

THE ERISA LAW GROUP, P.A.

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ERISA ACTION REQUIRED AND NEWS BRIEF

TO: CLIENTS AND COLLEAGUES

DATE: NOVEMBER 2005

You might be required to take action immediately to meet deadlines. Please scan this page to determine the items that might apply to you.

- (a) New Pension Plan Limitations for 2006
- (b) Automatic Rollover Issues – December 31, 2005 Deadline
- (c) Update on Rights of Your Employees Called for Military Service – Notice Now Required
- (d) Reminder: Get 401(k) Funds into the Plan Promptly
- (e) New Determination Letter Procedures - Warning
- (f) 2006 Changes to Health Plans for HIPAA Portability
- (g) 401(k) Safe Harbor Notices Must Be Distributed Now
- (h) Grace Period for Unused Cafeteria Plan Contributions – December 31, 2005 Deadline

Our goal is to keep our clients on solid legal ground with respect to their ERISA plans, to stay clear of expensive plan mistakes, and to enable clients to understand and achieve their ERISA goals.

FIRM ACHIEVEMENT

Jeffery Mandell of The ERISA Law Group, P.A. has been named to BEST LAWYERS IN AMERICA 2006. Jeff has garnered this prestigious award for 11 years in a row, making him among a select group of attorneys nationwide. BEST LAWYERS is a peer-review of 18,500 U.S. attorneys on the legal abilities of attorneys.

WELCOME

○ The ERISA Law Group, P.A. welcomes **Sandra “Sam” McCue** to the firm. Sam has over 22 years of administrative assistant/paralegal experience, and began working with the firm in March of this year.

*Achieving your employee benefit objectives...Solving your employee benefit problems
Clients locally and coast to coast...Since 1982*

Sam is a graduate of the University of Washington, with a degree in Interdisciplinary Arts and Sciences with high honors. She is originally from the Treasure Valley and recently returned to this area from a 15 year stint in Seattle. Sam (who drafted this) brings balance, beauty and humor to our firm.

○ The ERISA Law Group, P.A. also welcomes **Lannette “Lynn” Miller**. Lynn formerly worked with Jeff at Hawley Troxell Ennis & Hawley, and we were fortunate to find her available to work with us. Lynn has 23 years of administrative assistant experience and will be working on a part-time basis.

Welcome Sam and Lynn!

(a) IRS ANNOUNCES NEW PENSION PLAN LIMITS FOR 2006

Various retirement plan limits are subject to annual cost-of-living and/or statutory adjustments. Particularly for key employees of companies, the new 2006 increased limits are welcome and encouraging. Here are some of the more commonly applicable new limits.

Maximum Contribution to 401(k), Profit Sharing and other Defined Contribution Plans

Increases from \$42,000 to \$44,000 for 2006

As a result, the most an employee can receive in the 2006 plan year in the way of employer and before-tax employee contributions, and forfeitures, in total, is the lesser of (a) \$44,000 or (b) 100% of annual recognized compensation. For most plans, the limit will apply for the plan year January 1 to December 31, 2006.

Warning – Employer contributions are still limited to a 25% of pay deduction limitation. As a result, participants of small employers may not be able to receive the \$44,000 or 100% of pay allocation.

Pre-Tax Section 401(k) Employee Contribution Limit

Increases from \$14,000 to \$15,000 for 2006

Section 457(b) and Employee Contribution 403(b) Limits

Increases from \$14,000 to \$15,000 for 2006

Age 50 Catch-up Contribution

Increases from \$4,000 to \$5,000 in 2006

Maximum Annual Recognized Compensation

Increases from \$210,000 to \$220,000 for 2006

To limit retirement plan accumulations for high paid employees, as well as to increase contributions for non-high paid employees, retirement plans generally may only recognize compensation up to this limit.

Highly Compensated Employee Threshold

Increases from \$95,000 to \$100,000 for 2006

Under ERISA's nondiscrimination rules, the employee population is divided into two groups – the highly compensated employees and the nonhighly compensated employees. A highly compensated employee generally is an employee who owns more than 5% of the employer sponsoring the plan or whose compensation in the preceding year exceeds a certain threshold (which will now be \$100,000).

Defined Benefit Plan Limit

Increases from \$170,000 to \$175,000 for 2006

In a defined benefit plan, the law limits the annual pension payable to the participant upon retirement (as opposed to limiting the annual additions going into a defined contribution plan – See Maximum Contribution above). If you desire to accumulate possibly significant retirement benefits over and above the \$44,000 annual defined contribution limit, a defined benefit plan should be explored.

Social Security Tax Wage Base

Increases from \$90,000 to \$94,200 for 2006

This change in the wage base will affect the way in which employer contributions are allocated to participants in “integrated” plans.

(b) AUTOMATIC ROLLOVER ISSUES – December 31, 2005 Deadline

If you have already addressed this issue, which has a December 31, 2005 deadline, you may skip this item.

Qualified retirement plans are required to allow a participant to keep his or her funds in the plan after he or she terminates employment until his or her normal retirement date. However, most terminatees desire to receive a distribution upon termination and respond to the tax notice and elect a method of distribution. But if a terminatee does not respond and his or her total benefits (not including amounts rolled into the plan) equal \$5,000 or less, most plans are required to provide a lump sum distribution to the former employee. If the terminatee's benefits exceed \$5,000 and he/she does not elect payment, then the plan may not force out such participant's benefits.

Once a plan has 100 or more participants, including former employees with plan account balances, ERISA requires the plan to hire an accounting firm to perform an annual audit, with the expense in time and fees that the audit entails. A plan is permitted to defray the costs of maintaining accounts for former employees by charging such costs (if reasonable) to their accounts. This may encourage terminatees to take distributions and is true even if the plan does not charge maintenance costs to current employees.

Congress changed the law, effective for distributions on and after March 28, 2005, to give the employer two choices for distributions of \$5,000 or less. Both of these choices involve changing plan documents and procedures.

- One choice is to lower the \$5,000 threshold for mandatory cash-outs to \$1,000. If the terminnee has up to \$1,000 in benefits and does not respond to the distribution election request, the plan will withhold 20% for federal income taxes and issue a check for 80% of the benefits (the terminnee can modify the 20% amount of withholding by filing a request for modification). If the terminnee has \$1,000 or more payable to him/her and does not elect a distribution, the plan must retain the participant's benefits. Small employers choose this alternative more often than they choose the next alternative, due to its ease of administration. The drawback of this option is that it can add to the plan's number of participants. This can eventually force the plan to incur the cost of an annual audit and it requires ongoing legal and administrative responsibility for these small accounts.

- The alternative is to keep the \$5,000 threshold for cash-outs. If the participant has up to \$1,000 in benefits and does not respond to the request for a distribution election, the plan will issue a lump sum distribution less 20% withholding as above. If the participant has more than \$1,000 but not more than \$5,000 in benefits and does not respond to the request for a distribution election, the plan can't just cut a check. The plan must instead automatically roll the benefits over to an individual retirement account (IRA) in the name of the terminnee. Such default IRAs require some administrative groundwork. This includes an agreement with a financial institution to accept the accounts for limited fees and in accordance with Department of Labor requirements, the review of the agreement by legal counsel, and written notice to the employees. Benefits over \$5,000 cannot be cashed out or rolled over without the participant's consent. The second alternative slows the growth in the number of participants and alleviates the employer's legal responsibilities for these amounts once they are rolled over.

There are pros and cons of each approach as applied to each employer's situation. For some employers, the first alternative is best. For others, the second alternative is most suitable. The approach your recordkeeper is recommending on a client-wide basis may or may not be most appropriate for you.

Either way, for plan years ending on December 31, 2005, the employer must adopt the amendment in writing and have everything in place by December 31, 2005. For our clients, your plan is already amended or is in process. If you have any questions as to whether you are on our list of required amenders for this matter, contact us.

**(c) UPDATE ON RIGHTS OF YOUR EMPLOYEES
CALLED FOR MILITARY SERVICE – NOTICE REQUIRED**

The Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) applies to virtually all employers and gives rights to employees who leave their civilian jobs to serve in the "uniformed services." We are concerned that many employers may not be complying with this law. In brief, employees who perform service must be in the same position with respect to employment and benefits that they would have been in if they had not left to perform military service.

The Veterans Benefits Improvement Act of 2004 (VBIA) requires employers to give employees notice of their rights and employers' obligations under USERRA. The Department of Labor has published the text of the required notice. Employers may post the notice where employee notices are customarily placed. Alternatively, employers may give the full text of the required notice to employees in other ways, including handing or mailing the notice to employees or distributing through electronic mail. The notice is available in poster form from the Department of Labor's website (<http://www.dol.gov/vets/>) or from this law firm on request.

The uniformed services are broadly defined to include the regular armed services including the Coast Guard, the reserves, the National Guard, and the uniformed corps of the U.S. Public Health Service. In general and with a number of exceptions, if the employee gives advance notice of his or her deployment and serves for up to five years, he or she must be treated as if he or she is on a leave of absence.

- Reemployment. If the individual timely applies for reemployment upon his or her return from service, then he or she is entitled to the same job he or she previously had with the employer. He or she must be given the promotions and raises that he or she would have had if he or she had remained on the job while serving in the uniformed services, and be given any necessary training to qualify for that "escalated" job.

- Retirement plan contributions. USERRA applies to all types of retirement plans, including qualified and nonqualified plans, SEPs, SIMPLEs, 457s, and 403(b)s. If the individual returns to his or her job, the employee must be treated as employed (for up to 5 years) while in the service for purposes of eligibility, accrual and vesting, and must be credited with the employer's contributions that would have been made during his or her absence. This includes matching, profit sharing and money purchase contributions, and defined benefit accruals. For 401(k) contributions, the employee has a period of time after reemployment (up to 5 years) to make these contributions. Earnings and forfeitures are not required to be credited to the employee. The compensation that must be used to calculate the contributions is the compensation that the employee would have earned if he or she had remained actively employed.

- Retirement plan loans. The maturity date of any loan from the plan is extended by the period of service, and the plan sponsor may design the plan to suspend loan repayments, although interest continues to accrue, during the period of service. A separate law, the Servicemembers Civil Relief Act, requires that interest rates charged on loans to individuals in military service must be capped at 6%. The plan's DOL-required written loan policy must reflect the loan provisions as applied to servicemen.

- Health benefits. Even if the employer is too small to be covered by the federal COBRA law, the individual must be given the opportunity to pay for health benefits for up to 24 (formerly 18 before the VBIA) months of the period of military service. He or she has a right to be reinstated to health benefits upon reemployment without waiting periods or preexisting condition exclusions.

Summary plan descriptions must be amended to take into account USERRA and VBIA. Employees need to be informed that if they return to work, for even *one day*, then they are entitled to USERRA's ERISA benefits. This is very material information which, if omitted from

the plan's SPD, would place the employer at risk for making up all of the missed contributions, including the 401(k) contributions, plus ongoing earnings thereon.

(d) REMINDER: GET 401(k) FUNDS INTO THE PLAN PROMPTLY

We have previously written about the Department of Labor's (DOL) deadlines for sending withheld 401(k) contributions (salary deferrals) to the trustee of your 401(k) plan. This is a high priority enforcement area for the DOL with potentially severe penalties. With the increasing complexity of 401(k) plans, we have seen an increase in late contributions in both small and large employers. A reminder on this subject is timely.

The DOL regulations state that deferrals must be deposited into the trust *by the earliest date when the contributions can reasonably be segregated from the employer's general assets*, and in no event later than the 15th business day of the month following the month in which the deferrals were withheld.

A common misconception we still hear is that the 15th business day of the following month is the deadline. *Not true!* You must determine when the deferrals could reasonably have been put in the trust – which can be as soon as 1 to 3 days after the funds were withheld – as applied to your specific payroll facts and circumstances.

We sometimes counsel clients to look at the timing of their actual deposits. If you have been able to deposit the deferrals by, say, the second business day after the payroll date on several occasions, then that history shows that a second business day deadline is feasible, and such date may become the deadline for deposit. Longer time frames for deposit must be justified by objective business factors.

Failure to timely deposit 401(k) contributions is both a "prohibited transaction" and a fiduciary breach under ERISA. It is treated as a prohibited loan from the plan to the employer, and in egregious cases, an embezzlement of plan assets. The income that the deposits would have earned had they been timely deposited must always be restored to the plan by an employer contribution, and an IRS penalty tax must be computed and paid based on the time value of the money. The late deposits must be reported to the Government in the plan's annual Form 5500. A knowing failure to report is a crime; worst case, the sanction for failures to timely deposit can (and does with regularity) escalate to jail time and fines.

Applying the DOL's regulations to each employer's facts and circumstances, in order to determine the date by which deposits should be made, is not a difficult task. Given this topic is always on the very top of the DOL's audit list, this determination is a prudent exercise.

(e) NEW DETERMINATION LETTER PROCEDURES

Many clients with 401(k), profit sharing and pension plans who have been with us for more than one or two years are familiar with the process of applying for and obtaining a determination letter from the Internal Revenue Service (IRS) on the qualification of your plan. Under existing procedures, an employer submits a given plan for a determination letter only upon plan establishment, or after amendments have been made in response to major legislative changes, or upon the occurrence of such events as a plan design change, merger, spinoff, or termination. The existing IRS procedures created huge peaks in workload, both for practitioners

such as this firm and for the IRS, as plans nationwide all were amended and submitted for determination letters at the same time (for example, the GUST process that ended in 2004). In part because of this huge burden the procedures created, the IRS continually extended the deadlines for amendments and submissions which made the process even more elusive, complex and prone to error. The risks of not properly handling the determination letter process are severe.

After years of study, the IRS has restructured the determination letter process to implement a system of staggered, cyclical submissions that will even out the work flow and better use both practitioner and IRS resources. Effective in 2006, individually-designed plans will now need to be submitted every five years, and pre-approved plans (such as prototype plans) will need to be submitted for opinion letters (at the level of the sponsoring office such as this firm, not at the level of the adopting employer) once every six years. The years in which the submissions will be made will be based on the last digit of the sponsor's federal employer identification number, which will have the effect of randomly and evenly distributing the workload over time. Plans will not need to apply for a letter more often than once in each five-year or six-year period, as applicable, although more frequent applications will be possible. The new procedures also even out the timing of required plan amendments (some of which generally will need to be submitted for approval and some of which will not be submitted).

We will provide more information on the new system as it becomes relevant to your specific plan.

Warning

An unfortunate trend continues to gather popularity. Increasingly, plans are not being submitted to the IRS for determination letters. Recordkeepers and financial institutions increasingly seem to either advise employers that the determination letter process is not valuable, or they fail to engage in a discussion regarding the merits of determination letters. In numerous, if not most, instances, the decision to not obtain a determination letter is, at worst, highly imprudent and, at best, unfair to the client who unknowingly assumes significant risks and/or gives up certain advantages. Often the reasoning underlying the decision to not obtain the letters is seriously flawed.

(f) 2006 CHANGES TO HEALTH PLANS FOR HIPAA PORTABILITY

New federal regulations under the Health Insurance Portability and Accountability Act of 1996 (HIPAA) go into effect as of the beginning of the first plan year that begins on or after July 1, 2005. Health plans with calendar plan years must comply as of January 1, 2006. Summary plan descriptions, enrollment materials, and other employee communications should be revised to reflect the following changes:

- **Notice of federal rights.** If your plan excludes coverage for pre-existing conditions (most plans do), you must provide a notice of the federal limitations on such exclusions, including the participant's right to obtain credit for previous coverage that could shorten the period of exclusion. You must disclose procedures for a participant to obtain a certificate of creditable coverage from a prior plan for credit against your plan's exclusion period, and from your plan to be provided to a subsequent plan when the employee leaves your employment.

- Certificate of creditable coverage. Plans are required to certify creditable coverage when coverage ends for a participant or upon a participant's request. The certificate now must contain an educational statement on HIPAA portability rights.
- Changes to special enrollment rights. The disclosure of special enrollment rights upon loss of other coverage and upon addition of a new dependent due to birth, adoption or placement for adoption has been changed. Special enrollment is now available if an individual has declined coverage under the employer's plan due to having other coverage, and such other coverage is no longer available because he or she has reached a maximum lifetime limit for benefits, no longer lives or works within the coverage area of the other coverage, or no longer qualifies as a dependent child due to having attained more than the other coverage's maximum age for dependent status.

Please contact us if you would like us to provide language you may use to satisfy the new disclosure requirements. If we are responsible for your health plan document matters, we will contact you shortly.

(g) 401(k) SAFE HARBOR NOTICE MUST BE DISTRIBUTED NOW

If you maintain an Internal Revenue Code cash or deferred arrangement (CODA, more commonly known as a § 401(k) plan), and if that plan is a so-called "safe harbor" providing either a required matching contribution or required 3%-of-pay profit sharing contribution, then the safe harbor's notice requirements apply to you. You must distribute a safe harbor notice to the participants within a time-frame preceding the beginning of the plan year. In most cases, this time-frame is no later than 30 days before the beginning of the plan year, which in most cases begins on January 1.

Accordingly, if your plan year runs from January 1 to December 31, and if you maintain a safe harbor 401(k) plan, then you should provide the notice for the 2006 plan year no later than December 1, 2006. If you do not have this notice, or are not sure that it is the correct notice, please contact us without delay. The notice is revised each year to reflect the yearly, current plan provisions.

The Treasury Department recently issued revised final regulations that changed the content of the safe harbor notice. To ensure that your safe harbor notice satisfies the new requirements of what must be disclosed to participants, please contact us and forward your safe harbor notice to us for a quick review.

**(h) GRACE PERIOD FOR UNUSED CAFETERIA PLAN CONTRIBUTIONS –
DECEMBER 31, 2005 DEADLINE**

Cafeteria plans can be used to pay for a number of different types of expenses on a pre-tax basis, including most commonly health insurance premiums, medical and dental expenses not covered by insurance, and dependent care expenses. In a cafeteria plan, the general rule is that an expense must be incurred during the 12-month plan year in order to be eligible for reimbursement from dollars saved for such plan year. If not so used, the dollars are forfeited under the so-called "use it or lose it" rule, which originated not in the Internal Revenue Code enacted by Congress but in a proposed Treasury regulation that was never made final.

Under years of pressure to eliminate the use-it-or-lose-it rule, the IRS announced a compromise. The new rule allows employers to amend their cafeteria plans to treat an expense incurred on or before the 15th day of the third month following the plan year (meaning on or before March 15 for most plans) as having been incurred during the preceding 12-month plan year.

If the employer adopts the new rule and an employee incurs eligible expenses by the 15th day of the third month after the plan year ends, then the employee may submit those grace period expenses for reimbursement from his or her account for the preceding plan year. Any expenses incurred during this 2½-month period are treated as having been incurred in the preceding plan year and in most cases will first be applied against any unused balance for the preceding year. Several issues follow if an employer desires to utilize the grace period. These include: (a) if the employee submits grace period expenses that use up the preceding year's unspent contributions and then discovers and submits expenses incurred in the preceding year, does the employee lose those preceding year expenses; (b) how will the run-off period for claim submittal be changed; (c) will the grace period disqualify an employee from participating in an HSA? The answers to the foregoing questions must be documented in the plan amendment. (d) Also, the plan's summary plan description must be modified and distributed to employees; and (e) the plan's claims forms will need to be modified.

Only if you amend your cafeteria plan by December 31, 2005 may you apply expenses incurred on or before March 15, 2006 against 2005 contributions. If you do not amend the plan and notify employees by year end, you cannot use the new rule for 2005 contributions (nor for 2006 or later years until the plan is timely amended).

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FUTURE GUIDANCE

There has been a lot of ERISA regulatory activity this year. Our December News Brief will cover, without limitation: (a) Roth 401(k)s; (b) Bankruptcy Reform Impact on Plans and IRAs; (c) New Dependent Definition for Health and Cafeteria Plans; (d) New 401(k) Hardship Rules and Treatment of Severance and Post-Separation Pay; and (e) New Deferred Compensation Rules under Code Section 409A.

This update is intended to provide general information only and does not provide legal advice. The application of ERISA laws can be complex. For information regarding the impact of these developments under your particular facts and circumstances, please call us.