

COMPENSATION AND BENEFITS POINTERS**April 2005**

This issue of Compensation and Benefit Pointers identifies a variety of significant developments affecting employee benefit programs and executive compensation arrangements.

- **Retiree Medical Plans and Medicare.** A federal district court in Pennsylvania has prohibited the EEOC from implementing a regulation that would have allowed employers to reduce or eliminate retiree medical coverage when a retiree becomes eligible for Medicare. The EEOC has announced that it will appeal the decision. The EEOC issued the proposed regulation in response to the Third Circuit's *Erie County* decision, which held, in general terms, that an employer violates the Age Discrimination in Employment Act when it treats Medicare-eligible retirees less favorably than other retirees under the employer's retiree health plan. Employers should continue to monitor developments affecting this issue. Employers intending to make changes (including changes to take into account the new Medicare Part D prescription drug benefit) should consider whether their plans are or can be structured to comply with *Erie County*.
- **Nonqualified Deferred Compensation.** The March 15, 2005, deadline for increasing deferrals under a nonqualified deferred compensation plan has passed, but plans may still allow individuals to elect:

- Until June 30, 2005, to defer annual and long-term performance-based bonuses for which the performance cycle ends on December 31, 2005 (if the cycle ends before December 31, 2005, the deadline will be earlier).
- Until December 31, 2005, to: (1) reduce deferrals; (2) make new payment elections for amounts subject to the new law; and (3) terminate participation in nonqualified plans subject to the new law. After 2005, changes to the time or form of payment will be severely restricted, and participants generally will not be able to change deferral elections mid-year or to accelerate payments.

Plan amendments that allow new elections should be drafted carefully to avoid forfeiting grandfathered protection for amounts deferred and vested before 2005.

- **Final 401(k) and 401(m) Regulations.** The IRS issued final regulations that apply to employee deferrals, matching contributions, and employee after-tax contributions under tax-qualified savings plans. The final regulations largely conform to the 2003 proposed regulations, but include some new requirements and clarifications.

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- ✓ **Retiree Medical:** EEOC barred from implementing a regulation permitting reduction in health benefits upon Medicare eligibility.
- ✓ **Executive Compensation:** June 30 deadline for elections to defer "performance-based compensation" under calendar year plans.
- ✓ **401(k) Plans:** New regulations are effective no later than January 1, 2006, but may be implemented earlier.
- ✓ **Stock Option Expensing:** SEC delays effective date for stock option expensing requirement and issues guidance permitting a range of valuation methods.
- ✓ **Defined Contribution Retirement Plans:** Optional forms of distribution may be eliminated without advance notice.
- ✓ **Suspension of Benefits:** IRS issues guidance limiting retroactive impact of *Heinz* decision.
- ✓ **HIPAA:** Security regulations are in effect for large health plans.
- ✓ **Employees on Military Duty:** Employers must post notice regarding employees' rights and obligations.

The following provisions of the new regulations are of immediate significance to employers:

- **Effective Date.** The regulations are generally effective for plan years beginning on or after January 1, 2006. (The effective date may be later for collectively-bargained plans.) However, an employer may implement the regulations for any plan year that ends after December 29, 2004, as long as the plan (1) complies with the regulations in operation during that plan year, (2) is properly amended before the end of the remedial amendment period, and (3) applies *all* of the requirements of the regulations to that plan year (except as described below for hardship distributions).
- **Hardship Distributions.** The regulations expand the circumstances under which a participant may take a hardship distribution on account of an “immediate and heavy financial need” to include certain funeral expenses and repair of the participant’s principal residence. The regulations also restore the definition of “dependent” that was in effect before January 1, 2005, effectively permitting hardship distributions for certain medical expenses of a non-custodial child. These provisions are the only exception to the rule that employers electing to comply with the new regulations before the required effective date must comply with all of the new regulations: an employer may adopt the new hardship provisions early and not comply with the rest of the regulations until the required effective date.

In deciding whether to implement the new regulations early and to prepare for future plan years, employers should be mindful of the following aspects of the regulations:

- **ESOP Aggregation.** ESOPs are *required* to be aggregated with 401(k) and 401(m) plans for ADP and ACP testing purposes if the ESOP is not a separate plan. (ESOPs are permitted, but not required, to be aggregated with non-ESOPs if the ESOP and non-ESOP are not part of the same plan.) However, ESOPs must still be tested separately for other purposes, such as the coverage requirements and nondiscrimination testing for certain benefits, rights, and features.
 - **Targeted QNECs and QMACs.** The regulations significantly limit the use of targeted qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs) to correct nondiscrimination testing failures. As a result, using QNECs or QMACs to satisfy the actual deferral percentage or actual contribution percentage test can be more costly under the new regulations than it is under current law.
 - **Safe Harbor Plans.** A plan that uses the safe harbor to satisfy the nondiscrimination requirements must specify whether it will comply with the nonelective or matching contribution safe harbor and may not provide that it will use the actual deferral percentage test if it fails to satisfy the safe harbor requirements. In addition, a plan that is designed to provide the safe harbor matching contribution formula must match catch-up contributions to the extent the participant has not previously received the maximum matching contribution for the plan year.
- **Expensing of Stock Options.** The SEC has delayed the effective date of Financial Accounting Standards Board’s Statement 123R until the beginning of a company’s next fiscal year (previously, Statement 123R would have been effective as early as June 15, 2005). The SEC has also published guidance on the accounting treatment of stock options and other share-based payment arrangements, interpreting Statement 123R and describing how it interacts with other SEC rules applicable to public companies. Notably, the SEC guidance indicates that a range of valuation methods is acceptable.
- **Eliminating Optional Forms of Distribution.** The IRS has eliminated the 90-day advance notice requirement for a plan amendment that eliminates an optional form of distribution under a tax-qualified defined contribution retirement plan. Employers that wish to eliminate or restrict optional forms of distribution in such a plan still (1) must comply with the anti-cutback rule, which generally permits optional forms to be eliminated or restricted as long as the plan offers a single sum distribution option that satisfies certain requirements, (2) may not eliminate an optional form with respect to participants who began to receive benefits before the amendment is adopted, (3) must retain any annuity form required under the qual-

ified joint and survivor annuity rules (which generally apply to money purchase plans), and (4) must provide participants with a timely summary of material modifications or updated summary plan description. The new rule allows certain optional forms to be eliminated prospectively without *advance* written notice.

- **Suspension of Benefits.** The IRS has issued guidance limiting the retroactive application of the U.S. Supreme Court's *Heinz* decision regarding the suspension of benefits under tax-qualified retirement plans. Under this guidance, employers that amended their retirement plans before June 7, 2004, to add or expand a provision requiring the suspension of benefits may amend their plans to avoid disqualification. Employers that have amended their plans' suspension of benefits provisions should review their plans to determine whether retroactive amendments are required and whether they can continue to rely on any favorable determination letter issued to the plan. The IRS guidance provides relief only under the Internal Revenue Code, not under ERISA.
- **HIPAA Deadline.** As of April 21, 2005, large health plans (plans that paid claims or premiums of over \$5 million in their most recent plan year) must comply with the HIPAA security regulations. (Smaller plans have an additional year to comply.) These regulations require health plans to implement administrative, physical, and technical safeguards with respect to *electronic* protected health information ("PHI"). To avoid the substantial penalties that can be imposed on employers that violate the HIPAA security rules, employers that sponsor large health plans should (1) conduct a risk analysis as provided in the security rules; (2) ensure that their policies and procedures for handling electronic PHI and their business associate agreements comply with the regulations, (3) appoint a security officer responsible for compliance with the HIPAA security rules, and (4) amend their plan documents to comply with these rules.
- **USERRA Notice Requirement.** As of March 10, 2005, employers are required to advise employees of their rights, benefits, and obligations under the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA). Employers may satisfy this obligation by posting a notice where employee notices are ordinarily posted or by any other method (such as email, regular mail, or hand delivery) that ensures delivery. A model notice is available on the Department of Labor's Veterans' Employment and Training Service website: <http://www.dol.gov/vets/programs/userra/poster.pdf>.

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