

QUALIFIED PLANS 2005-12

Friday, December 30, 2005

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HAPPY NEW YEAR

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1. Round Up of Year-End Legislative Activity

Activity in the 109th Congress intensified this month as the leadership of both parties jockeyed for political positioning on controversial budget reconciliation and appropriations bills, while most rank-and-file members of Congress were eager to complete legislative business for the year and return home. Here is an update on the end-of-the-year legislative activity affecting benefit plans.

A. House Passes Pension Funding Bill

Efforts to enact pension funding reform by the year's end finally culminated in the passage of the comprehensive funding reform bill by both Houses of Congress. Significantly, on December 15, the House passed a managers' amendment to H.R. 2830 (the House comprehensive funding reform measure) by a vote of 294-132. The Senate passed its version of the funding reform bill on November 16

(Qualified Plans 2005-11). Passage of the pension funding reform bills by each House sets the stage for a House-Senate Conference Committee where members from each chamber will attempt to reconcile differences between the two versions. The Conference Committee is not expected to convene until 2006.

Generally, the majority of the provisions of the House bill, as detailed in our side-by-side comparison (Qualified Plans 2005-10, Enclosure 1), remained unchanged. However, two changes are worth noting. First, the bill limits the phase-in of the "funding target" for underfunded plans – the funding target generally equals the present value of all benefit liabilities accrued to date. In short, plans that are, for example, at least 92 percent funded in 2007 would not be required to make a contribution for that year. The 92 percent threshold increases in 2% increments over five years so that, in 2011, plans would have to be 100 percent funded to avoid required contributions. The second change stemmed from an agreement that was struck between House legislators and the United Auto Workers ("UAW") union. Specifically, the restriction on increasing benefits for those plans that are less than 80 percent funded would be phased-in over five years.

We are uncertain when an agreement on the final details of the funding bills will be reached. Although we expect a Conference Committee to convene in early 2006, it is unclear when a final vote on any measure reported out of the Committee will be held. However, it is likely that some type of funding reform will be enacted in early 2006 because contributions are due by April 15, 2006 and, without these legislative changes, plan liabilities for purposes of determining contributions again would be measured using the lower 30-year Treasury rates.

B. Budget Reconciliation

On December 19, House and Senate Conferees reached agreement on a conference report for the spending-cut budget reconciliation bill (S. 1932, the Deficit Reduction Act of 2005), and the House passed it later the same day by a 212 to 206 vote. After much procedural wrangling, the Senate followed suit by passing a slightly-revised version of the conference report by a 51 to 50 vote (with Vice-President Cheney breaking the tie). Because the conference report had to be amended due to procedural reasons before the Senate vote, the House will now have to vote on it again before it goes to the President for his signature. It is unclear

whether the House will vote on the revised budget reconciliation bill by the end of the year, as many House members have returned home for the winter recess.

As previously reported (Qualified Plans 2005-10 and -11), the House and Senate versions of the bill each included provisions to significantly increase PBGC premiums. The conference agreement includes provisions to:

- Increase the single-employer flat rate premium from \$19 to \$30 per participant beginning in 2006 (and index it for inflation beginning in 2007).
- Impose a \$1,250 per participant premium to be paid by employers that have terminated their pension plans in bankruptcy. These premiums would be paid for three consecutive years once a company emerges from bankruptcy. The provision is generally effective for plans terminated after 2005 and expires at the end of 2010. Plans terminated with respect to a bankruptcy filing before October 18, 2005 are exempt.
- Increase the multiemployer premium from \$2.60 to \$8 per participant beginning in 2006 (and index it for inflation beginning in 2007).

Significantly, unlike the earlier House and Senate versions of the bills, the conference report does not include language providing that these PBGC premium increases would be superseded once the comprehensive funding reform legislation is enacted. Thus, it appears that the Conference Committee reconciling the pension funding bills is unlikely to further change PBGC premiums (other than to repeal the "full funding limit" under the variable-rate premium).

Unlike the budget reconciliation measure, the House version of the tax reconciliation bill (H.R. 4297) was not acted upon before the year's end due in part to opposition to the extension of the reduced capital gains tax rate (currently at 15 percent) past 2008. As a result, action on the tax cut measure will resume in early 2006. So far, there are no pension-related provisions in that bill.

C. Hurricane-Related Tax Relief and Technical Corrections

On December 16, the House and Senate passed identical versions of the Gulf Opportunity Zone Act (H.R. 4440), a tax bill primarily designed to provide tax incentives and other tax relief to individuals and businesses affected by Hurricanes Katrina, Rita, and Wilma. The President signed the bill into law on December 21 (Pub. L. No. 109-135). Importantly, the same pension-related relief that was afforded to Hurricane Katrina survivors in the Katrina Emergency Tax Relief Act ("KETRA") (Qualified Plans 2005-9) was extended to individuals affected by Hurricanes Rita and Wilma. These provisions were originally included in the Senate tax reconciliation bill (S. 2020) (see Qualified Plans 2005-11), but they were stripped out and moved separately as part of the broader Hurricane tax relief bill.

Also included in the Hurricane-related tax package were a number of technical correction provisions affecting previously enacted tax legislation – including previously introduced corrections to the deferred compensation provisions of Code section 409A, as well as to the changes made in 2004 to the definition of "dependent."

Definition of "Dependent" – In October 2004, Congress changed the definition of "dependent" under Code section 152 as part of the Working Families Tax Relief Act ("WFTRA") (Qualified Plans 2004-10). These changes, which were intended to bring conformity to the definition of "child" for purposes of various provisions under the Code, inadvertently also had the effect of restricting the definition of dependent for certain pension and other benefit plans, including health plans, dependent care flexible spending arrangements ("dependent care FSAs"), and health savings accounts ("HSAs").

H.R. 4440 effectively amends the HSA rules to permit an individual to qualify as a "dependent" without regard to whether (i) the individual has income greater than \$3,200 (for 2005), (ii) the individual is married and files a joint return, or (iii) the individual claims another person as his or her dependent. Another provision makes similar changes with respect to dependent care programs, including dependent care FSAs. The changes will allow individuals to receive tax-free distributions to pay for medical care and dependent care-related expenses incurred by a dependent, but they no longer affect pension plans because the relevant IRS rules for 401(k) and similar plans have already

been amended to allow plans to ignore the WFTRA changes.

Use of Offshore Trusts Under Code Section 409A – The bill also includes technical corrections to Code section 409A. Like the definition of "dependent" changes, these corrections were originally introduced in the waning days of the 108th Congress as part of a package of technical corrections (see Qualified Plans 2004-12). The first technical correction changes the effective date for the offshore funding and financial trigger provisions of Code section 409A(b) to January 1, 2005. Thus, the correction effectively eliminates any grandfather treatment for amounts previously contributed to an offshore trust or a trust with a financial health trigger. Fortunately, the bill instructs Treasury and the IRS to issue transition guidance within 90 days of enactment.

The proposed regulations under Code section 409A limit the extent to which foreign-based deferred compensation would be subject to the requirements under Code section 409A (Qualified Plans 2005-10). For example, any benefit under a broad-based foreign retirement plan would not be considered deferred compensation under Code section 409A. Despite this limitation, however, the technical correction would require U.S.-based plan sponsors of nonqualified deferred compensation arrangements that use an offshore trust as a funding mechanism to act promptly to avoid immediate taxation and penalty taxes under Code section 409A for amounts contributed prior to January 1, 2005.

2. Significant ERISA Fiduciary Provisions in the Pension Funding Bills

While the comprehensive pension funding reform bill proposals to effectively re-write the defined benefit funding rules have received considerable attention (as have the cash balance and "EGTRRA permanence" provisions), the bills also include significant amendments to the prohibited transaction rules under ERISA and the Code. These provisions – which have gone relatively unnoticed – are summarized below.

A. Title I Amendments

During a House Education and the Workforce Committee mark-up in June, a number of new proposals to amend ERISA's prohibited transaction and fiduciary rules supported by the securities industry were adopted and added to the bill. The

House Ways and Means Committee approved parallel provisions relating to the Code's prohibited transaction rules on November 9. Whether the prohibited transaction amendments would be included in the Senate version of the funding bill remained unclear until the principals of the Senate Finance Committee (Sens. Charles Grassley (R-IA) and Max Baucus (D-MT)) and the Senate Health, Education, Labor, and Pensions ("HELP") Committee (Sens. Michael Enzi (R-WY) and Edward Kennedy (D-MA)) added the amendments to a managers' amendment to S. 1783. The provisions were subsequently approved when the full Senate passed S. 1783 on November 16. Both the House and Senate amendments include:

- **New Statutory Exemptions Under Section 408 for** –
 - **"Block Trading"** – The exemption would allow the sale of securities between a plan and a party-in-interest on a "block" basis (*i.e.*, on behalf of a number of investors) provided (i) the transaction is an arm's-length transaction, (ii) no plan's interest in the block trade may be more than 10% of the block, and (iii) the counter-party to the trade is not a fiduciary;
 - **Investing and "Blind" Trading of Plan Assets Via Alternative Trading Systems or Electronic Communication Networks ("ECNs")** – The exemption would allow the investment and trading of plan assets via electronic or alternative trading systems provided (i) there is a willing buyer and seller, (ii) the transaction is anonymous (*i.e.*, neither party knows the others identity), and (iii) the transaction is an arm's length transaction; and
 - **Foreign Exchange Transactions** – Generally, this exemption would obviate the need for detailed foreign exchange instructions from the fiduciary so long as the price was no less favorable than the price available in comparable transactions and in each case was no less

favorable than the price at the time of the transaction.

- **Bonding Relief For Brokers, Dealers, and Investment Advisers** – ERISA's bonding requirements (sec. 412) generally would not apply to banks and insurance companies, brokers and dealers (and their affiliates with respect to which the broker or dealer agrees to be liable to the same extent as if the broker or dealer held the assets directly), and registered investment advisers;
- **Correction of Party-in-Interest Transactions** – In the case of the purchase, sale, or holding of a security or commodity (other than employer securities or real property), a prohibited transaction would not be found if the transaction is corrected within 14 days of the discovery of the fact that the transaction would otherwise be prohibited.

While the House and Senate version of the amendments to the prohibited transaction rules are similar, the Senate version does not include the following amendments currently in H.R. 2830:

- **Broad New Statutory Exemption For Purchases, Sales, and Loans Between Plans and Service Providers For No More Than Adequate Consideration** – This exemption – which is limited to transactions between plans and entities that are parties-in-interest solely by reason of providing services to plans – would allow service providers to engage in a variety of transactions (in addition to the provision of services with plans), such as loans in connection with purchasing plan investments and purchases and sales of securities on a principal basis, as long as the party-in-interest is not a plan sponsor or fiduciary; and
- **Changes to the Plan Assets Regulations** – Generally, the DOL would be required to revise its "plan assets" regulations by, among other things, increasing the percentage requirement under the "significant plan participation" exception from 25 to 50

percent. This change will make it easier for certain pooled investment arrangements to avoid ERISA regulation.

Whether the final version of the legislation will include the additional House amendments listed above remains unclear.

B. Default Investments

H.R. 2830 and S. 1783 both direct DOL to issue regulations on "default investments." Specifically, under each version of the bill, if certain notice requirements are satisfied, ERISA section 404(c) protection would be afforded to fiduciaries of plans that, in the absence of a participant's investment election, provide for the investment of the participant's account balance in default investments in accordance with DOL regulations. The bills direct the DOL to issue regulations on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation, long-term capital appreciation, or a blend of both. It is important to note that the "default investment" provision is available for all plans that allow participants to direct their own investments, not just "auto enrollment" arrangements where the issue has received the most attention. We expect the default investment provisions to be included in the final version of the funding bill.

C. Investment Advice

The Senate and House provisions relating to investment advice differ significantly. S. 1783 provides relief under ERISA sections 404 (the general fiduciary rules) and 405 (relating to co-fiduciary liability) for the provision of investment advice by the plan sponsor or other plan fiduciaries to plan participants if certain requirements are met. The House version of "investment advice" relief, on the other hand, provides an exemption from the prohibited transaction rules for the provision of investment advice to plans and plan participants by regulated financial institutions where the institution's (or an affiliate's) products are among those available under the program. In other words, the House investment advice proposal permits the provision of so-called "conflicted" investment advice, while the Senate version provides relief from ERISA's fiduciary rules only for "unconflicted" advice. At this point, it is unclear which version will be included in the final bill (or whether the versions will be combined into one proposal). However, we expect some type of investment advice provision to be

included in the final version of the funding bill, as the concept of increasing participant access to some type of investment advice is supported by members in both Houses of Congress on both sides of the aisle.

3. IRS Guidance on Deadlines For Certain Plan Amendments

The IRS recently issued guidance clarifying the dates by which certain amendments must be adopted and indicating whether it will issue related model amendments. IRS Notice 2005-95 (Dec. 19 IRS Bulletin). This guidance addresses some of the confusion engendered by the final IRS guidance describing the new determination letter procedures. Rev. Proc. 2005-66 (Qualified Plans 2005-8). Under the new determination letter guidance, a plan is required to adopt an interim amendment to reflect any plan change. The deadline for adopting the interim amendment depends on whether the amendment is required on account of a statutory or regulatory change or instead is a discretionary change relating to the plan's design. The basic principles are as follows:

- in general, an interim amendment to reflect legal changes must be adopted by the date the employer files its income tax return for the year in which the change is effective; and
- an interim amendment to reflect a discretionary change in plan design must be adopted by the end of the year in which the change is effective.

In some cases, this guidance conflicts with prior IRS guidance.

In Notice 2005-95, the IRS reaffirms that the general timing rules described above apply unless (a) an earlier amendment is required, for example, to avoid a cutback, add a cash or deferred arrangement to an existing plan, or change to a safe harbor 401(k) plan, or (b) other IRS guidance sets forth a specific deadline. It then clarifies the timing for the adoption of certain amendments, as follows:

Retroactive Annuity Starting Date – A plan must adopt an interim amendment to comply with the final retroactive annuity starting date regulations no later than December 31, 2005 (or the deadline under the general rules described above, if later). The IRS does not intend to issue a model amendment. (See Qualified Plans 2003-7 for a

discussion of the retroactive annuity starting date regulations.)

Automatic Rollover of Mandatory Cash-Outs – A plan must adopt an interim amendment to reflect the automatic rollover of mandatory cash-outs by the later of (1) the due date for filing the employer's income tax return for the taxable year that includes March 28, 2005, (2) the last day of the plan year that includes March 28, 2005, or (3) December 31, 2005. The IRS has issued a model amendment. The due date for operational compliance with these rules has not changed. (See Qualified Plans 2004-12 and 2005-2 for a discussion of the automatic rollover rules, as well as the model amendment.)

Early Implementation of 401(k) Regulations – Although compliance with the final 401(k) regulations is not mandatory until January 1, 2006, plans have been permitted to implement them voluntarily for any plan year ending after December 29, 2004, provided certain requirements were met. A plan that implemented the final regulations before January 1, 2006 must adopt an interim amendment by the later of (1) December 31, 2005, or (2) the end of the plan year during which the final regulations were implemented. (See Qualified Plans 2005-1 for a discussion of the new 401(k) regulations.) Although the IRS does not intend to issue a model amendment, the final regulations are reflected in the "LRMs" published earlier this year. See Qualified Plans 2005-4.

Safe Harbor 401(k) Plan Notice Rules – The guidance clarifies that, for years before 2007, a safe harbor 401(k) notice may cross-reference the plan's summary plan description in accordance with Q&A-8 of Notice 2000-3. After the 2006 plan year, the safe harbor 401(k) notice will have to include the information referenced in the SPD.

Roth 401(k) Contributions – Beginning in 2006, plans may permit participants to designate all or a portion of their pre-tax 401(k) contributions as taxable Roth 401(k) contributions. Such an amendment must be adopted by the end of the plan year in which the amendment is first effective. The IRS intends to issue a model amendment. (See Qualified Plans 2005-3 for a discussion of the Roth 401(k) proposed regulations.)

Required Minimum Distribution Rules For DB Plans – Defined benefit plans must adopt an amendment to reflect the final 401(a)(9) regulations by the end of the initial five-year (six-year for pre-approved plans) remedial amendment period

described in Rev. Proc. 2005-66. (Sponsors of prototype IRAs that reference the temporary regulations are not required to amend their documents merely to reference the final regulations or make other conforming changes that are expected to have no effect on plan operations. If an IRA sponsor does make a change, it need not apply for a new Opinion Letter.) The IRS does not intend to issue a model amendment. (See Qualified Plans 2002-5, 2002-12, 2003-1, and 2004-6 for a discussion of the final 401(a)(9) regulations applicable to defined benefit plans.) Strict operational compliance with these rules is required for 2006 and later plan years for all defined benefit plans.

Reforming Amendment For Suspension of Benefits – An employer that amended a plan's suspension of benefits provisions prior to June 7, 2004 in a manner that violated the Supreme Court's holding in Central Laborers' Pension Fund v. Heinz, 541 U.S. 739 (2004) must be in operational compliance with a reforming amendment by January 1, 2007, as provided in Rev. Proc. 2005-76. See Qualified Plans 2004-6, 2005-4, and 2005-11 for a discussion of the Heinz case and subsequent IRS guidance. The reforming amendment must be adopted by the end of the initial five-year (six-year for pre-approved plans) remedial amendment period described in Rev. Proc. 2005-66.

Pension Funding Equity Act of 2004 ("PFEA") – The deadline for amending a plan to comply with the PFEA's changes to section 415(b) is the last day of the 2006 plan year. The IRS does not intend to issue a model amendment. (See Qualified Plans 2004-4 and 2004-11 for a discussion of the PFEA provisions.)

Amendments to "PEO" Plans – In order to remain qualified, the IRS required a professional employer organization to either terminate its plan or convert it into a multiple employer plan, generally by May 2, 2003. Sponsors of such plans have until the end of the initial five-year (six-year for pre-approved plans) remedial amendment period to adopt amendments reflecting transitional guidance issued by the IRS in Rev. Proc. 2003-86. The IRS does not intend to issue a model amendment. (See Qualified Plans 2002-5 and 2003-12 for a discussion of the rules applicable to PEO plans.)

Hurricane Katrina Relief – The Katrina Emergency Tax Relief Act of 2005 provides that qualified individuals may receive favorable tax treatment with respect to distributions that are qualified Hurricane Katrina distributions. Any related

plan amendment must be adopted by the last day of the 2007 plan year (2009 plan year for governmental plans). In Ann. 2005-70, the IRS provided administrative relief with respect to hardship distributions and loans. A plan that does not provide for loans or hardship distributions may be amended to provide such distributions by the end of the 2006 plan year. The IRS is considering issuing a model amendment. See Qualified Plans 2005-9 (and an update elsewhere in this memorandum) for a discussion of the Hurricane Katrina relief.

4. IRS Updates "Cumulative List of Changes in Plan Qualification Requirements"

Beginning February 1, 2006, the IRS will open the determination letter process to "Cycle A" individually-designed plans (both defined benefit and defined contribution plans) for EGTRRA and other post-GUST changes. Cycle A plans are plans sponsored either by (i) employers whose EIN ends in 1 or 6, or (ii) a controlled group of corporations that sponsors more than one plan, provided the group sponsors elects to file under Cycle A. Cycle A plans must be submitted for a determination letter between February 1, 2006 and January 31, 2007 to benefit from the extended EGTRRA remedial amendment period. (See Qualified Plans 2005-8, for a description of the new determination letter procedures.)

In accordance with the new determination letter procedures, the IRS has published its annual Cumulative List of Changes in Plan Qualification Requirements that the IRS will take into account in reviewing Cycle A plans. Notice 2005-101 (Dec. 27 IRS Bulletin). This Cumulative List reflects legal changes under the Economic Growth and Tax Relief Reconciliation Act of 2001, the technical corrections made by the Job Creation and Worker Assistance Act of 2002, the Pension Funding Equity Act of 2004, the American Jobs Creation Act of 2004, and various regulations and other IRS guidance effective after December 31, 2001. In reviewing Cycle A plans, the IRS will consider only items listed on the 2005 Cumulative List.

In addition to the items on the 2004 Cumulative List (Qualified Plans 2004-12), the 2005 Cumulative List includes new references to guidance relevant to defined benefit plans and ESOPs, as well as references to guidance published in 2005. Notably, the 2005 Cumulative List includes references to guidance on Roth 401(k) contributions, even though final guidance has not been issued.

5. IRS Guidance on KETRA

Hurricanes Katrina, Rita, and Wilma have wreaked havoc on Florida and along the Gulf Coast. In addition to the federal assistance provided to those areas declared disaster areas, the IRS, the DOL, and the PBGC have provided targeted relief for employee benefit plans, plan sponsors, and plan participants directly and indirectly affected by the storms. In addition, Congress passed the Katrina Emergency Tax Relief Act ("KETRA"), which provided pension-related relief to individuals affected by Hurricane Katrina (Qualified Plans 2005-9). Since KETRA's enactment, however, plan sponsors, plan administrators, and benefit practitioners have struggled with interpreting and applying the new relief provisions. On November 30, the IRS issued guidance relating to KETRA (Notice 2005-92, Dec. 19 IRS Bulletin), providing clarification on some important issues.

KETRA Relief is Voluntary – As reported (Qualified Plans 2005-9), KETRA allows (i) Qualified Hurricane Katrina Distributions ("QHKDs"), (ii) liberalizes the plan loan rules (e.g., allows loans up to \$100,000 and permits individuals to defer loan repayments for one year), and (iii) allows the re-contribution of hardship distributions to construct or purchase a primary residence. Although not explicitly stated in the Notice, it is important to note that these relief provisions are entirely voluntary. Therefore, a plan sponsor can refuse to make QHKDs or to allow participants to defer loan repayments. However, if a plan allows, for example, QHKDs, the Notice confirms that the plan must be amended by December 31, 2006 (for calendar year plans) (December 31, 2009 for governmental plans).

Qualified Hurricane Katrina Distributions – Generally, an individual located in a Hurricane Katrina disaster area who sustained an economic loss by reason of the Hurricane may (i) receive a QHKD, (ii) spread the income tax resulting from receipt of the distribution ratably over three years, and (iii) re-contribute such amounts over a three-year period (but QHKD amounts may only be re-contributed if the distribution is treated as an eligible rollover distribution under the Code). The Notice provides that an individual is able to designate as a QHKD most distributions from an eligible retirement plan (i.e., a 401(k), 403(b), 457(b) plan or an individual retirement account ("IRA")). For example, the Notice states that periodic payments and required minimum distributions ("MRDs") received by a individual on or after August 25, 2005 and before January 1, 2007, are permitted to be treated as QHKDs. Because periodic payments and MRDs

are not eligible to be treated as rollover distributions, however, such amounts (if designated a QHKD) cannot be re-contributed to the plan. Although these types of distributions cannot be re-contributed, it appears that the receipt of these distributions may be spread over three years for income tax purposes.

While not directly addressed in the Notice, it appears that because most distributions may be designated a QHKD, a distribution of employer contributions from a profit sharing plan may be made before such amounts have been held by the plan for two years. Specifically, according to a long-standing IRS rule, a distribution from a profit sharing plan generally may not be made until the amounts are held in the plan for at least two years. However, because a plan may designate a QHKD as a permitted distribution event, it appears that amounts that otherwise would not be permitted to be distributed may be distributed as a QHKD to the participant without affecting plan qualification.

Economic Loss – As stated, KETRA allows a plan to make a QHKD to an individual affected by the Hurricane and who sustained an "economic loss" by reason of Katrina. The guidance did not clarify whether an individual living in a Hurricane Katrina disaster area must certify that he or she suffered an economic loss. The Notice provides, however, that in making a determination that an individual sustained an "economic loss," the plan sponsor is permitted to rely on reasonable representations that an economic loss was sustained by reason of the storm. The Notice also provides that a QHKD may be made without regard to the individual's need, and the QHKD amount is not required to correspond to the amount of the economic loss suffered by the individual. Thus, for example, if a participant's economic loss is minimal, the individual may still receive a \$100,000 QHKD. The Notice further clarifies that KETRA relief is available to the entire states of Louisiana, Alabama, Mississippi, and Florida, regardless of whether the area was affected by the Hurricane. The relief, however, remains limited to those participants who actually sustained an economic loss by reason of Katrina.

QHKDs Are Separate Distributions – The Notice confirms that a QHKD is a separate type of distribution under a Code section 401(k), 403(b), or 457 plan. Thus, for example, a plan sponsor is not required to "run" through the 401(k) hardship distribution rules prior to making a QHKD. However, some plan sponsors have required a participant affected by Hurricane Katrina to meet the hardship rules prior to making a QHKD (which is permissible due to the voluntary nature of the KETRA relief).

The Notice indicates that, in this event, the distribution will not be treated as a hardship distribution (which is not eligible to be rolled over), but will be treated as a QHKD. Consequently, the distribution can be re-contributed to the plan under the general rules applicable to the re-contribution of a QHKD.

Reporting QHKDs – The Notice articulates the manner and forms on which a plan sponsor and individual must report the payment and receipt of a QHKD. Specifically, a plan sponsor must report the payment of a QHKD on a 1099-R (using either distribution code 1 or 2 in Box 7) regardless of when and if such amounts are re-contributed. A participant must also report a QHKD on a Form 8915. Form 8915 is not yet available, but the IRS expects to make it available soon.

6. IRS Suspends Reporting and Withholding Requirements for Deferred Compensation Arrangements under Section 409A

As part of the American Jobs Creation Act of 2004, Congress added new rules applicable to nonqualified deferred compensation arrangements under Code section 409A and also imposed new reporting and withholding requirements with respect to such arrangements. These new rules are generally effective in 2005. Plan sponsors and administrators have been concerned that the IRS has not issued guidance on how to determine and report 2005 deferrals for these purposes. Fortunately, recent IRS Notice 2005-94 (Dec. 31 [IRS Bulletin](#)) suspends the reporting and wage withholding requirements for 2005.

Notice 2005-94 provides generally that:

- deferrals for 2005 (and earnings thereon) are not required to be reported on an employee's Form W-2 or on a non-employee's Form 1099-MISC (e.g., no Code Y reporting for 2005);
- for 2005, employers are not required to report as wages amounts includible in an employee's income under section 409A that the employee has neither actually nor constructively received during 2005 (i.e., no reporting on box 2 of Form 941 or box 1 and 12 (Code Z) of Form W-2), or to withhold income taxes on such amounts, and other

payers are not required to report amounts includible in a non-employee's income under section 409A that the non-employee has neither actually nor constructively received during 2005 (*i.e.*, no reporting on box 7 or 15b of Form 1099-MISC); and

- future guidance may require employers and payers to file corrected information returns and furnish corrected payee statements for 2005 (*i.e.*, Form W-2 or 1099-MISC) that report any previously unreported amounts includible in income under section 409A. The failure to comply will likely trigger reporting and withholding penalties (and interest). Importantly, this does not impact Code Y reporting.

The IRS expects to issue additional guidance in the first half of 2006 regarding the reporting and withholding requirements. Employees (and non-employees) will not be subject to penalties for underreporting with respect to amounts includible in gross income under section 409A for 2005 if they report and pay any taxes due with respect to such amounts in accordance with future guidance. However, interest will apply on any underpayments of tax resulting from the employee's (or non-employee's) failure to include amounts in 2005 on his or her income tax return.

7. Further IRS Guidance on Options and SARs Under Section 409A

The IRS recently issued Notice 2006-4 (Jan. 17 IRS Bulletin) providing additional guidance on the exemption of stock options and stock appreciation rights (collectively, "stock rights") from the nonqualified deferred compensation rules of Code section 409A. The Notice also requested comments on several issues related to stock rights under section 409A.

Background - Based on the relevant legislative history, the IRS has provided exemptions from section 409A for a stock right that, among other things, is granted with an exercise price at least equal to the fair market value ("FMV") of the underlying shares on the grant date. Thus, determining the FMV of shares underlying a stock right has become critically important to employers and executives.

The exemptions from section 409A for stock rights are contained in both IRS Notice 2005-1 and the proposed regulations under section 409A. (See Qualified Plans 2004-12 and 2005-10 for summaries of Notice 2005-1 and the proposed regulations.) Notice 2005-1 and the proposed regulations provide certain rules for making the FMV determination, but employers (particularly privately held employers) remain concerned about them.

Guidance on Pre-2005 Grants – Until further guidance is issued, Notice 2006-4 provides that principles similar to those set forth in the rules governing incentive stock options ("ISOs") under Code section 422 will apply to the FMV determination for pre-2005 grants. The ISO rules treat the exercise price of an option as being at least equal to FMV if the employer made a good faith attempt to set the exercise price at such an amount. Whether a good faith effort was made depends on the relevant facts and circumstances under the ISO rules. Thus, a stock right granted before 2005 should meet the FMV requirement of the section 409A exemptions if a good faith effort was made to establish the exercise price at FMV or higher.

Guidance on Post-2004 Grants – The Notice also addresses the valuation issue for stock rights granted after 2004, but prior to the effective date of final regulations under section 409A. Confirming that an exemption under either Notice 2005-1 or the proposed regulations could apply to such grants, Notice 2006-4 states that an employer may determine the FMV of the underlying shares using a reasonable valuation method. Notice 2006-4 does warn, however, that final regulations may establish standards for valuations that are more detailed.

Request for Comments - In the Notice, the IRS requests further comments on the stock right valuation issue. The IRS also states that it is considering comments on, and requests further comments on, two aspects of the proposed regulations that have caused concern among employers issuing stock rights – (1) the definition of "service recipient stock," and (2) the treatment of modifications, extensions, and renewals.

8. IRS to Grant Limited Relief for Relative Value Disclosures

In its Winter 2006 Employee Plans News, the IRS announced that it expects, in early 2006, to grant relief for plan sponsors that must provide new relative value and financial effects disclosures to participants beginning for distributions with annuity starting dates on or after February 1, 2006. The

relief is expected to be quite limited. Sponsors will still need to comply with the new disclosure requirements, published in late 2003, for distributions beginning February 1, 2006. However, they will only need to make reasonable good faith efforts to comply with these requirements, including new relative value and financial effects disclosure, through 2006. The IRS will permit this period of reasonable good faith compliance because it does not expect to issue final guidance on certain disclosure issues (raised in proposed rules this past January, e.g., potentially affecting social security "leveling" options) until early 2006.

The new relative value and financial effects disclosure requirements, and proposed IRS guidance extending the compliance deadline for most disclosures until February 2006 distributions, are described in Qualified Plans 2003-12, Qualified Plans 2004-7, and Qualified Plans 2005-1.

9. IRS Boosts User Fees

The IRS recently announced major increases in the "user fees" it charges to process various requests and applications. IR 2005-144 (Dec. 19, 2005). Many of the increases are two to six times the current rates – with some as high as \$13,000-\$15,000 – and are claimed to more accurately reflect the IRS' cost in processing particular matters. Fortunately, the new rates do not go into effect before February 1 so there is some time to make filings at a substantially lower cost.

The full schedule will be published in January in forthcoming Rev. Proc. 2006-8 and is currently posted on the IRS website. Examples of some of the larger increases include –

- Funding waivers – \$13,000 (up from \$2,570).
- Private letter rulings – \$9,000 (up from \$2,570).
- Waiver of 60-day rollover period – \$500-\$3,000 (depending on the amount involved, up from \$95).

The increases for plan opinion and determination letter requests are more modest, except for certain prototype filings, and generally do not take effect until July 1, 2006. The fee for an individually designed plan determination letter filing will increase from \$700 to \$1,000.

10. Safe Harbor Methods for Valuing Roth IRA Conversions

The IRS recently issued Revenue Procedure 2006-13 (Jan. 17 IRS Bulletin), which provides two safe harbor methods for calculating the "fair market value" of an unannuitized annuity contract that is being converted to a Roth IRA. As anticipated, the guidance generally requires the value of all additional benefits under the contract to be taken into account in order to comply with the temporary/proposed section 1.408A-4 regulations issued earlier this year, which applies to post-Aug. 18, 2005 conversions (see Qualified Plans 2005-8). This calculation is important because it is the amount that the taxpayer must include in gross income and must be reported by IRA providers on Form 1099-R.

The basic safe harbor applies until further guidance is issued and the second safe harbor (called the "simplified safe harbor") applies only for 2005 conversions. They both follow the minimum required distribution ("MRD") rules for valuing annuity contracts that have not yet been annuitized under Treasury Regulation section 1.401(a)(9)-6, Q&A-12, with modifications. This approach is consistent with commentators request that they are following the MRD rules for this calculation. The safe harbor methods are briefly described below:

The basic safe harbor Fair Market Value = X + Y + Z where:

(X) Account Value: the dollar amount credited to the employee or beneficiary under the contract (which may not be reduced to reflect any surrender charges under the contract).

(Y) Additional Benefits: the actuarial present value of any additional benefits (such as survivor benefits in excess of the account balance, any guaranteed minimum benefits, and any charges that are expected to be refunded, rebated or otherwise reversed at a later date) that will be provided under the contract. However, for this purpose (1) future distributions are not to be assumed, and (2) the exclusions provided under Treas. Reg. § 1.401(a)(9)-6, Q&A-12, (c)(1) and (c)(2) are not taken into account. [Note: The prior sentence does not apply to 2005 conversions. This means that, for 2005 conversions, future distributions may be assumed in calculating the present value of additional benefits, and certain additional

benefits – additional benefits that do not exceed 20% of the account value, or where the only additional benefit is a final payment on death that does not exceed the premiums paid less the amount of prior distributions – may be disregarded.]

(Z) Charges: all front-end loads and other non-recurring charges assessed in the 12-months immediately preceding the conversion.

As noted above, the simplified safe harbor method follows the MRD rules, with only adding back the charges assessed within the prior 12-months. Hopefully, this will be viewed as helpful last-minute guidance as IRA providers prepare 2005 Forms 1099-R for 2005 conversions (due to IRA holders by Jan. 31, 2006).

11. Agencies Update Mortality Tables

Both the PBGC and IRS/Treasury recently took steps to update the mortality tables they use to help measure the funded status of defined benefit plans for their respective purposes.

The IRS proposes to update the mortality tables used to determine current liability for minimum funding purposes for plan years beginning on and after January 1, 2007. 70 Fed. Reg. 72260 (Dec. 2, 2005). The proposed tables would be based on the RP-2000 Mortality Tables (replacing the 1983 Group Annuity Mortality Tables) thus reflecting considerably longer life expectancies. Some points worth noting include:

- There continues to be separate tables for males and females.
- The IRS rejected the creation of separate mortality tables based on differences in job classification (*i.e.*, blue-collar vs. white-collar), annuity size, employment status and industry.
- The mortality tables would be based on mortality improvements through the year of the actuarial valuation and would reflect the impact of further expected improvements in mortality.
- An optional, simplified rule for small plans is provided.

- Changes in mortality tables for disabled participants are being separately reviewed.

Comments on the IRS rules are requested by March 29, 2006.

The PBGC adopted final rules updating its mortality tables, effective January 1, 2006, based on a version of the Group Annuity Mortality-94 tables, 70 Fed. Reg. 72205 (Dec. 2, 2005). The PBGC rates are used to determine the level of underfunding in distress terminations, whether plans are sufficient for guaranteed benefits, and for other purposes under Title IV of ERISA. In addition, plans must use them for purposes of determining if notices of underfunding (sec. 4010) are required to be provided. Finally, many actuaries use them to ensure that plan mergers and transfers comply with the "before and after" tests of Code section 414(l) on a "safe harbor" basis.

12. Final DOL Regulations on USERRA

The Veterans and Employment Training Service of DOL has released final regulations under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), which protects employees while absent from work due to military service. 70 Fed. Reg. 75246, Dec. 19, 2005. Proposed regulations were issued in September 2004 (Qualified Plans 2004-9). These final regulations will be effective January 18, 2006.

Generally, the protections described in the regulations apply to an employee who:

- is absent from employment by reason of military service;
- has given his or her employer advance notice, either written or verbal, of the absence due to military service;
- returns to employment after serving no more than 5 years in the military;
- returns to employment, or applies for reemployment, in a timely manner after the end of the military service; and
- is discharged from military service on an honorable basis.

The protections apply broadly to virtually all employers except in the following three situations:

- the employer can show that its circumstances have so changed as to make reemployment impossible or unreasonable (e.g., compliance would require the employer to create a useless job);
- the employer can show that reemployment would impose an undue hardship on it (e.g., a person becomes unqualified for a position due to a disability); or
- the pre-military service employment was for a brief period of time and there was no reasonable expectation that the employment would continue indefinitely.

The regulations describe the implications of the reemployment rights on employee benefit plans, including plans subject to ERISA, such as profit-sharing plans, 401(k) plans, defined benefit plans, cash benefit plans and health plans, as well as plans that are not subject to ERISA because they are sponsored by a church or State. Generally, a returning employee is treated as having been on a leave of absence and not as having incurred a break in service for plan purposes. This means that the period of time that a returning employee spent in the military, as well as any time before or after his or her period of military service, is treated as service credit for eligibility, vesting, and benefit accrual purposes. The final regulations address many issues that have arisen in administering USERRA, as summarized below.

Timing of Payment of Employer Contributions for Reemployed Service Members

– In general, employer contributions to a retirement plan that are not contingent on employee contributions or elective deferrals (e.g., profit-sharing contributions, money-purchase plan contributions, discretionary employer contributions) for a reemployed service member must be made within 90 days following reemployment or, if later, when contributions are normally made for the year during which the military service was performed. (This is a change from the proposed regulations, which provided that contributions must be made within 30 days following reemployment.)

Timing of Employee Contributions for Reemployed Service Members – Employees are permitted to make-up missed employee contributions or elective deferrals (e.g., after-tax amounts, pre-tax deferrals, mandatory employee

contributions, and, although the regulations are silent, apparently so-called governmental plan "pick-up" contributions under Code section 414(h)), in whole or in part, during a period equal to three times the length of the employee's immediate past period of military service, up to 5 years. Employees may not include interest on make-up payments. The final regulations omit the requirement in the proposed regulations that employees who return from military service but terminate employment before the end of the repayment period must be permitted to continue making missed payments after terminating employment. The Preamble notes that this requirement would benefit few employees and place too great a burden on plan sponsors. It also notes that this right was not clearly mandated by the statute.

Differential Pay – The final regulations, citing IRS guidance, clarify that employee contributions and elective deferrals, including payments to 403(b) plans and 457 eligible deferred compensation plans, may be made from differential pay. However, contributions made from differential pay reduce the participant's right to make-up missed contributions upon rehire.

Repayment Option – Employees who receive a distribution from a defined benefit plan in connection with a period of military service have the option to repay that amount (with interest), resulting in appropriate credit under the plan. The proposed regulations would have permitted this repayment option in the context of defined contribution plans, but in light of comments pointing out the administrative burdens, the final regulations do not extend the repayment right to defined contribution plans. The USERRA repayment option, which is broader than the Code's general repayment option for rehired employees, is generally available for a period extending from the time of reemployment until three times the length of military service, up to 5 years; the employee and employer may negotiate a longer repayment period.

Multiemployer Plans – In general, multiemployer plans are subject to the same rules that apply to single employer plans. However, in accordance with a change in the final regulations, if a returning service member resumes employment with a different employer than the employer he or she was employed by before the period of military service, and both employers participate in the same multiemployer plan, the returning service member will receive service credit for his period of military service only if the two employers are connected by a common job referral plan or practice. If the returning

service member is credited with his or her period of military service, unless the plan provides otherwise, the last employer that employed the service member before the military leave commenced is responsible for the employer contribution. The reemploying employer must provide notice of reemployment to the plan administrator within 30 days of the date it has knowledge that the employee was reemployed under USERRA.

Health Plans – The final rules contain greater clarification on the interaction of USERRA continuation coverage rights and rights available under COBRA. As a general rule, the final regulations provide that compliance with COBRA will not suffice for compliance with USERRA if USERRA provides a more generous rule.

Rights and Benefits on Leaves of Absence

– A continuing question under USERRA has been what benefits available to some employees on leave must also be provided to those employees on military leave under USERRA. Though not providing many bright line tests, the final regulations do provide some factors to consider, such as duration of the leave, the purpose of the leave, and the ability of the employee to choose when to take the leave. However, whether the leave is paid or unpaid is not a factor in considering whether the leave is comparable.

13. DOL Recognizes Divisions Within Separate Accounts

Our firm recently obtained an advisory opinion from the Department of Labor in which the Department clarified that, under some circumstances, divisions within an insurance company pooled separate account may themselves be treated as "separate accounts" for ERISA purposes. DOL Adv. Op. 2005-22A (Dec. 7, 2005).

The opinion was obtained on behalf of Hartford Life Insurance Company ("Hartford"), which maintains a single pooled separate account that is divided into a number of divisions. Each division has a different investment objective or style, and investors select one or more particular divisions for investment. The gains and losses of each division are accounted for separately, and the investment experience of any one division does not affect the gains or losses of any other divisions. Hartford has found that organizing its separate account in this manner (rather than creating several separate accounts) reduces its administrative costs and thereby improves Hartford's ability to meet the needs of its customers.

Section 3(17) of ERISA defines a separate account as "an account established or maintained by an insurance company under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company." Except under certain limited circumstances, ERISA's plan asset regulations provide that, if ERISA plan assets are held in an insurance company separate account, all of the assets of the separate account become plan assets subject to ERISA. 29 C.F.R. § 2510.3-101(h)(1)(iii).

Prior to the new advisory opinion, there had been some question as to whether ERISA and non-ERISA assets could be held in different "divisions" of the same separate account without transforming all assets in the separate account into ERISA-covered assets. In the opinion, the DOL concluded that, where the income, gains, and losses attributable to each division of a separate account are credited to or charged against the assets of that division (and not to the assets of any other division or to insurer's general account) – without regard to the investment experience of any other division or the general account – each division will satisfy the definition of "separate account" under section 3(17) of ERISA. Thus, the presence of ERISA assets in one division would not itself transform the assets of other divisions into plan assets.

DOL Advisory Opinion 2005-22A should give insurance companies greater flexibility in organizing and administering their separate accounts while providing certainty regarding the ERISA "status" of sub-divisions of those separate accounts.

14. New SEC Executive Compensation Disclosure Rules Expected Soon

With the 2006 proxy season around the corner, the Securities and Exchange Commission (the "SEC") appears poised to release, as early as January 2006, revamped rules on executive compensation disclosures for public companies. In response to Enron and calls for better disclosure in this area, in recent years the SEC has required more rapid disclosures of insider transactions on Forms 4 (see [Qualified Plans 2002-9](#)) and changes to executive compensation arrangements on Forms 8-K (see [Qualified Plans 2004-3](#)). Now, the SEC appears ready to require more complete – and more

understandable – annual proxy disclosures on executive compensation.

Currently, the federal securities laws require annual disclosure about the compensation paid to the CEO and the four other most highly-compensated executive officers of a public company. Under the current rules, this information is typically found in various portions of a company's annual proxy statement. For example, information on salaries, bonuses, and certain other types of compensation is included in the Summary Compensation Table, information on options and stock appreciation rights is found in the Option/SAR Grants Table and the Option/SAR Exercise Table, and information on qualified and nonqualified defined benefit plans is found in the Pension Plan Table. Critics of the current disclosure rules complain that the annual proxy disclosures are difficult to comprehend and incomplete.

SEC staff have been encouraging companies to improve these proxy disclosures in recent years. Christopher Cox, the new Chairman of the SEC, recently stated that the agency's new rules will be designed to provide for greater "wage clarity" and to make executive compensation disclosure more substantive and easier to understand. It seems likely the SEC will respond to the many calls for more comprehensive annual disclosures on benefits earned under nonqualified defined benefit plans (so-called "SERPs"), nonqualified deferred compensation plans, and a wide variety of executive perks.

Cox's recent comments indicate that a total compensation figure (including salary, bonus, stock and option awards, and all other benefits) may need to be reported each year for each covered executive. Many have suggested that such figures should be prepared on a "tally sheet" each year and available for compensation committees and shareholders to review. If a total annual compensation number for each executive needs to be disclosed, companies will likely need to calculate the amount of annual accruals under SERPs and other nonqualified deferred compensation plans. Annual accruals under such plans will also likely be needed for required Form W-2 reporting under Code section 409A beginning with 2006. Hopefully, the SEC rules will be harmonized with the IRS rules in this area.

15. SEC Clarifies Validity of 12b-1 Fee "Rebate" Programs

On November 30, the SEC Division of Investment Management issued a no-action letter to E*TRADE Securities, clarifying that, under certain circumstances, a broker receiving Rule 12b-1 fees from unaffiliated mutual funds that it markets to its customers can rebate those fees under a customer incentive program. Although broadly applicable to mutual fund arrangements, we highlight it here because it may have important implications for financial institutions that offer third-party mutual funds to employee benefit plan and IRA customers.

E*TRADE indicated that it currently offers a rebate program involving more than 5,000 mutual funds that it offers to its customers. The program is designed to attract new customers, attract new investments from existing customers, and provide a "persistency bonus" to long-term customers. Under the program, customers are eligible for semi-annual fee rebates based on various factors. The rebates are calculated based on the 12b-1 and other administrative fees attributable to the customer's account, but are paid out of E*TRADE's general assets. (The letter notes that the rebates may, in some cases, actually exceed the amount of 12b-1 fees received by E*TRADE with respect to the account, because not all funds pay such fees.)

E*TRADE indicated that it operates the program independent of any of the funds that it markets, that it is not affiliated with any of the funds, and that it has no agreement or understanding with any fund or fund adviser to rebate fees, though it may advise the fund of the rebate program. According to E*TRADE, some mutual fund boards of directors have objected to the rebates and specifically asked that they be excluded from the program, because of uncertainty as to whether the payment of rebates could undermine the Rule 12b-1 requirement that the board must find that the payment of a 12b-1 fee will benefit the fund and its shareholders. This requirement was noted by the SEC in an earlier no-action letter (the "Mahaffy Letter", Mar. 17, 2003).

The SEC staff clarified certain statements in the Mahaffy Letter regarding the duty of a fund's board to consider rebates as a "pertinent factor" in determining whether a 12b-1 plan was permissible. According to the E*TRADE letter, "the appropriateness of a board's determination would depend upon all of the relevant facts and circumstances." In this respect, the letter notes that

if all or almost all of the 12b-1 fees are being rebated, the board might reasonably conclude that the continuation of the 12b-1 plan at the current level is not justified. But, rebates are not themselves prohibited.

The letter further notes the importance of the fact that E*TRADE adopted the rebate program on its own, without the participation of the underlying funds. Thus, the letter points out that if a fund were to enter into an agreement or arrangement with a broker to rebate fees to select shareholders or classes of shareholders, or otherwise arrange to selectively rebate fees to shareholders, such an arrangement could raise serious shareholder discrimination questions under the Investment Company Act of 1940, and any broker who participates in such an arrangement could be liable for aiding and abetting the fund's violation.