■ EMPLOYEE BENEFITS UPDATE

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Legal News: Employee Benefits Update is part of our ongoing commitment to providing legal insight to our clients and our colleagues.

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Thank you.

Harvey Kurtz
Managing Editor

Employee Benefits Developments for January/February 2007

Qualified Retirement Plans

IRS issued guidance on the new rollover alternative for non-spouse beneficiaries of qualified plan accounts (Notice 2007-7). The announcement provides that a qualified plan may, but is not required, to permit rollovers to non-spouse beneficiaries. Preliminary understandings of this provision of the Pension Protection Act of 2006 ("PPA") suggested that non-spouse beneficiaries would have an independent right to make such rollovers and a plan amendment would not be required. Under current rules of the IRS, this amendment is optional and, therefore, must be adopted by the end of the 2007 plan year in order to authorize any non-spouse beneficiary rollovers allowed by a plan during the 2007 plan year. A non-spouse beneficiary rollover must be a plan-to-IRA transfer made from a plan qualified under Code Section 401(a) or a 403(b) or governmental 457(b) plan. Non-spouse beneficiary rollovers are not subject to the direct rollover rules (Code Section 401(a)(31)) — which is the reason adding them to a plan is optional, the notice requirements of Code Section 402(f) — so no tax advice notice needs to be provided, or the mandatory withholding requirements of Code Section 3405(c). The appeal to non-spouse beneficiaries of this provision is, in general terms, that they may be able to take the money into income over their entire life expectancy, instead of, for example, over a period as short as 5 years. The rules are complex so caution in applying them is advised.

IRS issued guidance on the provision included in the PPA that permits qualified plans to be amended to permit hardship payouts for the designated beneficiary of a participant in a 401(k) plan or a 403(b) Plan. There are six categories of reasons for hardship withdrawals sanctioned by the 401(k) regulations: medical care, principal residence purchase, post-secondary education tuition and fees, funds needed to prevent eviction, funeral or burial expenses, and expenses to repair damage to one's home that would qualify for the Code's casualty deduction. Under prior law, hardship withdrawals could only be made based on hardship of the participant, and, in certain cases, the participant's spouse and dependents.

Beginning in 2007, plans may be amended to permit hardship withdrawals based on the financial hardship of a primary beneficiary of a participant. A primary beneficiary for this purpose is someone who is named as a beneficiary under the plan, and has an unconditional right to all or part of the participant's account balance under the plan upon the participant's death. All other hardship withdrawal requirements must also be met.

Similar guidance is expected later for 457(b) plans and nonqualified deferred compensation plans under Code Section 409A that authorize withdrawals upon the occurrence of an "unforeseeable emergency."

The owner of an IRA is a disqualified person (for prohibited transaction rule purposes) and cannot invest the assets of his IRA in notes issued by his daughter and son-in-law's 95 percent-owned business. This ruling may seem obscure at first glance, but IRAs, including rollover IRAs, are frequently very large, and we are often asked to what extent these sources of capital may be used in entrepreneurial ways. This ruling helps illustrate some of the limitations.

IRAs are subject to the prohibited transaction rules in Code Section 4975 (which rules also apply to qualified plans), but it is the Department of Labor, not the IRS, that makes the rulings as to how this section should apply to various situations. IRA owners are considered to be "fiduciaries" with respect to the IRAs they own. Fiduciaries are strictly prohibited from lending money to plans (in this case the IRA) as to which they are a fiduciary.

If a person is a fiduciary, so are that person's spouse, parents, children, and spouses of children. In addition, a fiduciary is considered to own any corporation which is owned 50 percent or more by members of his family. The Department of Labor concluded on these facts, that the IRA purchase of notes from the IRA owner's children's company (which the IRA owner is considered to own) is a prohibited extension of credit by a plan fiduciary to a plan as to which he is a fiduciary.

The impact of a prohibited transaction in an IRA is the current taxation of the entire IRA account balance, not just the portion of the IRA engaged in the prohibited transaction. This is not to say IRAs cannot be used in some creative entrepreneurial ways. However, there are significant restrictions. This ruling is a good illustration of several of those restrictions.

IRS recently published a checklist for sponsors of 401(k) plans to help them keep their plans in compliance with the law. If you view it on-line, you can link to more extensive documentation on any question in the checklist. It may be time well-spent, either to reaffirm that your plan is in good shape or to find potential problem areas before the regulators do. The checklist is at: http://www.irs.gov/pub/irs-tege/pub4531.pdf.

Employee Welfare Benefit Plans

The Treasury Department released guidance on rollovers from health Flexible Spending Accounts (FSAs) and Health Reimbursement Arrangements (HRAs) to Health Savings Accounts (HSAs) (Notice 2007-22). The Tax Relief and Health Care Act of 2006, enacted December 20, 2006 (and summarized in our January Employee Benefits Newsletter), allowed employers to amend their health FSAs and HRAs to provide for a one-time rollover to HSAs (called "qualified HSA distributions") by 2012. The following points are included in the guidance:

- An individual with a $-0- balance at plan year end, participating in a health FSA with a three-month grace period, may disregard general purpose health FSA coverage and be HSA eligible on the first day of the next plan year. The $-0- balance is to be determined on a cash basis and cannot take into account expenses incurred but not yet reimbursed as of the end of the year.
- An individual with a $-0- balance at plan year end in a general purpose HRA, similarly determined on a cash basis, can be HSA eligible on the first day of the next plan year if the individual has waived HRA coverage for the year or if the employer, for all participants, either terminates the HRA or converts it to an HSA-compatible design.
- Under the new rollover rules, a health FSA or HRA must satisfy all of these conditions by the end of the plan year in order for a qualified HSA distribution to be made: the plan must be amended to permit the rollover; the employee must elect the rollover; and the year end balance must be frozen. The funds must than be transferred within two and a half months after the end of the plan year and the resulting balance in the health FSA or HRA must be zero.
- The qualified HSA distribution may not exceed the lesser of the balance in the health FSA or HRA on September 21, 2006, or as of the date of the distribution.
- A person who participated in the health FSA of one employer on September 21, 2006, and later participates in

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The Employee Benefits attorneys of Foley & Lardner LLP counsel employers on employee benefits and executive compensation matters to reduce exposure to employee complaints, governmental agency actions, and union-related problems. We counsel on health, dental, disability, life insurance, severance, cafeteria, and flexible benefits plans. Our counsel also extends to Medicare and Social Security benefits, COBRA compliance, and post-retirement benefits issues. We also advise clients in resolving benefits issues arising in mergers and acquisitions. We work closely with Foley trial lawyers who represent corporations and their benefit plans in litigation involving employment benefits and other obligations under ERISA.

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the health FSA of another employer, may not elect a qualified HSA distribution from the second health FSA.

A very short transitional rule is made available that expires on March 15, 2007. It is for participants who want to be HSA eligible by April 1, 2007, but who also have a balance in their health FSA (which must have a 3-month grace period as part of the plan) or HRA after December 31, 2006. Under the transitional rule, the plan amendment must be completed by March 15, 2007; the participant's election and the distribution must be completed by March 15, 2007; and there is no prohibition under the transition rule on making reimbursements from the health FSA or HRA after year-end (although the distribution balance must still be calculated on a cash basis).

Executive Compensation

A senior Treasury Department official said, on January 25, 2007, that the final Code Section 409A regulations "should be issued before the end of the first quarter of 2007." We'll see.