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COMPENSATION AND BENEFITS
Benefits News
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Benefits e-News: A Value Added Service from Robinson & Cole LLP

Benefits e-News is a monthly electronic newsletter reporting on recent changes in the law affecting employee benefits and other developments affecting plan sponsors and their employees. Benefits e-News provides web links to the Internal Revenue Service, the United States Department of Labor, the United States Department of Health and Human Services HIP HIPAA web site, and the Pension Benefit Guaranty Corporation. Benefits e-News is easy to navigate. To access a web link, position your cursor on the link and click your mouse. To return to Benefits e-News, click the back button on your browser.

We hope that you find Benefits e-News to be informational and helpful. If you know of others who would like to receive this online newsletter (or if you would like to discontinue receiving Benefits e-News), please click here and send us an email message. If there are certain topics that you would like covered in future issues, please let us know.

Cash Balance Pension Plan Regulations Issued

The IRS has issued proposed regulations relating to the age discrimination requirements applicable to retirement plans. These regulations apply to all plans, but contain significant provisions relating to cash balance plans. All plans, especially defined benefit plans, will need to be reviewed and possibly revised if these regulations are finalized in their current form. Although the regulations will not be effective until finalized, the regulations technically relate back to 1988.

The most significant provisions address the conversion of a traditional defined benefit pension plan into a cash balance pension plan and accruals under cash balance plans. If conversions are made on an age-neutral basis and other requirements are satisfied, a plan will satisfy the age discrimination requirements with respect to the conversion. Under the regulations, a converted plan must satisfy one of two alternatives. Under the first alternative, the converted plan determines each participant’s benefit as not less than the sum of the participant’s accrued benefit under the traditional defined benefit plan and the cash balance account. If this alternative is used, the plan would not have a wear-away period for

benefits accrued prior to the conversion. Alternatively, the converted plan could establish each participant's opening account balance as an amount not less than the actuarial present value of the participant's defined benefit plan accrued benefit as of the date of the conversion using reasonable actuarial assumptions. A wear-away period could be used under this alternative without violating the age discrimination prohibition. An interest rate assumption could not be used if it increased, directly or indirectly, upon the attainment of a certain age, resulting in lower present value for older participants. For accrual purposes, the regulations focus on pay credits and not interest credits in determining whether the benefits are discriminatory.

In a separate announcement, the IRS has indicated that when the proposed regulations are finalized, the current moratorium on the issuance of determination letters to cash balance plans would be lifted.

PWBA Grants Excise Tax Relief for Voluntary Fiduciary Correction Program Filers

The PWBA has announced a new class exemption under which a plan sponsor may receive relief from the excise tax associated with prohibited transactions, provided that such prohibited transactions are corrected under the Voluntary Fiduciary Correction Program (VFC Program), a program which permits plan sponsors to correct prohibited transactions or other fiduciary breaches using specific correction methods. The IRS had previously announced that a plan sponsor would not be subject to the IRS excise tax on prohibited transactions if the plan sponsor corrected the transaction under the VFC Program.

The new exemption applies to four specific prohibited transactions. If a plan sponsor successfully corrects an error under the VFC Program, the DOL will issue a no action letter with respect to the corrected prohibited transaction. Prior to the new class exemption, a plan that received a no action letter under the VFC Program could have been subject to the DOL's excise tax on prohibited transactions.

Under the new class exemption, the following four prohibited transactions will not result in the DOL excise tax if the plan sponsor corrects the error through the VFC Program:

• The failure to transmit participant contributions to a plan within the mandatory time frames and/or failure to transmit participant loan repayments to a plan within a reasonable time after withholding by the employer.

• The making of a loan by a plan at a fair market value interest rate to a party-in-interest.

• The purchase or sale of an asset at fair market value between a plan and a party-in-interest.

• The sale of real property to a plan by an employer and the lease back of such property to the employer at fair market value.

Treatment of Overpayments from Defined Benefit Plans

The IRS recently clarified how employers should treat the overpayment of annuity benefits from defined benefit plans. Where a participant has received overpayments for one year due to a miscalculation, the subsequent year's distributions can be reduced by the excess amount plus interest. In the case of overpayments over several years, the overpayments can be recovered by the plan by reducing future payments so that the actuarial present value of the reduction is equal to the excess payments plus interest. Where there has been overpayment to a participant in the form of a lump sum distribution, and a participant repays the plan, the participant will be able to deduct the repayment on Schedule A of Form 1040, subject to the 2% floor on miscellaneous itemized deductions.

IRS Issues New Regulations On Plan Loans

The IRS has issued final regulations providing additional guidance on participant loans. Although in most aspects the final regulations are the same as the proposed regulations, in certain areas there are substantive differences. The regulations apply to loans made on or after January 1, 2004.

The proposed regulations limited a participant to two outstanding loans during a year. This limitation has been eliminated. Although plan sponsors can continue to limit the number of outstanding loans by plan design, no limitation on the number of loans is required. There is no change to the statutory limit on the dollar amount of loans.

If a participant fails to repay a loan, it will be deemed distributed. A loan that has been deemed distributed and that has not been repaid will be considered to be outstanding for purposes of determining the maximum amount of any subsequent loan.

The new regulations provide guidance on refinanced loans, where one participant loan replaces an initial loan. A refinanced loan should be treated as a new loan and the interest rate for the refinanced loan determined as of the date of refinancing. The 50% cap must be determined by taking into account the participant's vested account balance as of the date of refinancing. The initial loan and the refinanced loan each must satisfy the level amortization and five year repayment requirement. The refinanced loan will satisfy these requirements if the refinanced loan provides for repayment within the original term remaining on the prior loan. Alternatively, the plan sponsor can implement a loan repayment structure where the refinanced loan consists of two separate loans with the latest permissible term of repaying the initial loan being five years from the original date of such loan.

The Soldiers' and Sailors' Civil Relief Act of 1940 caps at 6% the interest rate that can be charged to participants on military leave. The regulations clarify that this cap applies to participant loans. The plan can suspend loan repayments during a participant's military leave without treating the loan as a deemed distribution. When a participant completes

end of the original term of the loan plus the period of military service (unless the loan is eligible for an extension). An affected plan participant can be offered a choice of increasing the amount of repayments or continuing to make repayments as initially agreed to and making a balloon payment at the end of the loan term. If a participant on military leave originally has a loan with a repayment term of less than five years, upon returning from military leave, the participant can refinance the loan to extend the payment term to five years plus the length of military leave.

Independent Fiduciaries Take Action to Sell Majority of United Airlines Stock Held by United Retirement Plans

Aon Fiduciary Counselors and State Street Bank and Trust, independent fiduciaries hired to manage the bankrupt airline's 401(k) plan and ESOP, respectively, have sold off much of the United stock previously held by the 401(k) plan and ESOP. The independent fiduciaries, who were hired by the boards responsible for administering the two plans, began selling off United stock held by the plans in September when it became clear United was in financial trouble. As a result of the sell-off, the 401(k) plan held no United stock as of December 9, the date United announced it would file for bankruptcy, and the ESOP had filed notices indicating that it would sell almost 40 million shares (however, the ESOP may not be permitted to sell its United shares, as the bankruptcy court has issued an order prohibiting any large stakeholders in United, including the ESOP, from selling shares until at least December 30th). The use of independent fiduciaries is a post-Enron trend designed to protect plan participants from company officers and executives who may put the interests of a financially troubled company before the interests of plan participants who are invested in company stock.

Nonstatutory Stock Options Must be Reported as Compensation

When an employee exercises nonstatutory stock options, employers must report as income the excess of the fair market value of the stock received upon exercise of the option over the amount paid for that stock. The IRS recently clarified that this amount should be reported by employers on Boxes 1, 3, 5 and 12 of Form W-2. This compensation should be coded with a new Code V in Box 12. This rule is mandatory for Forms W-2 issued in 2003.

Value of Donated Leave to be Income to Employee

Generally, if an employee donates leave, the value of the donated leave is taxable income to the employee. However, in the aftermath of September 11, the IRS granted a waiver of taxation on the value of donated leave. If an employee donated unused leave and the employer paid the value of such leave to a charitable organization, the employee would not be taxed on the value of the foregone leave. The IRS has announced that effective January

1, 2003, this interim exemption will end and donated leave will be taxable income to the employee, although the employee may be able to claim a tax-deduction for the value of the foregone leave.

DHHS RELEASES GUIDANCE ON HIPAA PRIVACY

On December 4, 2002, the Department of Health and Human Services provided an early holiday gift by releasing new guidance on the Privacy Rules under HIPAA. The guidance addresses different issues with respect to the Privacy Rules and includes information reflecting the Department's August modifications to the Rules. At 122 pages, the guidance addresses, among other topics, incidental uses and disclosures, the minimum necessary standard, business associates, marketing, public health, research, and workers' compensation. The Department has indicated that more guidance is forthcoming and that future topics will be based on areas where the Department receives the most questions on compliance. Top officials have publicly indicated that an area of forthcoming guidance may be the impact of the Privacy Rules on employer health plans. Most health plans, health care clearinghouses, and health care providers who conduct certain electronic transactions must comply with the Privacy Rules by April 14, 2003.

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