

# QUALIFIED PLANS 2006-12

Friday, December 29, 2006

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## HAPPY NEW YEAR

### HIGHLIGHTS

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### 1. DOL FAB on PPA Benefit Statements

Department of Labor ("DOL") Field Assistance Bulletin ("FAB") 2006-03 (Dec. 20, 2006) provides interim "good faith" guidelines for plan administrators to follow in complying with the PPA's periodic pension benefit statement requirements (section 105 of ERISA), which are effective for plan years beginning after December 31, 2006. Issued "pending further guidance," the FAB explains that plan administrators will satisfy their obligation under ERISA section 105 to provide periodic benefit statements by acting in good faith based on reasonable interpretations of the requirements of section 105. DOL is required to develop model pension benefit statements by August 18, 2007.

Key questions addressed by the FAB include the following.

#### Due Dates for the First Round of Statements

– Generally, the due date is 45 days from the end of the quarter or the calendar year for which the statements are required (except for certain DB plans). For example, for 401(k) and other participant-directed "individual account plans" with plan year that is a calendar year, statements must be furnished within 45 days after the end of the first calendar quarter on March 31, 2007. Defined benefit plans that choose the alternative notice provision under section 105(a)(3)(A) of ERISA will need to provide the required notification by December 31, 2007.

**Multiple Documents or Sources for Benefit Statement Information Permissible** – Code section 401(k) and other individual account plans often have multiple service providers and information required on benefit statements may require information from more than one of these service providers. Pending further guidance from DOL, it will be permissible to deliver benefit statement information in multiple documents from different sources, provided that participants and beneficiaries receive an explanatory notice with information on where they can find the benefit statements information. The notice must be provided in advance of when the first round of the benefit statements would be due.

**Use of Electronic Media (Including Distribution Through a Website)** – DOL regulations already provide a "safe harbor" for disclosing information through the electronic media (29 CFR 2520.104b-1(c)), which may be followed to deliver the statements. In the FAB, DOL outlines two additional "good faith" electronic distribution options: (1) statements may be provided in accordance with the recently issued IRS guidance (26 CFR 1.401(a)-21), relating to the use of electronic media to provide certain notices and documents to participants and beneficiaries (which is quite similar to the DOL safe harbor and is highlighted in Qualified Plans 2006-10); or (2) through continuous access to one or more secure websites, provided participants receive an explanatory notice explaining how to access the required pension benefit statement information, as well as the participant's right to request and obtain, free of charge, a paper statement. The notice must be provided in advance of when the first round of the benefit statements would be due, and annually thereafter.

**Diversification Notice - Due Date/Meeting the Notice Requirement Through the First Round of Benefit Statements** – For plans that, prior to January 1, 2007, provide participants with diversification rights at least equal to the new diversification rights conferred by PPA, the diversification notice obligations will be deemed satisfied when the plan administrator provides the first round of the quarterly pension benefit statements, assuming the statements comply with this FAB and PPA (because the quarterly benefit statements are required to contain the diversification information similar to the one required to be provided in connection with the diversification notice).

**Other Issues** – DOL clarified the following points.

- Plan loan provision do not cause a plan to be participant-directed for purposes of the benefit statement provisions.
- Benefit statements need only include limitations and restrictions imposed "under the plan," and need not include limitations and restrictions imposed by investment funds, other investment vehicles, or by state or federal securities laws.
- The FAB provides language that will satisfy the diversification requirement.
- DOL identifies the web link that should be used on the statements.

## **2. DOL Asks for Help Developing PPA Investment Advice Guidance**

One of the more controversial provisions of the Pension Protection Act of 2006 (the "PPA") is a new exemption from ERISA's prohibited transaction restrictions for investment advice. The exemption provides conditional relief for the provision of investment advice by a fiduciary adviser to plan participants, and for certain related transactions. By its terms, the exemption applies only to participant-level advice provided in individual account plans. To be exempt, the advice must be provided through an "eligible investment advice arrangement," which must either –

- (1) provide that any fees received by the fiduciary adviser for investment advice, or with respect to the sale of securities or other property, do not vary depending on the investment options selected; or
- (2) use a computer model meeting detailed conditions to be prescribed.

This month, the Department of Labor ("DOL") issued two Requests for Information ("RFIs") related to the new investment advice exemption. 71 Fed. Reg. 70427, 70429 (Dec. 4, 2006). Comments are due by January 30, 2007.

## **A. RFI for Computer Modeling and Fee Disclosure**

The first RFI specifically requests information relating to the computer modeling and fee disclosure requirements of the exemption. The exemption requires a computer model to meet certain requirements, including that the model must apply generally accepted investment theories; it must utilize relevant information about the participant, such as age, life expectancy, retirement age, or risk tolerance; and it must not be biased in favor of the adviser's affiliated investment products. The exemption also requires an "eligible investment expert" to certify that the model meets applicable requirements prior to its use, and later if the model is modified.

In addition, certain disclosures must be provided to participants in connection with the advice program, whether advice is provided through a computer model or through a fee-leveling arrangement. In particular, new ERISA section 408(g)(6) requires a fiduciary adviser to provide participants and beneficiaries, among other information, written notification of all compensation relating to the advice that the fiduciary adviser or any affiliate will receive in connection with advice or related securities transactions. The PPA directs the DOL to issue a model fee disclosure for use in connection with the exemption.

The PPA calls for regulatory guidance from the DOL related to the computer modeling provisions in three areas. First, the statute requires an eligible investment expert to certify, in accordance with rules prescribed by DOL, that a computer model meets applicable requirements. Also, DOL may issue regulations which provide guidance on the nature of material modifications to a computer model that will require subsequent certification. Third, DOL may prescribe qualifications necessary to serve as an "eligible investment expert."

The first RFI asks for comments related to the computer model issues identified above or with respect to the model fee disclosure form DOL is developing. In this regard, the Department asked several specific questions, although commenters are not limited to answering the specific questions asked.

Specific questions asked by DOL include:

- What qualifications or expertise (financial, educational, professional

experience, etc.) would be required to determine whether a computer model meets the conditions of the exemption?

- What types of modifications are made to existing computer advice models and who makes them?
- What is the current process for designing, developing and implementing computer investment advice models?
- What types of information relating to fees received by fiduciary advisers and their affiliates would be helpful to participants and beneficiaries in making their investment decisions?
- What challenges exist for presenting fee information in a manner that is clear and understandable by the average plan participant?

## **B. RFI Related to IRAs**

The second RFI requests information as to the feasibility of applying the computer model provisions to IRAs and similar accounts. In this regard, the PPA directs the DOL, in consultation with the Treasury Department, to solicit information as to the feasibility of applying computer model advice programs to IRAs and similar plans that are subject to the prohibited transaction rules of the Code. On the basis of the information solicited from the public, the DOL is to determine whether any computer model investment advice program may be used to provide advice to the account beneficiary.

The Department asked several specific questions regarding the use of computer models for IRAs and other accounts, but commenters are not limited to these issues.

- Are there any computer investment advice programs that are or may be used to provide advice to participants of plans such as IRAs (and other similar accounts) that meet the requirements of the advice exemption?
- If there are computer model programs used by IRAs that do not meet the requirements of the advice exemption, what requirements are not met and would it be possible for such models to meet all of the criteria?

- If there are computer model programs that meet all the requirements of the exemption, do any of the programs permit the beneficiary to invest in virtually any investment? If not, what are the difficulties in creating such a model?
- What investment options are considered by computer investment advice programs and what information on such options is needed?

The PPA directs the DOL to solicit information in connection with the use of computer model programs for IRAs not only from the public, but also from the top 50 IRA trustees based on assets. Some of our clients have already received specific requests from the DOL in this regard.

The RFIs ask several questions related to fee disclosure. For example, DOL has requested information related to the types of compensation that advice providers and affiliates receive in connection with investment advice. They also asked for help in presenting fee information in a way that is helpful and understandable to participants. In this regard, DOL has several current projects targeting the disclosure of compensation in connection with services arrangements, particularly focusing on the receipt of indirect compensation, including projects related to the Form 5500, the services exemption under section 408(b)(2) and the disclosures required by section 404(c) regulations. These RFIs provide another opportunity to educate the DOL on the challenges financial institutions face in tracking and reporting fee information and in describing fee information to participants in a meaningful way.

### **3. IRS Model Notice and Guidance on New ESOP Diversification Rules**

IRS Notice 2006-107 (Dec. 18 IRS Bulletin) contains important transition guidance on the diversification rules of new Code section 401(a)(35) (and the parallel ERISA provision section 204(j)) for public company ESOPs that have a matching or 401(k) component. Plan sponsors were clamoring for early guidance in this area because of its general effective date of January 1, 2007. The guidance addresses some issues, summarized below, though others remain.

The Notice indicates that regulations will be issued on the issues reflected in the Notice and

additional matters. The Notice requests comments by March 18, 2007.

**Diversification Notice Not Required Before January 1, 2007** – An immediate concern of many sponsors was the requirement to provide Notice to participants under section 101(m) of ERISA, as added by the Pension Protection Act ("PPA"). The Act provides for Notice at least 30 days before the first date on which an applicable individual is eligible to exercise the right to direct the divestment of employer securities. This appeared to mean that Notice could be required by December 2, 2006 for calendar-year plans. According to the Notice, DOL has advised Treasury that plans with plan years beginning on or after January 1, 2007, but before February 1, 2007 (generally, plans with calendar-year plan years), are not required to furnish the Notice earlier than January 1, 2007. In FAB 2006-03 (summarized elsewhere in this issue), DOL later said that plans providing diversification rights at least as generous as under PPA need not send a separate notice and instead may rely on the diversification statement included in the quarterly benefit statement.

**Model Notice** – The Notice includes a model Notice to be used to comply with ERISA section 101(m). The model Notice includes reference to the 20% maximum rule of thumb for investment in any single security, but does not include information concerning net unrealized appreciation (NUA) and the effect that diversification may have on the tax consequences of subsequent distributions not in employer stock.

Although not specifically addressed in the Notice, the law generally defines "applicable individual" to include any participant with 3 years of service and any beneficiary who can exercise the rights of a participant under the plan. The Notice adds alternate payees with accounts under the plan.

**Employer Stock in Pooled Vehicles Exempt** – Another concern was that the diversification rules and related Notice requirements could be read to apply to employer securities held indirectly, such as in an S&P 500 index fund. The Notice exempts these types of holdings, and provides that stock held in a regulated investment company or similar pooled investment vehicle that is regulated and subject to periodic examination by a state or federal agency is exempt if it is made in accordance with the stated investment objectives of the vehicle and the holdings are diversified so as to minimize the risks of large losses.

**No Guidance on Application of Diversification Rules to Spin-offs of Freestanding ESOPs**

– The new diversification requirements do not apply to ESOPs not subject to 401(k) or 401(m), often referred to as "freestanding ESOPs." The Notice reiterates that point, but does not indicate whether a freestanding ESOP can be created by spinning off the non-401(k) and 401(m) portion of an ESOP into a separate plan to avoid the 401(a)(35) diversification rules.

**Service Counting Clarified** – The new diversification requirements apply to individuals with 3 years of service, using the definition for vesting purposes. The Notice clarifies the general rule, for example, for plans using the hours of service method, to mean after the end of the third applicable computation period that constitutes the completion of a third year of service for vesting computation under Code section 411(a)(5). For elapsed time plans (or plans with immediate vesting), it is the third anniversary from date of hire.

**Diversification Investment Options, Restrictions and Conditions** – The Notice reiterates the general provision under section 401(a)(35) that the investment options offered for investing divestment proceeds must include not less than three investment options, other than employer securities, and each investment option must be diversified and have materially different risk and return characteristics. For this purpose, investment options that satisfy the DOL's 404(c) regulation (29 CFR Sec. 2550.404c-1(b)(3)) are treated as being diversified and having materially different risk and return characteristics.

The Notice provides some new information on the related requirements that (i) a plan is not treated as failing to meet the requirements of section 401(a)(35) merely because the plan limits the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly, and (ii) a plan may not impose restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other assets of the plan. With regard to these limitations, the Notice provides two examples of provisions that violate section 401(a)(35):

- Where a plan allows applicable individuals the right to divest employer securities on a periodic basis (such as quarterly), but permits divestiture of another investment on a more frequent basis (such as daily). In other words,

the "no greater restrictions" rule trumps the "at least quarterly" rule. Presumably, because this was not clear from the statute, the Notice also provides a transition rule until the end of the first quarter in 2007, discussed below.

- A plan under which a participant who divests his or her account of employer securities receives less favorable treatment (such as a lower rate of matching contributions) than a participant whose account remains invested in employer securities.

The Notice also provides the following examples of provisions that do not violate section 401(a)(35):

- A provision that limits the extent to which an individual's account balance can be invested in employer securities. Thus, a provision that does not allow more than 10% of an individual's account balance to be invested in employer securities is permitted.
- A provision under which an employer securities investment fund is closed, i.e., other amounts invested under the plan cannot be transferred into an investment in a class of employer securities (and no contributions are permitted to be invested in that class of employer securities). However, a provision under which, if a participant divests his or her account balance with respect to investment in a class of employer securities, the participant is not permitted for a period of time thereafter to reinvest in that class of employer securities, is prohibited.
- The imposition of fees on other investment options under the plan merely because fees are not imposed with respect to investments in employer securities.

**Securities Law Restrictions** – The statute provides that a restriction imposed by reason of the application of securities laws is not an impermissible restriction or condition, and the Notice expands this to include a restriction that is "reasonably designed" to ensure compliance with such laws. The Notice further provides as an example of such a condition

that, for purposes of ensuring compliance with Rule 10b-5 of the Securities and Exchange Commission, a plan may limit divestiture rights for participants who are subject to Section 16(b) of the Securities Exchange Act of 1934 to a period (such as 3 to 12 days) following publication of the employer's quarterly earnings statements.

**Delayed Effective Date for IPOs** – One concern expressed by some plan sponsors is that in an IPO, the statute could be read to require diversification rights to apply to the stock in the ESOP the day the stock becomes publicly traded. That would be impractical to administer, and also could violate typical "lock-up" agreements by which employees are not allowed to immediately "flip" their shares. The Notice provides some relief in that regard by providing that a plan may restrict the application of otherwise applicable diversification rights under the plan for up to 90 days following an initial public offering of the employer's stock.

**Transition Rules** – The Notice provides relief on the investment restriction and condition rules with two transitional rules: (1) where the plan restricted diversification rights with respect to employer securities pursuant to a plan provision that was in effect on December 18, 2006, such restriction may continue to be imposed until March 31, 2007, and (2) until January 1, 2008, for plans that, on December 18, 2006, allowed applicable individuals the right to divest employer securities on a periodic basis, but did not impose an otherwise applicable restriction on a stable value fund, or permitted divestiture of another investment on a more frequent basis, provided the other investment is not generally available (e.g., the other investment is only available to a fixed class of participants).

#### **4. Cash Balance Plans – End of Determination Letter Moratorium and Initial IRS Guidance for PPA Changes**

In Notice 2007-6 (Jan. 16 IRS Bulletin), the IRS announced that it is beginning to process determination letter applications for cash balance plans that have been subject to an IRS moratorium for many years. The Notice also provides some initial transition guidance and solicits comments regarding the new rules applicable to cash balance and other hybrid pension plans enacted as part of the Pension Protection Act of 2006 ("PPA").

#### **A. Determination Letter Process**

Determination letter applications for defined benefit plans that had been converted to cash balance and other hybrid designs (generally referred to as "hybrid plans" in this article) have been held up in a moratorium for over 7 years – since September 15, 1999. The moratorium had been imposed in light of mounting questions (including in numerous class action lawsuits) about the legality of hybrid plans and possible regulatory or legislative action to address the issues. In light of the legislative validation of hybrid plans under the PPA, the IRS has lifted the determination letter moratorium. For purposes of processing these determination letter requests, the IRS provides the following guidance:

- **Age Discrimination.** In general, the IRS will review plans to determine if accruals for periods after the conversion satisfy the age discrimination accrual rules in Code section 411(b)(1)(H). For this purpose, a plan will not be considered age discriminatory merely because it provides that interest credits through normal retirement age are accrued in the year of the related hypothetical allocation. However, the IRS will not consider whether any pre-June 30, 2005 conversion, including any wear-away period that followed the conversion, satisfied the age discrimination rules. Thus, it appears the IRS is taking the position that the basic cash balance benefit formula is not age discriminatory – the issue that continues to vex the courts – but that it will not opine as to whether the effect of the conversion of the prior traditional benefit to a cash balance benefit satisfies age discrimination rules.

We note that class action cases regarding whether pre-PPA cash balance accruals satisfy age discrimination requirements continue to rage on, with courts coming out on both sides of the issue. While courts have not typically given much evidentiary weight to IRS determination letters, the guidance in Notice 2007-6 that the "frontloading" of interest credits will not be viewed by the IRS as age discriminatory may be helpful in the defense of plan sponsors that are subject to these suits.

- **Pre-PPA Distributions.** The Notice indicates that the IRS will issue guidance interpreting the PPA effective date rules for relief from the Code section 417(e) requirements for valuing lump-sum distributions. Until that guidance is issued, the IRS will not issue a determination letter for a plan that does not satisfy the requirements of Notice 96-8 (which generally requires the so-called 417(e) "whipsaw" calculation for plans that do not use one of the interest rates approved in 96-8) for distributions made before August 18, 2006.
- **Backloading.** The Notice notes that the backloading rules under Code section 411(b)(1)(A), (B) and (C) were not modified by the PPA and continue to apply. As with pre-moratorium determination letter reviews, we expect the IRS to look closely at whether and how hybrid formulas satisfy the backloading rules.
- **Terminating Plans.** The IRS notes that the PBGC has indicated that the PPA's relief from the 417(e) rules will not apply to any plan that has a termination date prior to August 18, 2006. This appears to mean that a plan that had been required to apply the 417(e) "whipsaw" rules as stated in Notice 96-8, must continue to apply those rules to all distributions if it is terminated effective as of any date prior to August 18, 2006.
- **Post-6/29/05 Conversions.** If a plan was converted to a hybrid design by an amendment adopted after June 29, 2005, the IRS will review the conversion to determine if it complied with the conversion requirements of the PPA.

## **B. Transition Guidance**

The Notice provides initial transition guidance on the application of some of the new hybrid plan rules enacted as part of the PPA.

**Definition of "Statutory Hybrid Plan"** – The PPA provides special rules that allow cash balance plans and other hybrid pension plans to automatically satisfy the age discrimination rules and

to avoid application of the whipsaw effect that can be caused by application of the lump-sum valuation rules under Code section 417(e) (as interpreted by the IRS in Notice 96-8). A cash balance or other hybrid plan can take advantage of these new rules if they meet the PPA's definition of an "applicable defined benefit plan." These plans generally include any defined benefit plan under which the accrued benefit is calculated as a balance of a hypothetical account or as an accumulated percentage of final average compensation. The Notice generally describes these plans as "statutory hybrid plans." Importantly, the Notice expands on the PPA definition to include a plan "under which the accrued benefit under the terms of the plan is calculated as the actuarial equivalent of such a hypothetical account balance or accumulated percentage." Consistent with prior law, many existing hybrid plans include a definition of accrued benefit that converts the plan's present value benefit to a normal retirement age annuity. There was some concern that such plans may not be eligible for the new PPA rules unless their form was changed to eliminate the normal retirement age annuity reference. It appears that the IRS does not view the new law as elevating form over substance in this manner.

The PPA instructs the Treasury to issue regulations to include plans that have an effect similar to an applicable defined benefit plan. The Notice indicates that plans that provide that a participant's normal retirement age benefit is expressed as a benefit that includes automatic periodic increases through normal retirement age, such as an indexed annuity plan, will be considered statutory hybrid plans. The Notice provides that plans that solely provide for post-normal retirement age indexing will not be considered statutory hybrid plans. Also, a variable annuity plan will not qualify if it has an assumed interest rate of 5% or more; the Notice describes a variable annuity plan for this purpose as any plan which provides that the amount payable is periodically adjusted by reference to the difference between the rate of return of plan assets or specified market indices and the assumed interest rate.

**Relief From the 417(e) Lump-Sum Valuation Rules** – The PPA generally permits qualifying hybrid plans to provide lump-sum benefit payments equal to the balance of the participant's hypothetical account (in the case of a cash balance plan) or the accumulated percentage of final average pay (in the case of a pension equity plan) without application of the 417(e) lump-sum valuation rules. The Notice provides the following guidance on the implementation of this rule:

- **Relief Limited to Certain Hybrid Plans.** Relief from the 417(e) rules applies only to plans where the benefit is based on a hypothetical account or the accumulated percentage of final average pay. It does not extend to other statutory hybrid plans (such as certain indexed benefit plans) that are eligible for the age discrimination relief and other hybrid plan rules of the PPA.
- **Effective Date Guidance Forthcoming.** The PPA provides that relief from the 417(e) rules is effective for distributions made after August 17, 2006. The Notice indicates that the IRS expects to issue regulations "shortly" interpreting this effective date. It appears that the guidance will be targeted to how the law change could impact distributions made prior to August 18, 2006. As noted above, the IRS will not issue determination letters for plans that did not follow the rules in 96-8 in making distributions prior to August 18, 2006 until further guidance is issued.

**Cut-Back Relief and Required Notice For Plans That Eliminate Whipsaw** – Some existing hybrid plans contain provisions for the whipsaw calculation described in Notice 96-8. This is most common in cash balance plans that provide interest credits at a minimum fixed rate that has exceeded the rate on 30-year Treasury securities applicable under the 417(e) rules. For example, where a plan has a minimum crediting rate of 5.5% and the applicable rate under 417(e) is less than 5.5%, the whipsaw calculation will cause the lump-sum distribution to exceed the participant's account balance. The PPA's effective date and cut-back rules generally provide broad relief for such plans to eliminate the whipsaw calculation for distributions after August 17, 2006. The Notice confirms the IRS view that the PPA permits a plan to be amended to eliminate the whipsaw calculation. However, the Notice provides that such an amendment would generally be subject to the advance participant notice requirements under ERISA section 204(h) and Code section 4980F. The Notice provides that the elimination of whipsaw may occur only if a 204(h) notice is provided at least 30 days prior to the effective date of the elimination. The actual amendment will not need to be adopted until the end of the first plan year beginning on or after January 1, 2009.

**Market Rate of Return** –The PPA requires that interest credits to cash balance accounts may not be made at a rate that exceeds a "market rate of return." The Notice indicates that Treasury intends to issue guidance in 2007 that addresses this requirement, including special rules on what minimum rates of return should be permitted, how the preservation of principal rule should be applied (the PPA provides that an interest credit of less than zero may not cause a participant's account balance to be less than the aggregate contributions credited to the account), and the extent of any relief from the anti-cutback rules of Code section 411(d)(6) for a plan amendment that changes the plan's cash balance interest crediting rate provisions. Pending further guidance, the Notice provides that a market rate of return will include (1) the rate of return on long-term investment grade corporate bonds, (2) the rate of interest on 30-year Treasury securities (as provided in Code section 417(e) before amendment by the PPA), and (3) the sum of any of the standard indices and associated margin for that index described in Notice 96-8.

**Special Rules For Conversion Amendments** – The PPA provides several requirements for the conversion of an existing defined benefit plan from a traditional benefit formula to a hybrid plan formula under an amendment adopted after June 29, 2005. The Notice largely restates the PPA's requirements in this regard, which generally require a participant's final benefit to equal the sum of (A) the accrued benefit accrued prior to the conversion, plus (B) the benefit accumulated under the new hybrid benefit formula from the date of conversion forward. A special rule in the PPA also requires that any early retirement and retirement-type subsidies under the plan's prior benefit formula that the participant is qualified to receive in the year of retirement must be credited to the participant's hybrid plan account. The Notice clarifies that the retirement subsidy determination is made as of the benefit commencement date for the participant.

**Mergers and Acquisitions** – As required by the PPA, the IRS indicates that it expects to issue regulations by August 17, 2007, regarding an amendment that converts a defined benefit plan into a hybrid plan with respect to a group of employees who become employees by reason of a merger, acquisition or similar transaction. Pending further guidance, the Notice indicates that such an amendment will not cause a violation of the age discrimination rules if the benefit for the affected participants is at least equal to the sum of (A) the benefits and rights earned under the old plan and

protected by the cut-back restrictions of Code section 411(d)(6) as of the date of conversion (which would include early-retirement and retirement-type subsidies provided under the old plan), plus (B) the 411(d)(6) protected benefits earned under the hybrid plan provisions from the date of conversion forward.

### **C. Request for Comments**

The IRS expects to issue proposed regulations with respect to this initial transitional guidance. They note that the initial regulations will not address all outstanding issues relating to the PPA rules for hybrid plans. In advance of the issuance of the proposed regulations, the IRS has asked for comments (by April 16, 2007) on the following issues:

- **Market Rate of Return.** The IRS requests input on the appropriate definition of a "market rate of return," including what minimum rates of return should be permitted, how the preservation of principal rule should be applied, and the extent of any relief from the anti-cutback rules of Code section 411(d)(6) for a plan amendment that changes the plan's cash balance interest-crediting rate rules.
- **Partial Hybrid Plan Benefits.** Comments are requested on how the PPA's hybrid plan rules should be applied to plans where only some participants' benefits, or only a portion of certain participants' benefits, are determined with reference to a hybrid benefit formula, including plans that involve an offset for benefits under another plan. In this regard, the IRS specifically invites comments on how (or whether) these plans should credit interest with respect to terminated vested participants.
- **Multiple Amendments.** The PPA requires the Treasury to issue regulations to prevent the avoidance of the purposes of the hybrid plan rules through the use of two or more plan amendments, rather than a single amendment. The IRS requests comments on how the use of multiple amendment or multiple plans can have the effect of a conversion of a plan to a hybrid plan.

- **Pension Equity Plans.** The IRS requests input on how other qualification rules, other than the age discrimination and lump-sum valuation rules, apply to hybrid plans where the benefit is calculated as an accumulated percentage of the participant's final average compensation. This type of design is typically referred to as a "pension equity plan" or "PEP."
- **Benefit Indexing.** The PPA permits hybrid plans to include certain arrangements where benefits increase under a specified index. The IRS requests comments on the appropriate type of indexing that should be permitted and whether there are any types of indexed plans that should not be treated as hybrid plans.

### **D. Future Prospects**

Between the processing of determination letters for hybrid plans, further guidance regarding the new PPA rules, and rulings in the many pending cash balance class action cases, 2007 will be a busy year for hybrid plan issues. Developments in all these areas will be relevant to employers who currently sponsor hybrid plans, as well as to employers who are, or may be, considering a conversion to a hybrid plan in the future.

## **5. PPA Prompts Additional Changes to Form 5500**

The Pension Protection Act of 2006 (the "Act") overhauls the funding rules for single-employer and multiemployer defined benefit pension plans generally beginning with 2008 plan years (Qualified Plans 2006-8). The Act also requires increased disclosure of pension plan information. In response to these new requirements, the Department of Labor ("DOL"), the Internal Revenue Service (the "IRS"), and the Pension Benefit Guaranty Corporation ("PBGC") recently proposed additional changes to the Form 5500 for 2008 plan years. 71 Fed. Reg. 71562 (December 11, 2006).

The proposed changes are due in large part to the significant changes that were made to the way pension plans will be required to determine their assets and liabilities. For example, with respect to single-employer defined benefit plans, the Act permits plan sponsors to elect to maintain a credit balance (e.g., a "funding standard carryover" and

"pre-funding" balance), and requires all plans to amortize any underfunding over seven years and to use the same interest rate to determine benefit liabilities. These plans are also required to use a mortality table prescribed by the Treasury Department, and plans may determine the value of its assets by "smoothing" the fair market value of the assets over only a 24-month period. Major changes to the multiemployer funding rules require certain underfunded multiemployer plans that are considered "endangered" or in "critical status" to adopt and comply with a "funding improvement plan" or "rehabilitation plan." (For more information on the changes to the single-employer and multiemployer defined benefit plan funding rules, see the detailed summary comparison of current law and the principal provisions of the Act on our website ([www.groom.com](http://www.groom.com)).)

The recently proposed changes to the Form 5500 supplement other major proposed revisions issued this past July (Qualified Plans 2006-7). These revisions were part of the DOL, IRS, and PBGC's initiative to move to a fully electronic filing and processing system to replace the existing paper-based ERISA Filing Acceptance System ("EFAST"). The supplemental proposed changes do not attempt to address comments received in connection with the proposed July changes. In order for the supplemental changes to be incorporated into the new electronic filing system (known as "EFAST2") in a timely fashion, the supplemental form changes need to be finalized by the February 2007 target date for finalizing the July 21 revisions. Comments on the supplemental proposed changes are due by January 10, 2007.

We briefly summarize the key changes below.

#### **A. Changes to the Form 5500, Schedule B**

As a result of the significant changes to the single-employer and multiemployer defined benefit plan funding rules, the DOL, IRS, and PBGC have concluded that the Act effectively makes the Form 5500, Schedule B obsolete. As a result, the DOL, IRS, and PBGC have decided to eliminate the Schedule B and replace it with two, separate actuarial schedules: Schedule SB ("Single-Employer Defined Benefit Plan Actuarial Information") and Schedule MB ("Multiemployer Defined Benefit Plan and Money Purchase Plan Actuarial Information").

**Schedule SB** – All single-employer defined benefit plans (including multiple-employer plans)

would be required to file a Schedule SB. Like the existing Schedule B, it will include a statement by an enrolled actuary, modified to reflect that the enrolled actuary no longer will be certifying as to the reasonableness of certain actuarial assumptions, which are now prescribed by the Act or will be prescribed in regulations. The remainder of the new Schedule SB will consist of basic actuarial worksheets designed to allow the DOL, IRS, and PBGC to evaluate the plan's compliance with the new defined benefit funding requirements, and will be divided up into the following sections:

- Basic Information;
- Beginning of Year Funding Standard Carryover and Pre-Funding Balances;
- Funding Percentages;
- Contributions and Liquidity Shortfalls;
- Assumptions Used to Determine Funding Target and Target Normal Cost;
- Minimum Required Contribution for Current Year; and
- Miscellaneous Items.

If a plan is "at-risk," the Schedule SB requires additional information regarding the plan's increased liabilities. Plans that are not subject to the new funding rules in 2008 (e.g., certain airlines and airline catering companies, certain defense contractors, and certain multiple employer rural cooperative plans) would not be required to provide this information, but would be required to provide certain information as an attachment.

**Schedule MB** – Because changes to the funding rules applicable to multiemployer and money purchase pension plans were not as significant as the changes to the single-employer defined benefit funding rules, the DOL, IRS, and PBGC propose using the existing Schedule B as the structure for the new Schedule MB. The old Schedule B would be modified to require the following information for multiemployer plans:

- a statement of the enrolled actuary reflecting that the actuarial assumptions must be individually reasonable;
- the plan's accrued liability, reported under the unit credit cost method;

- information on extensions of amortization periods and use of the shortfall method;
- information reflecting whether the plan is in endangered or critical status, and if so, whether the plan is complying with the requirements of the funding improvement or rehabilitation plan; and
- a schedule of active participant data.

## **B. Supplemental Changes to Form 5500, Schedule R**

Section 503 of the Act requires multiemployer plans to report the amount of assets transferred in a multiemployer plan merger, information on withdrawing employers and their withdrawal liability, information on employers contributing to multiemployer plans, and information on participants for whom no employers made contributions. The July 2006 proposed revisions generally called for the disclosure of the same information. Taking these changes together, the supplemental proposed changes would modify Schedule R to capture this information in the following ways:

- by requiring plans to provide a list of employers contributing more than five percent of the total contributions for the year (the July 21 revisions required the identification of employers contributing "five percent or more");
- by expanding the disclosure of information relating to participants for whom no employer contributions were made for the current plan year and the two preceding plan years, and information regarding the number of employers withdrawing from the plan and the assessed and estimated withdrawal liability; and
- by collecting information relating to a plan's funded percentage resulting from liabilities arising from mergers and transfers of assets.

For plans with over 1,000 participants, information relating to asset allocation otherwise required to be disclosed on Schedule B would be moved to the new Schedule R, including information relating to, among other things, the percentage of total plan assets held as stock, debt (without break-outs for

government, investment-grade, and high yield debt), and real estate.

## **C. Simplified Annual Reporting for Plans With Less Than 25 Participants**

The Act also requires the DOL and IRS to provide for the filing of a simplified annual return for retirement plans with fewer than 25 participants. The July 2006 proposed revisions allowed certain small plans to file a two-page Form 5500-SF. The DOL and IRS believe that this proposed short form meets the requirements under the Act. However, multiemployer plans would not be eligible to file the short form.

The Act's simplified reporting requirement is effective beginning in 2007. However, because the supplemental proposed changes are effective for 2008 plan years, plans that would otherwise be permitted to file a simplified form may file an abbreviated version of the current 5500 for 2007. Specific guidance regarding this simplified reporting option will be included in the instructions to the 2007 Form 5500.

## **6. IRS Wrestles With Phased Retirement Issues**

The IRS recently released Notice 2007-8 (Jan. 16 [IRS Bulletin](#)), requesting comments on the Pension Protection Act ("PPA") provision (Code sec. 401(a)(36)) allowing pension plans to make in-service distributions at age 62. Inasmuch as this provision allows a type of "phased retirement" without all of the baggage that IRS proposed to impose on such programs back in November 2004 ([Qualified Plans 2004-11](#)), IRS quite reasonably asks in the Notice whether they should finalize these rules.

The Notice reflects that IRS is struggling with whether the PPA provision allows distributions of fully subsidized benefits at age 62 – even if that is prior to normal retirement age – and, if so, how that affects the characterization of the benefits under the vesting and anti-cutback rules of Code section 411. Comments on these issues are requested by April 16. We suspect that additional issues are likely to surface as well.

Our sense is that employers should be reluctant to move ahead with changes in this area until the IRS has proposed guidance on the new PPA provision. If past experience is any indication,

this liberalization could prove to be more complex than it first appears.

## **7. Tax and Health Care Package Enacted**

In the closing days of the 109<sup>th</sup> Congress, the House and Senate each passed the Tax Relief and Health Care Act of 2006 (H.R. 6111) (the "Act"), which President Bush signed into law on December 20 (Pub. L. No. 109-432). The Act includes long-awaited extensions of a number of expiring tax provisions (so-called "tax extenders"), including the research and development tax credit, state sales tax deduction, and the deduction for college tuition payments. The Act also contains controversial trade provisions as well as changes to the Medicare physician payment provisions.

Notably, the Act includes several significant expansions to the Health Savings Account ("HSA") provisions, such as increases to the HSA contribution limits and administrative simplifications. The Act also makes changes to the incentive stock option ("ISO") and employee stock purchase plan ("ESPP") tax reporting requirements, and provides some relief to certain individuals who incurred significant alternative minimum tax ("AMT") liabilities in the early 2000s as a result of exercising ISOs. A brief overview of these provisions follows.

### **A. HSA Provisions**

The HSA provisions – which generally are the same as those that included in a bill (H.R. 6134) approved by the Ways and Means Committee in late September – were a late and largely unanticipated addition to the Act. From a retirement plan perspective, the most notable provision in the Act permits individuals to make a one-time transfer of amounts in an IRA to an HSA. The transferred amounts would not be includible in income or subject to the additional 10% tax on early withdrawals from an IRA. The transferred amount would, however, count against the maximum HSA contribution limit for the year (e.g., \$2,850 for self-only and \$5,650 for family coverage for 2007). If, at any time during the 13-month period beginning with the month of the transfer, the individual is no longer an eligible individual under the HSA rules (e.g., the individual is no longer covered by a high deductible health plan (HDHP)), the transferred amounts would be includible in income and subject to an additional 10% tax. The provision is effective for taxable years beginning after 2006.

Among other things, the Act also makes the following changes (again generally effective for taxable years beginning after 2006, unless otherwise noted):

- increases the limit on contributions to HSAs so that it is not limited to the annual deductible of the HDHP; instead, contributions would be limited only by the indexed dollar amount (\$2,850 self-only; \$5,650 family for 2007);
- allows individuals who become covered by an HDHP after January to contribute up to the full annual limit, even though they were only eligible individuals for a portion of the year;
- effective after the date of enactment, permits an individual to transfer (before January 1, 2012) the balance remaining in his or her health FSA or HRA account as of September 21, 2006 (or, if less, the balance on the date of the transfer) to an HSA; and
- allows employers to make contributions to HSAs on behalf of non-highly compensated employees in higher amounts (or higher percentages of deductibles) than to highly compensated employees without violating the "comparable contribution" rules.

More details on the HSA changes are included on our website ([www.groom.com](http://www.groom.com)).

### **B. ISO/ESPP Reporting**

Under Code section 6039(a), a corporation that transfers stock to an individual pursuant to the exercise of an ISO must provide the individual with a written statement regarding the transfer. Similarly, a corporation must provide a written statement to any individual who transfers shares of stock acquired under an ESPP at a price of between 85 and 100 percent of the value of the stock at grant. The statements are required to be provided by January 31 of the following year.

The Act amends Code section 6039 to require employers in these circumstances to also file a return with the IRS "at such time and in such manner, and setting forth such information, as the Secretary may by regulations prescribe." It is likely

that upcoming regulations will require that the return be filed by either the end of January or February of the following year and include information similar to that required by the regulations under the individual statement requirements of current law. Treas. Reg. § 1.6039-1.

The new reporting requirements will apply beginning in 2007, with the new IRS report likely due by the end of January or February in 2008.

### **C. ISO AMT Relief**

The exercise of an ISO does not result in any taxable income for regular income tax purposes as long as certain holding period and other requirements are satisfied. The spread on the exercise of an ISO is, however, treated as alternative minimum taxable income under the AMT rules. In general, individuals who are subject to the AMT as a result of the exercise of an ISO receive a tax credit in the year the stock is sold that can be used to offset the regular income tax (as reduced by certain other nonrefundable credits) to the extent it exceeds the AMT tax in future years. Unused credits may be carried forward indefinitely and used in later years. If, however, the stock is subsequently sold for less than the amount paid for the stock upon exercise, an individual may not be able to ever fully use the credit to offset regular income tax liabilities because of the \$3,000 limit on the deductibility of net capital losses. In particular, this has been a huge problem for employees of once high-flying technology companies who exercised their ISOs in the early 2000s before the large "correction" in the equity markets.

In general, the Act provides a special rule under which an individual can use a refundable tax credit against the regular income tax of up to 20% per year (or the lesser of \$5,000 or the full amount of the unused AMT credit, if the unused credit is less than \$25,000) of any unused AMT credit attributable to tax years before the 3<sup>rd</sup> taxable year preceding the taxable year (e.g., 2003 or before for the 2007 tax year). The credits can be used beginning with the 2007 tax year through the 2012 tax year. The special rule phases out for individuals above certain income limits.

## **8. IRS "Cumulative List of Changes in Plan Qualification Requirements" For 2007 Determination/Opinion Letter Submissions**

Beginning February 1, 2007, the IRS will open the determination letter process to (a) "Cycle B" individually-designed plans (i.e., individually-designed plans sponsored by an employer whose EIN ends in 2 or 7), (b) multiple employer plans, and (c) pre-approved (i.e., prototype and volume submitter plans) defined benefit plans. The IRS will review these plans for compliance with the EGTRRA and other post-GUST changes listed on the recently issued 2006 Cumulative List. Notice 2007-3 (Jan. 8, 2007 [IRS Bulletin](#)). The favorable letters issued by the IRS on these plans will cover only the items listed on this Cumulative List. Generally, sponsors should file these plans with the IRS for review between February 1, 2006 and January 31, 2007. However, mass-submitters and national sponsors should submit their pre-approved plans by October 31, 2007. (See [Qualified Plans 2005-8](#) for a detailed description of the new determination letter procedures.)

In addition to the items on prior Cumulative Lists, the new List includes quite a few new items. Most notably:

- PPA Provisions – Several items on the Cumulative List reflect changes made by the Pension Protection Act of 2006 ("PPA") that are effective in 2007 or earlier. For example, the List includes the new provision allowing a nonspouse beneficiary to roll over a plan distribution to an IRA. Other PPA items include diversification requirements for publicly traded employer stock, liberalized 401(k) hardship rules, cash balance and hybrid plans, and more rapid vesting of nonelective employer contributions.
- Sponsors of pre-approved defined benefit plans must include these provisions in their plans, and the IRS opinion/advisory letters will cover them (except for cash balance/hybrid plan provisions). In contrast, sponsors of individually-designed plans may include PPA provisions in their plans, but the IRS determination letter will not cover

them. Sponsors who do make PPA changes nevertheless must identify them in the application. Of course, terminating plans must reflect all applicable provisions for the year of termination and the IRS letter will cover them.

- **New Section 415 Regulations** – The Cumulative List includes changes required pursuant to the soon-to-be issued final section 415 regulations. Proposed regulations were published in May 2005 (Qualified Plans 2005-5). Surprisingly, IRS is sticking with a 2007 limitation year effective date for these regulations – which are likely to add complexity and make changes in a number of important areas.
- **Miscellaneous Provisions** – The Cumulative List includes a number of other new items for which the IRS has yet to publish final guidance. These include items addressing (a) permissible "normal retirement ages" under Code section 401(a) and (b) Roth 401(k) distributions (proposed regulations were published in January 2006 (Qualified Plans 2006-1)).

In light of the fact that Cycle B plans have to reflect a number of items for which the IRS has yet to issue final guidance, most sponsors are likely to submit their plans later in the filing cycle – after all relevant IRS guidance has become available and been digested. Unfortunately, individually designed plan sponsors apparently will have to wait for the next cycle of filings (beginning in 2011) to obtain protection for PPA changes.

## **9. IRS Waives Reporting of 409A Deferrals for 2006, But 2005 and 2006 Violations of 409A Trigger Last Minute Reporting and Withholding Obligations**

The IRS announced in Notice 2006-100 (Dec, 18 IRS Bulletin) that employers will not be required to report on 2006 Forms W-2 (or 1099-MISC) amounts deferred in 2006 that are subject to Code section 409A. However, the IRS decided not to waive reporting of section 409A violations that occurred in 2006 or 2005 or the withholding requirements related to 2006 violations. We

summarize below what this "interim guidance" means for employers and employees.

### **Reporting of Deferred Amounts**

Employers generally must report the annual amount deferred under a nonqualified plan subject to section 409A on an employee's Form W-2 with a Code Y in box 12 (Form 1099-MISC for independent contractors). Last year, the IRS issued Notice 2005-94 making Code Y reporting optional for 2005. Notice 2006-100 does the same for 2006. Because the IRS has yet to provide guidance on how to calculate the "deferred amounts" to be reported, employers will understandably be relieved by this guidance.

### **Violations of Section 409A and Includible Amounts**

If a violation of section 409A occurs with respect to an employee participating in a nonqualified plan, all vested amounts deferred for the employee under the plan that are subject to section 409A become immediately includible in the employee's taxable income (the "Includible Amount"). Thus, the employee will owe federal income tax on the Includible Amount in the year of the violation. The employee will also owe an additional tax equal to 20 percent of the Includible Amount and interest.

The Notice provides rules on how to calculate the Includible Amount for an employee based on a 2006 violation under a nonqualified plan. Generally, the Includible Amount equals the amount of plan benefits received by the employee in 2006 plus the vested "amount remaining deferred" under the plan at December 31, 2006. For violations involving a retirement plan, the "amount remaining deferred" is based on rules in the FICA tax area (Code §3121(v)(2)). For violations involving stock rights (e.g., discounted options), the "amount remaining deferred" is generally equal to the spread on the stock right. For other violations (e.g., transfer to a foreign trust after March 21, 2006), a reasonable, good faith approach is required.

As feared, the Notice makes clear that the plan aggregation rules announced in Notice 2005-1 and the proposed regulations under section 409A apply for purposes of determining the Includible Amount. Thus, a violation under one arrangement subject to 409A (e.g., exercise of a discounted option) could cause amounts deferred under all similar arrangements subject to 409A (e.g., other outstanding discounted options) to be includible in

income. However, IRS officials have indicated informally that the spread on discounted options that are outstanding at December 31, 2006 does not have to be included in income if the discounted options can still be replaced with non-discounted options under the transition relief available under section 409A, as extended by Notice 2006-79.

### **Reporting and Withholding on 2006 Violations**

Employers are required to report Includible Amounts for an employee based on a violation of section 409A during 2006. These amounts must be reported in boxes 1 and 12 of 2006 Form W-2 with a Code Z in box 12. Employers are also required to report Includible Amounts for an independent contractor based on a 2006 violation of section 409A (reporting in box 7 and 15b of 2006 Form 1099-MISC).

Employers must also withhold federal income taxes on such Includible Amounts for employees. The IRS provides detailed guidance in the Notice on the withholding and deposit requirements for such amounts and confirms that no additional withholding is required with respect to the 20 percent additional tax and interest. In brief, the IRS guidance includes two relief provisions to assist employers in meeting their withholding obligations, provided that the taxes are deposited by January 31, 2007.

Transition relief available under section 409A should dramatically limit the number of 2006 violations. However, the IRS has taken the position that the exercise in 2006 of certain options or stock appreciation rights ("SARs"), in particular discounted options or SARs, will result in a violation.

### **Reporting on 2005 Violations**

Last year, the IRS waived reporting of 409A violations occurring in 2005, but warned that employers might be required in the future to file amended 2005 Forms W-2 to report these violations. Unfortunately, the IRS is now requiring such amended returns. Thus, employers must file corrected Forms W-2 or 1099-MISC reporting Includible Amounts resulting from a 2005 violation (determined in the same manner as for 2006 violations) by the fast approaching due date for 2006 returns.

No federal income tax withholding is required with respect to Includible Amounts related to 2005 violations.

Given the particularly liberal transition relief available under section 409A during 2005, including relief for the exercise of discounted options, there should be few reportable violations.

### **Effect of Employer Compliance With Notice**

While Notice 2006-100 is only "interim guidance" on these issues, employers who comply with the Notice will avoid reporting and withholding penalties. They will also not be required to revisit 2005 and 2006 reporting and withholding if future IRS guidance provides different rules (e.g., on calculation of Includible Amounts).

### **Guidance for Employees**

Employees are required to report and pay regular income taxes, the 20 percent additional tax, and interest on Includible Amounts (calculated as described above) for 2005 and 2006. If an employee did not do so with his 2005 return, he will be required to file an amended 2005 return (Form 1040-X) and pay any additional taxes due. An amended 2005 return needs to be filed by the due date for the 2006 return, including extensions. The Notice provides guidance on the calculation of interest and warns employees of estimated tax penalties for failure to adequately withhold for 2006.

Similar to the relief provided employers, employees will not be subject to penalties for underreporting (and underpaying taxes, and related interest) with respect to Includible Amounts for 2005 and 2006 if they report and pay any taxes due with respect to such amounts in accordance with the Notice requirements.

### **FICA Taxes Not Addressed**

The Notice makes clear that it has no impact on the FICA treatment of nonqualified deferred compensation subject to Code section 3121(v)(2) and does not address FICA treatment for other amounts (e.g., discounted options).

### **Request for Comments**

As noted above, the Notice provides interim guidance on these reporting and withholding issues. The IRS continues to work on further guidance on these topics and specifically requests comments on these issues.

## **10. SEC Revises Proxy Disclosures on Equity Awards**

The Securities and Exchange Commission (the "SEC") recently changed its rules governing public company disclosures of executive and director compensation. Specifically, the SEC changed the rules for reporting the annual amount of compensation received from option and other stock awards from the rules the agency had "finalized" in August (Qualified Plans 2006-8). 71 Fed. Reg. 78338 (Dec. 29, 2006).

One of the major changes the SEC made in August was to require that a single total compensation figure be provided for each covered executive and Board member each year. Under the new rules, this annual figure was to include the full value of option and other equity awards made during a year. For example, if an executive was granted restricted shares in 2006 valued at \$100,000 and vesting in four years, the full value of \$100,000 would be included in the annual compensation figure for 2006.

Under the revised rule issued last week, the total annual compensation figure will instead include an equity compensation amount based on the expense recognized in the company's financial statements for the year based on such awards (regardless of when the awards were made). Generally, this amount will be calculated under FAS 123R based on the portion of such awards earned for services performed during the year. Thus, in the example above where the award vests over a four-year service period, only \$25,000 ( $\$100,000/4$ ) would be included in the annual compensation figure for 2006.

While the full value of option and other equity awards (the \$100,000 value in the above example) is not included in the total annual compensation number, the new rule still requires disclosure of the full value of awards made during a year. This information will be shown for covered executives in a column newly added to the "Grants of Plan-Based Awards" table in the proxy, and will be provided in a footnote for Board members.

The SEC proxy disclosure requirements apply to a company's principal executive officer, principal financial officer, and three other most highly compensated executive officers. The determination of the most highly paid officers each year is based on the total annual compensation number described above (less certain amounts related to retirement benefits). Thus, the change in computing the annual

compensation related to equity awards could impact which of a company's officers will be treated as one of its most highly compensated. In particular, large irregular equity awards should have less impact on the determination.

The SEC will consider comments made within 30 days on this "interim final rule," which will be effective (along with the other recent changes) for the 2007 proxy season.