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employee benefits lawflash

alert

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Employee Benefits Year-End Checklist

December 18, 2006

As 2006 comes to a close, clients' immediate concern is what needs to be completed by year end. The following checklist describes year-end action items with respect to (1) executive compensation and equity compensation plans, (2) health and welfare plans, (3) tax-qualified retirement and savings plans, and (4) fiduciary/plan investment matters. These lists are not exhaustive but are intended to provide a reminder of the general set of issues facing us at year end.

Executive Compensation and Equity Compensation Plans

Year-end action items for executive compensation and equity compensation plans include the following:

- Elections to defer compensation to be earned in 2007 generally must be made by December 31, 2006 under section 409A of the Internal Revenue Code.

- Elections to change the time or form of payment for existing deferred compensation that is otherwise payable in 2007 must be made by December 31, 2006. A payment date election in 2006 cannot accelerate a payment into 2006 or postpone a payment that would otherwise be made in 2006. Elections to change the time or form of payment for deferred compensation that is otherwise payable in 2008 or thereafter must be made by December 31, 2007. For more details, please click here to view our October 5, 2006 LawFlash.

- Although the transition period for correcting discounted stock options and SARs under section 409A has generally been extended to December 31, 2007, public companies that have issued discounted options or SARs must correct the noncompliance by December 31, 2006 with respect to officers and directors who are subject to section 16(a) of the Securities Exchange Act of 1934 if the company has reported or "reasonably expects" to report an incremental financial statement expense as a result of the discounted options or SARs. For more details, please click here to view our October 5, 2006 LawFlash.

- Any stock options with exercise periods that were extended in violation of section 409A should be amended to comply with section 409A by December 31, 2006, or the option holder may want to make a payment date election by December 31, 2006.

- Any violations of section 409A in 2005 or 2006 must be reported on Form W-2 or Form 1099 for the applicable year. For more details, please click here to view our December 1, 2006 LawFlash.

- Equity compensation plans should be amended to include mandatory antidilution adjustment provisions. For more details, please click here to view our July 27, 2006 LawFlash.

- Compensation committees of public companies should consider the Compensation Discussion and Analysis and other disclosures that will be required in the 2007 proxy statements. Compensation committees also should consider whether changes should be made to the equity grant process or the process for setting other compensation to facilitate improved proxy statement disclosure. For more details, please click here to view our July 28, 2006 LawFlash.

Health and Welfare Plans

As employers turn their attention to their health and welfare plans, year-end tasks and issues include:

- Reviewing and executing provider contracts and updating plan documents, SPDs, and online material to reflect 2007 changes to welfare benefits.

- Distributing information before, or within 60 days after, the start of a plan year describing any material reduction in covered services or benefits provided under a group health plan.

- Distributing Medicare Part D Certificates of Creditable Coverage (these were due November 15 to fulfill the annual distribution notice requirement and are distributed on an ongoing basis to participants who are newly eligible for prescription drug coverage). Samples of the current notice can be found on the CMS website at: http://www.cms.hhs.gov/CreditableCoverage/02_CCafterMay15.asp#TopOfPage. Note that the current certificate will soon be replaced with yet another version of the certificate, which need only be used on an ongoing basis. To view a sample of what this revised certificate might look like, please visit: http://www.cms.hhs.gov/PaperworkReductionActof1995/PRAL/itemdetail.asp?filterType=none&filterByDID=-99&sortByDID=2&sortOrder=descending&itemID=CMS1186984.

- Completing the Medicare Part D Retiree Drug Subsidy application. Employers that wish to continue receiving the subsidy and those that wish to begin receiving the subsidy for the first time in 2007 must complete the application process for 2007.

- Communicating enhanced dependent care spending account opportunities and ensuring that your dependent care spending account administrator is prepared to accept claims associated with the new opportunities. For more details, please click here to view our June 5, 2006 LawFlash.

- Reviewing debit card practices. This past summer, the IRS released additional debit card guidance that puts into doubt the practices of many debit card providers. While new Notice 2007-02 instituted a one-year delay for 2007, employers should begin to prepare for a future where debit cards can only be used at merchants whose debit card terminals reflect healthrelated Merchant Category Codes (MCCs), such as physician offices, pharmacies, dentist offices, vision care offices, hospitals, and other medical care provider offices. Employers should review their debit card providers' system and consider restricting debit card usage to merchants that have appropriate MCCs, that otherwise satisfy the limited additional rules in the Notice, or can take advantage of the one-year delay.

- Implementing FASB/GASB changes for postretirement benefits. New FAS No. 158 applies to, among other things, other postretirement plans for fiscal years ending after December 15, 2006 and will require reflecting the cost of postretirement benefits such as retiree medical plans on a corporation's balance sheet. GAS Nos. 43 and 45 apply to fiscal years beginning after December 15, 2006 and, when fully phased in, will require government employers to report the current and future costs of healthcare and other benefits. Both standards will lead to a renewed focus on limiting retiree medical benefits or possibly accumulating assets to offset the liabilities.

- Reconsidering the 2½-month cafeteria plan claim extension. If an employer adds the 2½-month extension to its cafeteria plan, it must be certain to amend its plan to include the extension before the start of the year. However, anecdotal evidence is beginning to indicate that forfeitures are not significantly reduced by the extension. Further, any employer that has adopted or may adopt a high-deductible health plan with an associated health savings account (HSA) will find that the 2½-month extension prevents some employees from participating in the HSA until April 1. While new legislation helps this problem, some employers have decided not to adopt the extension or have even eliminated the extension to ensure the greatest flexibility with respect to current or future plans to adopt high-deductible plans and HSAs.

- Reviewing HSA comparability rules effective January 1, 2007 or making employer HSA contributions through a cafeteria plan to sidestep the new comparability rules.

- Communicating increased HSA contribution limits once President Bush signs recent HSA legislation into law.

- Conducting year-end dependent care spending account 55% utilization testing and preparing to adjust taxable income on Form W-2 if necessary to pass the 55% utilization test.

- Reviewing relevant provisions of the Pension Protection Act of 2006 (the PPA). While the majority of PPA issues require action in 2007 or later years, expanded Code section 420 transfer opportunities, tax-free transfers for health or long-term care premiums for retired public safety officers, and Association Health Plan VEBA changes either will be in place or will begin by January 1, 2007.

- Preparing for Form W-2 disclosures for dependent care spending account contributions and other welfare items such as HSA contributions or group-term life imputed income.

- Disclosing employer Medicare Part D Creditable Coverage Disclosure to CMS. Employers must annually disclose to CMS whether their employer drug coverage is creditable. This requirement practically applies to all employers with prescription drug plans. The 2007 notification must be made online by March 1, 2007. The online application can be found at: https://www.cms.hhs.gov/apps/ccdisclosure/.

Tax-Qualified Retirement and Savings Plans

Following is a summary of the actions that may need to be taken by year end or shortly thereafter concerning tax-qualified retirement plans:

- Plan amendments for compliance with the final section 401(k) and 401(m) regulations issued in December 2004 that apply for plan years beginning on or after January 1, 2006 must be adopted by the end of the 2006 plan year. Among other mandatory changes, these amendments require earnings on excess deferrals and excess contributions for the "gap period" after the close of the plan year through the time of distribution to be distributed along with the excess amounts.

    - **Note:** The PPA changes this rule and eliminates the need to distribute gap period earnings on excess amounts for plan years beginning in 2008; nevertheless, the amendment is still mandatory.

- Plan amendments for discretionary changes (i.e., changes not required by law) in plans must be adopted by the end of the plan year in which the amendment is effective. For example, a plan with a calendar plan year must be amended by December 31, 2006 if either of the following discretionary provisions were added to the plan:

    - Provisions permitting an employee who makes elective deferrals to a 401(k) or 403(b) plan to designate whether some or all of those deferrals are "Roth" contributions.

    - Provisions allowing automatic enrollment of participants to a 401(k) plan, absent an affirmative opt-out election by the participant.

- Defined contribution plans that hold publicly traded employer securities must, for plan years beginning on or after January 1, 2007 (later for some collectively bargained plans), provide participants with the opportunity to divest any employer stock held in a plan account and reinvest an equivalent amount in any of at least three other investment options. A phase-in rule allows participants to have diversification rights for employer stock holdings attributable to contributions made on or before December 31, 2006—33% of such holdings must be diversifiable in the first year, 66% in the second year, and 100% in the final year. (There is no phase-in for participants who are at least 55 years old and who have completed at least three years of service as of the first day of the 2006 plan year.) These rules do not apply to stand-alone ESOPs.

    - Although the diversification rules generally become effective January 1, 2007, the IRS has issued transition guidance that allows those plans with restrictions on diversification in place as of December 18, 2006 until March 30, 2007 to comply with the new rules.

- On or before January 1, 2007, participants, beneficiaries, and alternate payees must be provided with a notice of their rights to diversification with respect to employer stock and of the importance of investment diversification. For more details, please click here to view our December 8, 2006 LawFlash.

- Qualified Joint and Survivor Annuity (QJSA) notices must be revised to reflect that the PPA's change of the notice and election period from 90 days to 180 days for plan years beginning after 2006. The PPA also requires that distribution notices describe the "consequences of failing to defer" receipt of a distribution.

- The final IRS "relative value" regulations provide that plan administrators were generally required to begin disclosing the relative value of optional forms of benefits payable in lieu of a QJSA for annuity starting dates on or after February 1, 2006. The IRS modified its final rule in 2006. Full compliance with the final rule is required for QJSA notices provided on or after January 1, 2007.

- Under the IRS's new determination letter program, individually designed plans have staggered, five-year remedial amendment cycles. The period for submissions for individually designed plans in the first cycle (Cycle A for employers with employer identification numbers that end in 1 or 6) began February 1, 2006 and ends January 31, 2007.

Fiduciary/Plan Investment Matters

- Participant Advisory Programs: Plan sponsors who previously held off on adding an investment advice component to their 401(k) plans may wish to contact their financial service providers to find out about any new PPA-compliant advice services that may be available beginning in 2007. The PPA provides an exemption that permits an investment advisor (acting as fiduciary) to provide participant-level advice to plan participants, even if the advisor is in some way affiliated with the underlying investments available under the plan. Advice must be provided pursuant to an "eligible investment advice arrangement." Plan sponsors/fiduciaries who make such an arrangement available are eligible for some measure of relief from liability. There are two recognized eligible investment advice arrangements: (1) the fee-neutral arrangement and (2) the computer model arrangement. In either case, use of an exemption must be authorized by an independent plan fiduciary; an independent expert must audit the arrangement (at least annually) and confirm that it fits within one of the statutory exemptions; detailed disclosure requirements must be satisfied before the advice is first provided, and at least annually thereafter; and other general requirements apply (e.g., compliance with applicable securities disclosure laws, compensation received by advisor must be reasonable and transaction must be arm's length). The plan sponsor or other fiduciary remains responsible for the prudent selection and monitoring of the advisor, but there is no duty to monitor the specific investment advice given by the investment advisor to any particular participant or beneficiary.

- Default Investments: Plan sponsors currently using a money market or other type of stable value option as a default investment when participants fail to make an investment election because of fiduciary liability concerns may wish to reevaluate that decision and contact their financial advisors to investigate alternatives. The PPA expands ERISA section 404(c) fiduciary relief for investments in a qualified default investment alternative (QDIA), effective for plan years beginning after December 31, 2006. QDIAs are intended to encourage the investment of employee assets in appropriate investment vehicles for long-term retirement savings. The DOL proposed regulations implementing the PPA default investment relief (published September 27, 2006). The proposed regulations can be relied on pending issuance of the final regulations next year and deem a participant to have exercised control over assets in his or her account if, in the absence of investment direction from the participant, the plan fiduciary invests the assets in a QDIA. A QDIA may be a life-cycle or targeted-retirement-date fund, a balanced fund, or a professionally managed account. The proposal establishes the specific conditions for fiduciary relief. The plan must offer a "broad range of investment alternatives" as defined in the DOL's regulation under section 404(c) of ERISA. Plan fiduciaries are not relieved of liability for the prudent selection and monitoring of a QDIA. The proposed regulations have already been the subject of a substantial number of critical comments, and it is not clear at this juncture whether the final regulations will include substantial changes.

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