with the objective of converting passive health plan participants into active health care consumers who are more engaged in the purchase of health care services. Two main types of account-based CDH plans have evolved: health reimbursement arrangements (HRAs) and HSAs. Although they are similar, there are several fundamental differences between the two models. Our *Research Brief*, “Consumer-Driven Health: An Effective Strategy for Controlling Health Care Costs,” explains the pros and cons of each model and provides Aon’s perspective on how these CDH programs can slow the rate of health care cost increases.

Health Reimbursement Arrangements: In 2006, IRS clarified that all medical reimbursements from an HRA or similar medical expense reimbursement plans are taxable if the plan allows the participant’s beneficiary (other than the employee’s spouse or dependents of the employee) to use up the account balance for medical expenses after the participant dies. Plans that currently have the offending death benefit clause need to remove it before plan years beginning after 2008.

Group Health Plans and TRICARE: Recently enacted Section 707 of Public Law No. 109-364 (10/17/06) bans the use of financial incentives to encourage TRICARE-eligible employees to opt out (or decline enrollment in) an employer’s group health plan and to enroll in (or remain in) TRICARE, the U.S. Department of Defense’s health plan for military personnel and their families. The definition of employers includes state or local governments but not employers with fewer than 20 employees.

Effective January 1, 2008, the new ban is modeled on the language that prohibits comparable financial incentives in connection with Medicare.

State-Mandated Health Care Reform: In 2006, Massachusetts enacted legislation that requires all residents of the state to carry health insurance either through their employer or through individual coverage. Employers with more than 10 employees working in the state, who are not sponsoring health coverage for those employees, will be assessed \$295 per employee annually and may incur surcharges if employees receive uncompensated care. The mandate affects these employers even if their major business operations are located outside of Massachusetts.

Dependent Care Assistance Plans: IRS finalized an update to IRC §21 dependent care credit regulations in 2007, effective for taxable years beginning after August 14, 2007. Among other things, the regulations say that dependent care expenses for periods during which the taxpayer is absent from work are not employment-related. However, short, temporary absences, such as for a minor illness or vacation, are disregarded if the taxpayer must pay for dependent care expenses on a weekly or longer basis. These regulations are important because employers rely on IRC §21 and its guidance to define qualifying expenses under their §129 dependent care assistance programs, even though there are some minor differences between §21 and §129.

Other Compensation

Executive Compensation: The Securities and Exchange Commission (SEC) has substantially overhauled its disclosure rules for executive and director compensation. Virtually all elements of compensation and benefits for each named executive officer and director must now be disclosed in proxy statements, annual reports, SEC registration statements, and other SEC reports (including Form 8 K) of public companies. Among other things, SEC has changed the definition of the named executive officers whose compensation must be disclosed. The Pension Benefit Table has also been substantially changed, and a new Nonqualified Deferred Compensation Table has been added. In addition, SEC has enhanced the stock option disclosure requirements to discourage questionable timing and pricing practices (e.g., backdating).

SEC's initial review of 350 public company disclosures under the new rules resulted in two themes. One, the Compensation Discussion and Analysis needs to be focused on how and why a company arrives at specific executive compensation decisions and policies. Two, the manner of presentation matters. Use plain English and organize tabular and graphical information in a way that helps the reader understand a company's disclosure.

Nonqualified Deferred Compensation: IRS final regulations for nonqualified deferred compensation (NQDC) plans subject to IRC §409A and supplemental guidance extend some transition relief provided in earlier guidance, however, employers with NQDC plans will have to take action before 2009 and follow the regulations in good faith in the meantime. Despite this relief, it is very important that plan sponsors do not simply abandon the 409A project for another year. Employers should make sure that they have:

- identified all plans that might be impacted by §409A;
- determined a course of action to insure “good faith compliance”; and,
- taken the steps required to document 2007 elections no later than December 31, 2007.

IRS provides an extension of the transition relief allowing participants to change the time and/or form of payment without that change being treated as an acceleration of benefits, provided the election (a) is filed by the participant no later than December 31, 2007 (for 2008 elections; December 31, 2008 for 2009

elections), (b) does not affect a payment that is otherwise due in the corresponding election year, and (c) does not accelerate a payment into the year of the election. This can be a very valuable tool in helping plan sponsors assist participants in transitioning into new plan designs. To the extent this transition relief is offered by an employer for 2007, certain elections need to be made by the participants (or the employer) on or before December 31, 2007.

- Elections can be made in 2007 to change the time or form of payments (but may apply only to amounts that would not otherwise be payable in 2007 and may not cause an amount to be paid in 2007 that would not otherwise be payable in 2007).
- Elections can be made in 2007 to defer short-term deferrals if the election is made by December 31, 2007. In general, amounts that would otherwise be paid between January 1 and March 15, 2008 would qualify as short term deferrals.

Also note that the ability to link a payment election under a nonqualified plan to an election under a qualified plan is extended through 2008. And finally, IRS has not yet issued guidance on how to calculate the amount of deferrals subject to §409A under NQDC plans for W-2 income tax reporting purposes. Thus, income tax reporting obligations for deferrals have been suspended for 2005, 2006, and 2007.

PPA: Employers will face new restrictions on funding nonqualified deferred compensation for certain employees if their qualified pension plans are poorly funded under the new “at risk” rules beginning in 2008. The new limits apply now for employers who are debtors in Title 11 (and similar) bankruptcy cases and for employers who terminate insufficient qualified plans.

Retirement: Defined Contribution and Defined Benefit Plans

Administrative Tasks

Minimum Distribution Requirement: Working participants who are 5% owners and terminated participants are required to take annual plan distributions once they attain age 70½. Employers should confirm that arrangements have been made to comply with this distribution requirement for 2007. Plan participants who received initial payments earlier this year may need to collect second payments by December 31, 2007. These rules apply to qualified plans as well as 403(b) and 457(b) plans. The age 70½ distribution requirement does not apply to working participants who are not 5% owners. However, some plans opted to continue the requirement despite the tax Code change. Review plan documents to confirm applicability in specific situations.

PPA Timing and Disclosure: The Act changes the notice and election period for 402(f), deferral of distributions, and qualified joint and survivor annuity (QJSA) rules from 90-days to 180-days effective for years beginning after 2006. In addition, the Act adds a new requirement for notices to participants who have the option to defer commencement. Such notices must describe the “consequences of failing to defer” receipt of a distribution. In interim guidance on this new requirement:

- For defined benefit plans, IRS says descriptions of the right to defer a distribution should include a description of how much larger benefits will be if commencement is deferred. This can be based solely on the normal form of benefit using the generic illustration option from the relative value regulation.
- For defined contribution plans, the description should indicate the investment options available under the plan (including fees) that will be available if distributions are deferred.
- For both types of plans, IRS says to include “the portion of the summary plan description that contains any special rules that might materially affect a participant’s decision to defer.”

PPA New Optional Distribution Form: Plans subject to the QJSA distribution requirement are required to offer the “Qualified Optional Survivor Annuity” option if it is not already an option under the line-up offered by the plan. The “QOSA” is a 75% joint and survivor option if the plan’s usual QJSA is the typical 50% joint and survivor form (or any other rate of less than 75%). The QOSA is a 50% joint and survivor option if the plan’s usual QJSA is a 75% or more joint and survivor benefit. Defined benefit plan sponsors will want to avoid adding a QOSA that is more valuable than the plan’s QJSA.

PPA Rollover Changes: Under PPA, after-tax funds can be directly rolled over to 403(b) annuities beginning in 2007. As with 401(a) qualified plans, the recipient plan can only be used if the contract provides for separate accounting. In addition, beginning in 2007 nonspouse beneficiaries are permitted to set up “inherited” IRAs to accept direct transfers of qualified plan death benefit distributions [and 403(b) and governmental 457(b) death benefit distributions]. The nonspouse death benefit distribution rules of 401(a)(9) apply to the IRA. As confirmed by IRS guidance issued early in 2007, the nonspouse beneficiary rollover rule is optional and is not subject to the direct rollover requirements, 402(f) notice requirements, or mandatory withholding rules. However, under a technical corrections bill introduced in the House and Senate in August, plans would be *required* to offer the nonspouse rollover rule beginning in 2008. An additional PPA rollover change becomes operational in 2008—nonRoth distributions from 401(a) qualified plans, 403(b) annuities and governmental 457(b) plans can be rolled over directly to Roth IRAs. The amount rolled is includable in income, exempt from the premature distribution penalty, but limited by the individual’s income limits (e.g., no rolling in 2008 or 2009 if AGI is \$100,000 or more).

Individual Participant Statements: Under PPA, for plan years beginning after December 31, 2006 (later for collectively bargained plans), quarterly benefit statements are required for defined contribution plan participants and beneficiaries who have the right to direct the investment of plan assets, and annual statements are required for those without such rights. Active, vested participants in defined benefit plans must be given benefit statements at least every three years, or a plan administrator may provide annual notice of the availability of a statement upon request. Defined benefit administrators will need to disclose any coordination of benefits with Social Security or other plans under floor-offset arrangements. Defined contribution benefit statements must provide an explanation of the importance of portfolio diversification, including a discussion of the inherent risk of holding more than 20% of assets in a single security, and a notice that further information on investing and diversification is available on the DOL website. DOL guidance released at the end of 2006 included model language for the diversification explanation, set a 45-day post-period safe harbor for furnishing the PPA statements, and said that defined benefit plans opting for the annual notification option would need to furnish the initial notification no later than December 31, 2007. More recently, DOL relaxed the 45-day rule for trustee-directed individual account plans to coincide with the date of filing the Form 5500 Annual Return/Report for the plan year to which the statement relates.

Implementing Design Changes

Amendment Deadlines: IRS’ relatively new determination letter program uses a system of staggered remedial amendment deadlines and new procedures for filing determination letter requests. The system uses five-year cycles (called Cycles A-E) for individually designed plans and six-year cycles for pre-approved plans (i.e., M&P and volume submitter plans). Consequently, individually designed plans will need to apply for determination letters only once every five years, and pre-approved plans only once every six years. The new system includes extensions to the EGTRRA remedial amendment period to coincide with the new staggered deadlines. Submissions for individually designed plans in the second cycle (Cycle B for employers with a TIN ending in 2 or 7) began on February 1, 2007, and will end on January 31, 2008. While waiting to submit determination letter requests, employers should remember that “operational compliance” with changed rules is generally not sufficient; interim plan amendments are needed to comply with changes in the law or regulations unless a law specifically gives additional time

such as the PPA extension until the end of the plan year beginning on or after January 1, 2009 (2011 for governmental plans). Amendments are, generally, due by the end of the plan year the change is effective if the change is discretionary; by the end of the remedial amendment period (e.g., the corporate tax filing date where the plan and corporate fiscal coincide) if the change is mandatory. But keep in mind that even amendments adopted during a plan year need to avoid violating the anticutback rule unless there is some specific exception for a particular change. Employers should keep tabs on how changes have been implemented in case details are needed for final plan amendments.

Correcting Late Amendments: Plan sponsors who missed an interim amendment deadline can correct the error using the IRS' voluntary correction program—Employee Plans Compliance Resolution System (EPCRS). The current program offers a reduced compliance fee (a flat \$375) for failures to make good faith EGTRRA amendments, amendments to address 401(a)(9) regulatory changes and other interim amendments under the new amendment “cycles” described above.

Advance Notice: Pension plan participants must be given advance “204(h)” notice of changes that reduce future accruals and certain retirement-type benefits. IRS has announced in a November, 2007 *News Flash employee plans news* that the PPA mandate to restrict certain payments based on a plan's funding status and the change to the interest and mortality rates used for determining lump sums and certain other options from traditional defined benefit plans need not be announced to employees in such advance notices.

Retirement: Defined Contribution Plans

Administrative Tasks

Salary Reduction Elections: Employers should verify that no participant will contribute more than the \$15,500 maximum limit on the amount of elective deferrals that can be made by a 401(k), 403(b), or 457(b) plan participant in 2007. The limitation remains at \$15,500 for 2008. [Note: The elective deferral limit is aggregated for all 401(k) and 403(b) plans. The limit applies separately, however, to any 457(b) plans.] Employers are responsible for enforcing these dollar limits for individuals who are on more than one payroll of related businesses. Employees are responsible for monitoring the limit if they participate in several plans during the year due to employment with unrelated businesses. Employers may wish to alert new hires and any other employees who may have participated in a plan of another employer that the 401(k), 403(b), and 457(b) limits apply per individual, not per plan. Employers might also consider notifying employees about the SAVER credit and how salary reductions can enhance the value of earned income tax credits.

Catch-Up Contributions: For 2007, savings plans may also permit participants who have attained age 50 to make “catch-up” contributions of up to \$5,000. The limitation remains at \$5,000 for 2008. [Note: The catch-up limit is aggregated for all 401(k) and 403(b) plans. The limit applies separately, however, to any 457(b) plans. Additional types of catch-up contributions may also be available under 403(b) and 457(b) plans.] Employers who are not currently offering catch-up contributions should assess the option and confirm that all related companies will offer the option to all participants if any of them offer it. Final IRS rules allow catch-ups to be offered even if certain groups excludable under the coverage rules and Puerto Rican plans fail to include the option.

Safe Harbor Plans: Plan sponsors who intend to satisfy 401(k) nondiscrimination requirements by making safe harbor contributions must provide annual notices to plan participants within a reasonable period before the beginning of each plan year. This rule is deemed satisfied if the notice is provided at least 30 days prior to the beginning of a plan year. Employers opting for the new PPA automatic enrollment design will also need to provide the information described in the next section.

Automatic Enrollment Plans: Whether or not opting to use the new safe harbor for automatic enrollment plans, a new PPA notice requirement applies to plans that automatically trigger elective deferrals for employees. Failure to satisfy the notice requirement can attract a penalty of \$1,000 per day. The notice must explain the participant's rights and obligations under the arrangement, their right not to have elective contributions made on their behalf (or to elect to have contributions made at a different rate), the period of time for making their own election, and how contributions will be invested if they do not provide instructions.

Design Changes

401(k) Plans: Amendments before the end of the 2007 plan year may be in order if changing to or from a safe harbor design or if optional provisions such as Roth deferrals or the expansion of the hardship withdrawals safe harbor were implemented during the year. Any necessary refinements would be included with other EGTRRA amendments. Current year amendments to reflect PPA changes are not generally required. For example, an amendment is not needed to implement the PPA hardship withdrawal option to treat a participant's beneficiary under the plan the same as the participant's spouse or dependent. Such an amendment may be implemented operationally and adopted by the PPA deadline (generally, the end of the 2009 plan year).

Roth 401(k): Beginning in 2006, plans could allow employees who make elective deferrals to 401(k) plans to designate whether some or all of those deferrals are "Roth" contributions. Such contributions are currently includible in gross income, with qualified distributions from the Roth account (including income) excludable from gross income. Currently, high-income individuals cannot establish Roth IRAs (e.g., a married taxpayer filing jointly cannot make Roth IRA contributions if modified adjusted gross income exceeds \$160,000). However, they can contribute to a Roth 401(k). Employers choosing to make Roth contributions available to employees during the 2007 plan year need to have amendments in place memorializing that decision by the end of the plan year.

For employees in all income levels, a number of factors need to be evaluated to determine whether Roth contributions are better than pre-tax deferrals. These factors include current and future tax brackets, tax credits and the taxation of future Social Security benefits. Plan sponsors need to consider how they might communicate this information, how payroll and account record keeping would need to be modified, and how the new Roth amounts would be handled under various plan loan and distribution rules.

Automatic Enrollment and Default Investments: Employers who had held back on implementing automatic enrollment (including the new PPA 401(k) safe harbor model) until final decisions were in place for choosing a default investment vehicle need wait no more. DOL finalized the default investment safe harbors in October. The result includes balanced funds, life-cycle or targeted-retirement-date funds, professionally managed accounts, and stable value funds or money market funds for up to 120 days. The automatic enrollment safe harbor starts participants out with a 3% employee deferral that increases 1% each year until topping out at least at 6%. The matching contribution requirement is lower than the commitment under the original safe harbor and need not be fully vested until two years of service. This and other preferential rules are worth a look.

Vesting: PPA changed the minimum vesting requirements for non-matching employer contributions to defined contribution plans by requiring compliance with either the 3-year cliff or 2-6 year graded vesting schedules. This change applies to contributions for plan years after 2006. IRS guidance confirms the ability to maintain bifurcated vesting schedules and explains how contributions deposited in 2007 can nonetheless be attributed to the 2006 plan year and thus subject to the plan's pre-PPA schedule.

Compensation: For plan years beginning on or after July 1, 2007, IRS regulations change the time period for recognizing compensation taken into account under a plan. In addition, some changes have

been made to the types of pay that is considered for certain purposes. In general, these changes serve to bar deferrals from, or contributions on account of, severance pay, parachute payments, and unfunded deferred compensation paid due to severance of employment. Plans are permitted to recognize certain types of compensation paid after severance of employment, but some employers may choose to simplify plan administration by limiting plan compensation to amounts paid prior to severance of employment—so *that elective deferrals stop with the last pre-severance paycheck*. Depending on current plan terms, it may be necessary to adopt an interim amendment before actually applying this change to any individual participant so as to avoid a breach of the anticutback rule. The sponsor of a calendar plan year, for example, would need to adopt such an amendment by the end of 2007.

The new rules may also require plan sponsors to change how they collect data for other purposes as well (such as for the highly compensated employee determination). Steps should be taken to clarify how data will be collected and identified for transmission to vendors as well as how data will be described in plan documents and summary plan descriptions.

403(b) Plan Compliance with Final Regulations: Final regulations describing the requirements for an annuity contract to be treated as a 403(b) plan, including a new written document requirement, were issued this year and become effective for most employers on January 1, 2009. Delayed effective dates apply to collective bargaining situations, church plans, and certain governmental 403(b) plans. Consequently, most 403(b) plans will need to comply in both form and operation with the final regulations on January 1, 2009. However, certain requirements in the final regulations are of immediate concern to 403(b) plan sponsors. For example, the final regulations prohibit life insurance contracts as funding vehicles for 403(b) plans, except for contracts issued before September 24, 2007. In addition, effective September 24, 2007, the final regulations prohibit participant investment transfers outside of the plan's normal lineup of investment choices, unless the plan sponsor enters into an information sharing agreement with the transferee investment provider no later than December 31, 2008. Plan sponsors need to determine the extent to which they will allow investment transfers to outside investments after September 24, 2007.

Gap Period Income: In 2006, final regulations dealing with corrections of nondiscrimination failures mandated the distribution of "gap period income" along with excess amounts. PPA reversed this decision, but not for the 2006 and 2007 plan years. Following suit, final regulations dealing with deferrals that exceed the annual dollar limit on deferrals (currently \$15,500, plus \$5,000 of catch-up deferrals) added the requirement to pay gap period income with that type of correction starting with 2007 calendar year corrections. A pending technical correction would extend the PPA treatment to these corrections; however, the effective date of the change will not be clear until that legislation is enacted. Meantime, plan administrators will need to evaluate the need for amendments and administrative changes.

KETRA/GOZA Hurricane Distributions and Loans: Plan sponsors who expanded plan distribution and loan provisions to assist victims of Hurricanes Katrina, Rita, and Wilma are reminded that plan amendments to memorialize those changes need to be adopted by the end of the first plan year beginning on or after January 1, 2007 (2009 for governmental plans).

Diversification Mandate for Plans with Employer Stock: Starting with plan years beginning after 2006 (later for some collectively bargained plans), for employer nonelective or matching contributions, defined contribution plans must allow participants to diversify out of publicly-traded employer stock after three years of vesting service. Participants must be allowed to diversify their employee elective deferral or after-tax contributions out of employer stock without a waiting period requirement. The plan must offer participants at least three investment options, other than employer stock, each of which is diversified and has materially different risk and return characteristics. In addition, PPA requires plans to provide notices about these diversification rights and the importance of diversification at least 30 days before participants

are eligible to exercise these rights. IRS' transitional guidance about the diversification requirements includes a model notice designed to comply with the PPA directive. Plan sponsors may wish to provide the notice with annual enrollment materials to assure plan participants are aware of their diversification rights.

Retirement: Defined Benefit Plans

Administrative Tasks

New Limits on Distributions Due to Funding Shortfalls: Under PPA, more limitations are triggered by a plan's weak funding position than ever before. In addition to the pre-PPA rules that could require a notification to employees and suspension of the payment of lump sum distributions under the "liquidity shortfall" rules or the nondiscrimination limits that apply to "high-25" employees, PPA imposes limits for plan years beginning after 2007 on the amount of benefits that can accrue, the ability to pay lump sums and other "prohibited payments", the ability to improve plan benefits, and pay certain "shutdown" benefits. These limits are generally triggered as the plan's funding ratio falls below 80%, with the most severe limits imposed for plans falling below a 60% target.

Plan sponsors will need to consult with their Enrolled Actuary about the plan's funding level, the possibility that limits may apply, and options for avoiding the limits by making additional plan contributions or providing security. Careful timing of the Enrolled Actuary's certification may be wise if there is an expectation that a limit will be imposed so that administrative procedures can be modified to respond to the change and so that participants can be warned of what to expect. However, care should be taken to avoid delays that could trigger unnecessary "presumptions" that will leave the plan without options during the final quarter of each plan year.

These and other requirements that are triggered as a single-employer pension plan's funded status declines are illustrated in a pension funding "thermometer" available online at <http://now.eloqua.com/er.asp?s=526&lid=662>.

Additional Distribution Changes: In addition to adding the "Qualified Optional Survivor Annuity" as described earlier in this *Alert*, plans offering lump sum and other accelerated distributions will begin to phase in the new interest rate segments and the revised mortality table that have been dictated by PPA for this purpose. With the announcement of the new mortality table coming just this week, some plan sponsors are considering retaining pre-PPA rates (which will generally produce greater lump sum benefits than the new rates) on an interim basis. While there are some technical concerns with this approach, Treasury representatives have informally confirmed that reasonable approaches during the transition period will not invite trouble.

Relative Value and Deferral Explanations: Once the new interest and mortality rates have been integrated into plan benefit distribution systems, disclosures depicting the relative value of various plan benefit options may require revision to explain the three segment rates used for calculating relative values of lump sums and certain other options. Relative value regulations finalized in 2006 included a requirement to disclose the interest rate used as a basis for that determination. Note too the requirement to disclose the "consequences of a failure to defer distribution" of plan benefits. Consider the merits of disclosing the possible effect of the transition to the new, lower, PPA interest rate basis and the possibility that the plan's funding status could restrain the types of optional forms of distribution available at a later date.

Suspension of Benefits Due to Employment: To the extent provided by the terms of the pension plan document, employers should distribute suspension of benefits notices to rehired retirees and active

employees who continue to work past the normal retirement date. Generally, benefit payments may be withheld from such participants if the plan provides for such suspension, the participant works more than 40 hours per month, and the plan provides a timely notice of the suspension to the participant. According to DOL regulations, the notice should be provided in the first calendar month or payroll period in which benefit payments are suspended.

PBGC Reportable Events: A reference chart for single-employer defined benefit plans to aid in determining events that must be reported to PBGC during the year is available online at: <http://now.eloqua.com/er.asp?S=526&lid=663>.

Design Changes

Vesting: PPA imposed a 3-year cliff vesting requirement on hybrid defined benefit plans that was generally effective upon enactment, but postponed until post 2007 years for plans in effect on June 29, 2005. Guidance on this and other hybrid plan issues is said to be imminent.

Hybrid Plans: PPA signaled a new age for cash balance and PEP plans. From PPA's August 17, 2006 enactment date, these plans are relieved of the "whipsaw" problem for distributions after that date. While IRS guidance on the change accommodated relief from the usual anticutback restrictions, the guidance did not waive the 204(h) advance notice requirement other than to drop the usual 45-day deadline to 30 days. For plans first converted after June 29, 2005, PPA requires the so-called "A + B" approach of adding new hybrid accruals (B) to previously accrued benefits (A). For both changes, plan administrators will need to implement design decisions with documentation, SPD changes, revised benefit calculation protocols, and revised distribution disclosures.

Maximum Benefit Limitation: For lump sums and other benefit distribution forms subject to the QJSA applicable interest rate rule, a change to the rules for maximum payments under IRC 415 applied to distributions in 2004 and 2005. The change expired for 2006, but was revived by PPA (with a modification) retroactive to the beginning of 2006 years. Plan sponsors need to implement corrections using transition rules issued by IRS and Treasury for payments that had been processed during the interim period.

In addition, revised final regulations call for a fresh look at the compensation taken into account by plans for benefit accrual and for determining highly compensated employees (see *Compensation* in defined contribution discussion above) along with a look at myriad other changes. Of particular note is a reversal on the interaction between the maximum benefit limit and the maximum compensation limit. The final rule now holds that the compensation limit (e.g., compensation in excess of \$230,000 in 2008) *does* apply in applying the benefit limit. For participants who remain in employment past normal retirement age, actuarial adjustments had been permitted to raise annual benefits beyond the benefit dollar limit as long as held down to actual pay without considering the \$230,000 (for 2008) figure. This is no longer the case. Plans will need to impose suspension of benefits limits or begin actual distribution of benefits to avoid plan disqualification. Amendments in advance of the plan year, and 204(h) notices to participants, may be warranted in implementing these changes.

Retirement: Reporting and Withholding

Administrative Tasks

Form 945: For 2007, file Form 945 by January 31, 2008, if income tax was withheld from benefit distributions. Taxpayers with withholding obligations in excess of \$200,000 are required to deposit

withheld taxes electronically. Because this requirement applies to retirement plan payors as well as employers, plan sponsors should confirm that this requirement is addressed.

Form 1099-R: Trustees of qualified retirement plans are generally obligated to prepare and file payee information statements for distributions made from each plan during the year and for certain other taxable transactions, such as defaulted participant loans and term insurance costs, that do not involve actual distributions. Certain associated tasks rest with the plan administrator. Arrangements should be made in advance so that all parties involved are prepared to address this reporting requirement. Care should be taken to assure that the same EIN is used on Form 1099-R that is used on Form 945 and on Form 8109 deposit coupons.

Withholding Notice: Persons receiving periodic payments that are not eligible rollover distributions must be notified at least once each calendar year of their right to make an election not to have withholding apply to the distribution or to revoke a previous withholding election. Though not required at any specific time, many payors find it convenient to satisfy this requirement by providing notice along with Form 1099-R each year. The current year cutoff for zero withholding for the default status typically communicated in such notices should be updated to the 2008 amount when new withholding tables are released.

Rollover Notice: Plan administrators should confirm that the rollover notices currently in use describe the expanded rollover rules under EGTRRA covering rollovers between qualified plans, 403(b) annuities, and governmental 457(b) plans. Several PPA changes affect this notice as well starting January 1, 2007.

If you would like a copy of a summary, chart, Research Brief, or Alert mentioned in this "Year-End Checkup", please call +1.800.438.6487, or contact your Aon consultant.

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