IMPORTANT EMPLOYEE BENEFIT AND EMPLOYMENT <u>ISSUES IN 2005-2008</u>

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- **<u>January 1, 2005</u>**: New Department of Labor ("DOL") COBRA Notices. The old 1986 COBRA Notices may no longer be used.

- **<u>January 1, 2005</u>**: All nonqualified deferred compensation ("NQDC") programs became subject to Section 409A of the Internal Revenue Code, except for benefits vested as of December 31, 2004, under certain "grandfathered" plans. These rules apply to traditional nonqualified deferred compensation plans (<u>i.e.</u>, defined benefit or defined contribution programs), employment agreements with deferred benefits, severance agreements and/or plans, foreign pension plans, stock appreciation right ("SAR") programs, and discounted stock option plans. Plan terminations and employed deferral elections for 2006 were required to be made by December 31, 2005. However, the proposed regulations allow employers until **December 31, 2007** to amend plans for Section 409A, as further addressed below.

- **<u>April 20, 2005</u>**: Large health plans with over **$5** million in premiums and/or annual receipts were required to comply with the HIPAA Security Rules to protect "electronic" protected health information ("ePHI").

- **<u>July 1, 2005</u>**: New HIPAA Certificates of Creditable Coverage must begin to be used for Plan Years commencing on or after July 1, 2005.

- **<u>September 30, 2005</u>**: Employers with Retiree Medical Plans providing prescription drug coverage must have applied for the Medicare subsidy.

- **<u>November 15, 2005</u>**: Employers were required to issue a Notice to active employees, spouses and dependents who are eligible for Medicare benefits, and participants in Retiree Medical Plans, confirming whether the prescription drug programs available to such individuals are at least as good as Medicare Part D.

- **<u>December 31, 2005</u>**: Qualified retirement plans were required to be amended for the new automatic rollover rules for account balances between **$1,001** and **$5,000**. However, IRS relief extended this action to the due date for an employer's 2005 tax return.

- **<u>December 31, 2005</u>**: Flexible Benefit Plan documents may be amended to allow participants to submit expenses incurred within **2-1/2** months after the end of a Plan

Year, as permitted under IRS Notice 2005-42. Flex Plan documents should also be reviewed to confirm Amendments exist for over-the-counter drugs and the DOL post-service claims procedures are in Plans and SPDs.

- **December 31, 2005**: Consider if defined benefit pension plans must be amended for the retroactive annuity rules.

- **January 1, 2006**: Employers may add a Roth feature to a Section 401(k) Plan, creating a Roth 401(k) Plan, for the first time.

- **January 1, 2006**: Employers are required to use the 2006 version of the mandatory W-4 Form for employees.

- **January 1, 2006**: The Department of Homeland Security has updated the I-9 Form for the first time since 1991 and employers should use the new I-9 Form for new employees. Failure to present the Form to government officials upon request can lead to fines of over **$1,000** per employee.

- **January 1, 2006**: Employer with employees in California must provide sexual harassment training if they have more than **50** employees, whether or not **50** employees are located in California. Similar training exists in Connecticut within **90** days of hire. General issues to address regarding California training are as follows:

  - The law generally applies to any employers transacting business in California.
  - The training must consist of **2** hours of training where the participant is engaged in the training, answering questions and such training is documented.
  - Some employers are using computer based programs to conduct the training.
  - The training must be measured to ensure that employees are engaged in the training and paying attention. Even if an employer has part-time sales employees in California, sales managers in other states must be trained if they supervise the sales personnel.
  - The California practices will become a "best practice" and can cover issues other than sexual harassment to encompass the **2** hours of required training.

- **January 18, 2006**: The DOL Final Regulations under the Uniform Services Employment and Reemployment Rights Act of 1994 ("USERRA") become effective, requiring employers to adopt reasonable procedures to allow employees to elect continuation health coverage and to address retirement plan issues. P&E recommends incorporating COBRA "like" procedures into SPDs and COBRA Notices to address the **24** months of USERRA extended health coverage.

- **January 31, 2006**: The sponsors of Prototype Plans (i.e., Schwab, Fidelity, Datair, etc.) are required to submit their documents for IRS approval. Employers using Prototype Plans have a **6** year cycle. Employers will have to resubmit plans for individual determination letters in 2008 and 2009. If Prototype Plans are amended they may be **converted** into individually designed plans.

- **<u>February 1, 2006 to January 31, 2007</u>**: Employers maintaining individually designed qualified retirement plans with EIN's ending in **1** or **6** may submit their plans for updated determination letters. Employers with EINs ending in **2** or **7** can submit between **February 1, 2007** and **January 31, 2008**. Other employers can similarly submit in the future based upon their EINs. This staggered determination letter program is intended to spread the IRS workload in issuing determination letters and to require new determination letters every **5** years.

- **<u>February 6, 2006</u>**: Federal contractors and subcontractors that interview or obtain candidates through the internet are subject to greater documentation requirements, although a **90** day grace period exists to allow contractors and subcontractors to update their systems.

- **<u>February 11, 2006</u>**: All defined benefit retirement plans are subject to the relative value rules in explaining alternative forms of benefits. Some defined benefit plans were subject to these rules effective as of October, 2004, if both subsidized and unsubsidized benefit options exist. Good faith compliance should exist to explain benefit options until 2007.

- **<u>March 31, 2006</u>**: An On-line Disclosure Form was required to be completed with the Center for Medicare and Medicaid Services ("CMS") at http://www.cms.hhs.gov/creditable to confirm if an employer's prescription drug plan provides creditable coverage, or not.

- **<u>April 14, 2006</u>**: Every **3** years a health plan must issue a new Notice of Privacy Policies or inform employees where to obtain the Notice. Large health plans with **$5** million or more in premiums or benefit payments originally issued such Notices prior to April 14, 2003. Most large health plans complied with this **3** year Notice requirement by including a Notice or statement of availability in 2006 open enrollment packages.

- **<u>April 20, 2006</u>**: Small health plans with under **$5** million in premiums and/or annual receipts are required to comply with the HIPAA Security Rules to protect ePHI.

- **<u>May 12, 2006</u>**: Insured medical plans in New Jersey must either extend dependent coverage until age **30**, or permit dependents that lose coverage before age **30** to elect to continue coverage until age **30**. Similar to domestic partners, employees with dependents who are not dependents for federal tax purposes may incur "imputed income" for any employer subsidies.

- **<u>May 15, 2006</u>**: New Model Notices and guidance was issued by CMS and are required to be used. The guidance includes a new Model Personalized Disclosure Notice, as well as minor changes to reorganize the Model Creditable Coverage Notice and the Model Non-Creditable Coverage Notice, which were rewritten to make them easier to understand. New information may be found at:

http://www.cms.hhs.gov/creditablecoverage/02_CCafterMay15.asp#TopOfPage.

- **July 4, 2006**: Insured prescription drug plans in New Jersey must cover female contraceptives, unless an employer requests an exclusion from the law for religious beliefs.

- **September 30, 2006**: Employers who maintain retiree medical plans must once again decide whether they wish to apply for the retiree drug subsidy ("RDS"). This filing must be made no later than **90** days before the beginning of each Plan Year. For non-calendar Plan Years, the filing date may be earlier than September 30, 2006.

- **November 15, 2006**: A new certificate of creditable coverage notice must be issued. Remember, the Notice must be issued before the annual Medicare Part D election period (i.e., every November 15 to December 31); prior to each individual's initial enrollment period for Part D; prior to the effective date of coverage for any Medicare eligible individual who enrolls in an employer's plan; whenever drug coverage changes so it becomes or is no longer creditable, and upon request. A Notice to all participants satisfies the first two notice requirements. P&E recommends including the Notice in the open enrollment packages for 2007 and future years.

- **November 30, 2006**: The Pension Protection Act of 2006 ("PPA") requires defined contribution plans to permit participants to **diversify** out of employer stock. Notice of this right must be given no later than **30** days before the first day an individual is eligible to diversify out of employer stock. Since the new diversification rule applies as of January 1, 2007, Notice must be given to avoid a **$100** per day penalty. IRS Notice 2006-107 provided transition relief from this rule.

- **December 1, 2006**: In response to the overwhelming amount of information and communications that are exchanged electronically in today's corporations, **the Federal Rules of Civil Procedure, which govern lawsuits in federal courts, are amended to account for the production of electronic information.** The amended Federal Rules require that counsel for both parties meet at the outset of a litigation to identify the existence, location and method of producing electronically stored data. This process will inevitably involve every company's CIO, IT group, Records Managers, CFOs, and Human Resource Departments. Attorneys will be required to disclose to their adversaries the type of systems their clients are using, the capacity of their networks, the backup procedures used, and the likely location of potentially responsive information. The attorneys will then agree upon the format of production (PDF, TIFF, etc) and timing. The attorneys are then required to confer with their assigned magistrate judge to put their agreement into a written order with court ordered deadlines for production. Far broader than traditional "paper" discovery, the rules contemplate the production of a wide array of digital information including emails, excel spreadsheets, IMs, voicemails, PDAs, word documents, laptop images, internet history and website alterations as well as overall enterprise network descriptions.

- **<u>December 31, 2006</u>**: Despite the new IRS staggered determination letter program, interim **amendments <u>are required</u>** to comply with the Final Section 401(k) Regulations. For example, Section 401(k) Plans should be amended to add new hardship distribution withdrawals for funeral and casualty expenses, and to modify testing procedures.

- **<u>December 31, 2006</u>**: Amendments for Roth 401(k) Plans must be executed if implemented in 2006. It should be noted that many entities have done analysis of the advantages and disadvantages of traditional pre-tax Section 401(k) contributions and after-tax Roth IRA contributions. Most studies reflect that if individuals can afford to make contributions on an after-tax basis, and do not anticipate being in a lower tax bracket at retirement, a Roth 401(k) is beneficial. Given the fact that Section 401(k) distributions prior to age **70** can also increase the taxation on social security benefits, and given the estate tax benefits of Roth 401(k) Plans, P&E anticipates Roth 401(k) Plans will become popular amongst a small group of highly compensated employees and for prudent younger participants. However, the average worker may still find it beneficial to save current income taxes, rather than to make an after-tax Roth 401(k) contribution.

- **<u>December 31, 2006</u>**: All NQDC programs (<u>i.e.</u>, defined compensation plans, severance agreements and employment agreements) must be amended as of January 1, 2005 to be in compliance with Section 409A of the Internal Revenue Code. P&E recommends starting this process as soon as possible. However, final regulations under Section 409A are not expected until March, 2007 due to the volume of comments given to the IRS and the complexity of all issues. Thus, this deadline was postponed until **December 31, 2007**.

- **<u>December 31, 2006</u>**: Ensure imputed income for domestic partners is properly included in employee income to issue valid W-2 Forms, and possibly amend retirement plans to exclude such income from the definition of compensation.

- **<u>January 1, 2007</u>**: Institutions that received more than **$5** million dollars a year from a State Medicaid Program, such as hospitals, are required to establish written policies for all employees of the entity, including management, and of any contract or agent of the agency, that provides detailed information regarding the false claim act, administrative remedies for false claims and statements, any state laws pertaining to civil or criminal penalties for false claims and statements, and whistleblower protections under such laws, with respect to the role of such laws in preventing and detecting fraud, waste, and abuse in federal health care programs, to be included as part of such written materials are detailed provisions regarding the entities' policies and procedures for detecting and preventing fraud, waste and abuse. Employee Handbooks for such entities must have a specific discussion of the laws and the rights of employees to be protected as whistleblowers, and the entities' policies and procedures for detecting and preventing fraud, waste and abuse. Accordingly, such entities must review these rules and **update their Handbooks** to be in compliance.

- **<u>January 1, 2007</u>**: Consider adding a Roth feature to a Section 401(k) Plan.

- **<u>January 1, 2007</u>**: Under DOL Proposed Regulations, if retirement plans have a default investment option, an **annual notice** is required to explain the default investment and the circumstances in which it applies. Since the DOL Proposed Regulations are expected to change the default investment options no immediate changes are required.

- **<u>January 1, 2007</u>**: A new New York state mental health mandate, Timothy's Law, requires every insurance policy in the State of New York to provide full coverage for the diagnosis and treatment of mental disorders, including nervous disorders, emotional disorders and dependency on alcohol or other drugs. The law also mandates that policies impose no limits on the coverage of mental disorders that are not imposed on physical disorders. This law is just another of a continuing number of state mandates. Fortunately, self-insured plans which are not governed by state insurance statutes continue to be preempted by ERISA.

  As a reminder, the Federal Mental Health Parody Rules were also extended for one more year through December 31, 2007. Those rules were expected to expire as of December 31, 2006.

- **<u>January 31, 2007</u>**: Employers using Volume Submitter and Prototype Plan should consider signing IRS Form 8905 to confirm they will continue to use a pre-approved plan document. Execution of this Form provides flexibility if an employer wants to change service providers before a new document is signed.

- **<u>March 1, 2007</u>**: Within **60** days after the beginning of each medical plan year a new On-Line Disclosure Form must be filed with CMS. Notice must also be given within **30** days after drug coverage terminates or changes its creditable coverage status. To complete the Form go to: http://www.cms.hhs.gov/apps/ccdisclosure/default.asp**.**

- **<u>March 31, 2007</u>**: Retirement plans with participant directed individual accounts must provide benefit statements at least once **each quarter**. Under PPA, the statements must now include an explanation of **investment risk** and **diversification** under the plan. The DOL has provided Model Language and posted a page with investing information on its website – www.dol.gov/ebsa/investing.html. Quarterly statements are to be provided **45** days after the end of each quarter starting with March 31, 2007.

- **<u>April 14, 2007</u>**: Small health plans must issue a new Notice of Privacy Policies or inform employees where to obtain the Notice. P&E recommends employers include this information in the 2007 open enrollment packages.

- **<u>July 1, 2007</u>**: The DOL, Health and Human Services ("HHS") and the Department of the Treasury released final regulations relating to wellness programs and other HIPAA nondiscrimination issues. These rules clarify the wellness program exemption from HIPAA's general prohibition on discrimination based on a "health factor." These final rules also clarify certain requirements that were part of the 2001 interim final nondiscrimination rules in areas such as the prohibition on "nonconfinement" clauses and certain "source of injury" exclusions. Changes must be made to plans for plan years beginning on or after July, 2007.

- **July 1, 2007**: All employers doing business in Massachusetts must adopt and maintain a premium conversion (i.e., Section 125 or Flex Plan), that allows employees to pay their share of health care premiums with pre-tax dollars. Such plans must also permit employees who may obtain health care coverage through the new Massachusetts Health Insurance Connector Plan (the "Connector") to pay for their Connector premiums with pre-tax dollars. Even employers outside of Massachusetts, with employees in Massachusetts, will be subject to the following:

    - The need to amend Flex Plans to address the payment of Connector premiums with pre-tax dollars
    - To file an Employer Health Insurance Responsibility Disclosure ("Employer HIRD") Form with the Division of Health Care Financing and Policy.
    - To demonstrate that the employer satisfies a fair share contribution (i.e., an employer must either cover at least **25%** of its employees employed in Massachusetts locations who work at least **35** hours per week; or the employer must pay at least **33%** of the premium cost for all of its Massachusetts employees who are regularly scheduled to work at least **35** hours per week). The initial reporting obligation for the fair share determination rules is the period ending September 30, 2007.).
    - To provide a Certificate of Creditable Coverage (similar to a HIPAA Certificate).

  Employers with employees in Massachusetts must carefully consider these new health care rules.

- **September 30, 2007**: The Equal Employment Opportunity Commission ("EEOC") has issued a revised EEO-1 Form that will be required for the 2007 Survey, which will be due from employers by this date. The new revised Form includes new race and ethnic categories and new job categories. In general, private employers subject to the Civil Rights Act of 1964 with **100** or more employees (excluding state and local governments, primary and secondary school systems, institutes of higher education, and tax-exempt membership clubs other than labor organization); employers with fewer than **100** employees if the company is owned or affiliated with another company, or their centralized ownership control or management, such that the group legally constitutes a single enterprise and employs more than **101** employees; federal contractors with **50** or more employees with purchase orders amounting to **$50,000** or more; and financial institutions issuing savings bonds are required to file the Form.

- **January 1, 2008**: Employers and insurers in Massachusetts must issue Certificates of Creditable Coverage, similar to the HIPAA Certificates. Failure to provide the Certificates could result in penalties of **$50** per individual, up to **$50,000** per year.

- **January 1, 2008**: Section 401(k) Plans using the new PPA safe harbor automatic enrollment features with matching contributions vested after **2** years have an **annual notice** requirement.

- **Miscellaneous**:

  - **Civil Unions in New Jersey**. New Jersey originally enacted a Domestic Partner Act on January 12, 2004 (the "DPA"). The DPA initially required state and local governments to provide certain domestic partner benefits, but did not apply to general corporate employers and self-employed individuals. The DPA has not been repealed and some individuals may prefer to simply remain domestic partners, where the full rights of a civil union are not desired.

    The New Jersey Supreme Court in the decision of Lewis v. Harris, 188 N.J. 415, (October 25, 2006) held that the equal protection guarantee of the New Jersey State Constitution was violated by denying rights and benefits to committed **same-sex couples** which were statutorily given to heterosexual couples. The court held that the state was required to fulfill the constitutional requirement by either amending the marriage statutes to include same-sex couples or enacting a parallel statutory structure of another name, in which same-sex couples would not only enjoy the rights and benefits, but also bear the burdens and obligations of civil marriage. Another alternative was to revise the New Jersey State Constitution.

    Effective as of **February 19, 2007**, New Jersey has enacted a civil union statute for same sex domestic partners. In order to establish a civil union in New Jersey the following actions must be satisfied:

    - Neither party must be in another civil union, domestic partnership or marriage in the State of New Jersey.
    - The parties must be of the **same sex** and therefore be excluded from the marriage laws of the State of New Jersey or any other state.
    - Both individuals must be **18** years of age, except where parental consent is provided for younger individuals.
    - Unlike States with typical domestic partner provisions (such as California), the New Jersey statute does **not require** the individuals to establish they are in a committed relationship through the establishment of joint bank accounts, living together for any period of time, or other joint property ownership. Only the above requirements need be satisfied, which are minimal in nature, and the same as getting married.

    If the parties meet the above requirements, they can obtain a civil union license or civil union certificate which establishes a civil union.

- **<u>New Jersey to Adopt Pre-Tax Treatment for Section 125 Plans</u>**. New Jersey has historically not implemented the favorable federal tax treatment made available to Flexible Benefit Plans ("Flex Plans") established under Section 125 of the Code. Legislation currently exists to permit employees to pay for medical benefits on a pre-tax basis. However, the statute does not cover Medical Flexible Spending Accounts, Dependent Care and other benefits made available under Flex Plans. More importantly, the statute **mandates** that employers with **11** or more employees established premium-only Section 125 Plans for their employees. P&E has provided comments regarding the legislation through the New Jersey State Bar Association, and will similarly keep our clients and contact apprised of all new developments.

- **<u>New Jersey Health Care Reporting Information</u>**. The New Jersey Access to Employer-Based Health Insurance Act requires employers to identify employees who receive health care benefits under the NJ FamilyCare Program and **report** the following information to the NJ Department of Human Services when there are **50** or more identified employees:

  - Employers name and address.
  - Whether employer offers health care coverage.
  - Number of employees and dependents receiving charity care.

  The Department of Human Services and/or the NJ Department of Labor will prepare a Reporting Form and send it to employers.

- **<u>Dependent Care Accounts</u>**. New IRS guidance clarifies several rules regarding reimbursements under Dependent Care Accounts under Flex Plans. These rules include the following:

  - Specialty Day Camps providing instruction as well as child care are permitted. However no part of an overnight camp is reimbursable and educational expenses, such as summer school tuition, are not reimbursable.
  - "Incidental" charges for meals and supplies, are permitted, as long as there is no separate charge for the snack, tee shirts, etc.
  - "Indirect" expenses such as an application fee, agency fee, or deposit is permitted if the child receives care from that provider. Reimbursement is not permitted until care is actually provided to the child.
  - Transportation costs charged by a provider to pick up or drop off a child are permitted, but only if the Dependent Care provider actually provides the transportation.

  Additional guidance clarifies the following eligibility provisions:

- Eligibility is determined on a daily basis. For example, reimbursement is not allowed for care provider to a **13** year old on or after the child's **13th** birthday.
- Only the employee with primary custody of a child is eligible for reimbursement of Dependent Care expenses.
- The employee must need the care to enable the employee to work or look for work. Dependent care provided during short, temporary absences, such as vacation or minor illnesses are reimbursable. However, care provided during an extended medical leave is not permitted.

Debit cards provide a convenient way for employees to use Dependent Care Accounts, as well as HRAs. If employers offer debit cards, IRS Notice 2006-69 makes the substantiation requirements much simpler. All employers should review their Dependent Care Plans in order to ensure that the advantage of the above rules are incorporated into Plan documents.

- **Pension Protection Act of 2006**. All employers must consider the impact of PPA, including automatic enrollment, investment advice to participants, diversification of employer stock and accelerated vesting for defined contribution plans. See the separate P&E Summaries regarding PPA.

- **Anti-Dilution Provisions in Equity Compensation Plans should be amended to eliminate discretion**. Most employers who establish equity compensation plans using stock options, restricted stock, and other programs typically provide that in the event of certain corporate events (such as stock dividends, stock splits, or similar changes in capitalization of a company), the amount of the award **"may"** either be adjusted or **"shall"** be adjusted to take the corporate event into consideration.

  As a result of the release of FAS 123(R), accounting firms believe that if a compensation plan contains an anti-dilution adjustment that is **permissive** in nature, the fair market value of an award must be recalculated in the event of an adjustment, resulting in an increased compensation expense. However, if an adjustment is **mandatory**, no adjustments are required. Equity plans can be amended to eliminate any discretion and require automatic adjustment without any adverse accounting charges, as long as the amendment is not adopted in contemplation of an equity restructuring event. All employers should review their equity compensation plans to confirm if adjustments are permissive or mandatory, and consider any necessary amendments.

- **EPCRS Update**. On May 5, 2006, the IRS introduced the new EPCRS Program under Revenue Procedure 2006-27. The changes include a reduction in the amount of contributions an employer must make for employees improperly excluded from qualified retirement plans from **100%** of the actual deferral percentage ("ADP") for nonhighly compensated employees ("NHCEs"); to **50%**

of the ADP for NHCEs. Matching Contributions must still be made as if the full ADP had been made, and obviously earnings must be made to make participants whole. The Revenue Procedure also addresses common problems involving loans.

The Self-Correction Program ("SCP") generally permits an employer to correct insignificant errors at **any time**, and significant failures within a **2** year period of time, without payment of any fee or sanctions. SCP requires a plan to have a favorable determination letter from the IRS or be established using a document that has been approved by the IRS.

The Voluntary Correction Program ("VCP") permits an employer to pay a limited fee at any time prior to audit, and to receive IRS approval for corrections.

The Audit Closing Agreement Program ("Audit CAP") also permits an employer to correct non-SCP or non-VCP failures that are identified on audit, and to pay a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure. The Audit CAP sanction also takes into account the extent to which any corrections occurred before the audit.

The EPCRS Program is a significant program for employers to correct compliance issues, which regularly occur despite diligent efforts of employers to properly follow all qualified retirement plan tax rules.

- **VFC Update**. The DOL introduced a new and improved Voluntary Fiduciary Correction ("VFC") Program, which became effective as of **April 19, 2006**. The new program is intended to be more user friendly for employers seeking to correct fiduciary errors, such as the failure to transfer employee contributions in a timely manner. Specific compliance errors are identified with corrective actions. Employers are encouraged to implement all corrective actions and file under VFC. No filing penalties generally exist, unlike the IRS Employee Plans Compliance Resolution Systems ("EPCRS") Program. Approximately **1,000** employers filed under the VFC Program in 2005. However, many employee benefits practitioners are still reluctant to file under VFC.

- **DFVC Program**. The Employee Benefit Security Administration ("EBSA") continues to maintain the Delinquent Filer Voluntary Compliance ("DFVC") Program to help employers pay nominal penalties if they have failed to file the annual Form 5500 required for welfare benefit plans, qualified retirement plans, or if employers never filed a statement with the DOL in connection with a nonqualified retirement program. The penalty for "large plans" with over **100** participants is **$2,000** per late return, with a maximum penalty of **$4,000** regardless of the number of late returns. The penalty for small plans is **$750** per late return, with a maximum of **$1,500**. P&E encourages all employers to review all welfare and retirement plans to ensure that proper Form 5500s are being filed, with accountant's opinions where necessary. Where deficiencies exist, employers should promptly file under the DFVC Program to minimize penalties.

- **Part-Time/Seasonal Employee Issues**. In 1994, the IRS issued a Field Directive reflecting that if part-time employees worked more than **1,000** hours, they must be eligible to participate in a qualified retirement plan. This rule existed even though specific "categories" of employees could be excluded from a qualified retirement plan, since the IRS believed that the exclusion of part-time employees working significant hours resulted in a subterfuge and avoided the general **1,000** hour eligibility rule. In February, 2006, the IRS issued an Employee Plans Determination Quality Assurance Bulletin entitled "Part-Time Employees Revisited". This Bulletin **expands** the IRS enforcement actions to part-time, temporary and seasonal employees. The IRS will not question such exclusions when determination letter applications are submitted, but may question the exclusion of part-time, temporary and seasonal employees on audit.

- **Hurricane Relief**. Various legislation, announcements, and other guidance has provided relief to employers and employees who were devastated by various hurricanes. Qualified plan amendments to make changes for hurricane use forms, including loans up to **$100,000** and hardship distribution repayments must be adopted on or before the last day of the first Plan Year beginning on or after January 1, 2007 (i.e., December 31, 2007 for calendar year plans).

- **Puerto Rico 401(k) Plans**. On September 22, 2004, the Puerto Rico Legislative Assembly enacted Act 404 requiring employers with Section 401(k) Plans covering employees in Puerto Rico to hold assets for Puerto Rican employees in a Puerto Rican Trust with a resident Trustee. On January 30, 2006, the Governor signed Act 49, which expressly **repealed** these requirements. Accordingly, retirement plans that are qualified under Puerto Rican Code Section 1165 may be funded through a Puerto Rican Trust or a Trust with a situs in the United States, and the Trustee of such Trust may be a resident of Puerto Rico or the US. Important issues still must be considered between the use of US and PR Trusts, as follows:

  A **12.5%** tax rate exists on lump sum distributions if a Trust funding a plan is a PR Trust or the Plan is funded through a US Trust that has a Trustee who is a resident of Puerto Rico acting as the paying agent, and during the plan year of distribution and the **2** prior years, an average of not less than **10%** of the plan assets are invested in either property located in Puerto Rico, stock in Puerto Rico registered investment companies, or any other property classified as property **located** in Puerto Rico. The investment requirement is not applicable for distributions received on or before **December 31, 2007**.

  Lump sum distributions from Trusts not complying with the above rules are still subject to a general **20%** withholding rate. However, the special **12.5%** withholding rate can apply for a US Trust with a Puerto Rican Trustee or agent that complies with the investment requirement described above. Based upon the above provisions, the following rules apply:

- From January 30, 2006 to December 31, 2007, all lump sum distributions paid out of a PR Trust (or a US Trust with a PR Trustee/Agent) will be subject to the special **12.5%** income and withholding tax rate.
- Effective January 1, 2008, lump sum distributions paid out of a PR Trust (or a US Trust with a PR Trustee/Agent) will be subject to the special **12.5%** income and withholding tax rate only if the employer or the Plan Administrator has certified to the payor that the Plan complies with the investment requirement.
- Effective January 1, 2008, lump sum distributions paid out of a PR Trust (or a US Trust with a PR Trustee/Agent) will be subject to the general **20%** income and withholding tax rate, if the plan does not comply with the investment requirements.
- Effective January 30, 2006, lump sum distributions paid out of a US Trust with no PR Trustee/Agent, will be subject to the general **20%** income and withholding tax rate.

- **<u>Long-Term Disability Benefits</u>**. Many employers continue to pay for **100%** of the cost of LTD benefits for employees. In the event an employee becomes disabled, the disability benefits are fully taxable to the employee. In accordance with Revenue Ruling 2004-55, an employer may ask employees prior to the beginning of each year if they wish to have the employer cost for LTD coverage included in their gross income. This election may be made "outside" of a Flexible Benefits Plan. If an employee makes this election, the disability benefits will be tax-free in the event of an unfortunate disability.

- **<u>HSAs, HRAs and FSAs</u>**. Many employers continue to review the use of highly deductible health plans and Health Savings Accounts ("HSAs"), Health Reimbursement Accounts ("HRAs"), and use of traditional Medical Flexible Spending Accounts ("FSAs"). As the use of consumer driven healthcare decisions evolves, additional consideration will be given to the use of HSAs and HRAs.

- **<u>Retiree Medical Plans</u>**. Some employers continue to maintain retiree medical plans for their employees. However, it is usually not until an employer wishes to change or terminate its retiree benefits that consideration is given to the documentation of such programs. Employers must ensure that a plan document and Summary Plan Description exists for all retiree medical plans to minimize liability and litigation when changes are made.

- **<u>Financial Planning</u>**. Some companies provide financial planning services to their senior executives, such as covering the cost for personal income tax preparation, tax advice, estate planning and related services. Provision of such services is a taxable benefit to employees. However, if some of the benefits are provided, in combination with an explanation of an employer's benefit programs, the cost for such programs can be reduced and the time necessary to complete a financial plan can be decreased. Similarly, the amount of imputed income can be reduced for executives. P&E would be happy to share our experience in conducting such projects.

- **Misclassified Workers**. The State of New Jersey announced on **April 10, 2006**, that both the New Jersey Treasury and Labor Departments are working together to identify and penalize employers that avoid paying for unemployment and disability insurance, and gross income taxes holding payments, to employees who are misclassified as independent contractors, or who are not properly reporting the payment of wages. New Jersey law establishes a **3** factor test to determine whether an individual is an independent contractor, based on who controls and directs the performance of services, whether the services are within the employer's usual business, and whether the worker is running a truly independent enterprise.

- **Damages for Computer Destruction**. In 1984 Congress enacted the Computer Fraud and Abuse Act ("CFAA"), which was intended to punish hackers who break into computer networks or send computer viruses. A recent 7th Circuit Case (International Airports Centers v. Citrin, No. 05-1522, 2006) now holds that an employee who destroys computer files, and uses a scrubbing program to render it impossible to recover files, can be held liable under CFAA. In this case, the employee actually took files to go into competition with the employer. As a precaution, P&E recommends expanding severance plans, employment agreements with severance benefits, severance agreements and releases, and Handbooks to specifically provide that not only must all documentation be returned upon a termination of employment, but employees may be held liable for damages under CFAA in the event that they destroy any files.

- **Telecommuters**. In a recent New York case, an employee residing and working **75%** in Tennessee and **25%** in New York was held liable for **100%** of income in New York State and City. Under New York law, the fact that an employee works out of state "for their own convenience" does not preclude New York State from taxing **100%** of an individual's earnings. The fact that the employee chose to work **900** miles away was not required by the employer. Employers who maintain telecommuting policies should review the state tax allocation issues with their employees for purposes of consistency between state withholding obligations and employee tax returns.

- **Section 401(k) Fees**. The DOL has an aggressive program to increase the scrutiny of Section 401(k) fees. If an employer has not reviewed internal and external fees recently, a Section 401(k) Request for Proposal project may be considered in 2007.

- **Certain Discrimination Awards Not Taxable**. Section 104(a)(2) was amended in 1996 to provide that damages for emotional distress are taxable. Thus, settlement of employment discrimination lawsuit are subject to tax, resulting in a greater cost to settle cases. However, in Murphy v. United States, (No. 05-5139, DC Cir., Aug. 22, 2006), the U.S. Court of Appeals held that damage awards for emotional distress, unrelated to lost wages or earnings, may **not** be taxed.

- **Due Diligence Summary**. P&E has prepared Due Diligence Summaries with most of our relationship clients to help review the status of plan documents, Form 5500s and to monitor employee benefit and employment compliance issues. If the Due Diligence Summary has not been updated in the last **2** years, or has not been prepared, 2007 may be the best time to update or review all employee benefit and employment programs and handbooks.

This Summary was prepared by the Law Firm of Palmieri & Eisenberg, located in Princeton, New Jersey, for clients and associates of the Firm. This Summary is being provided to help educate clients and employers regarding these new rules. P&E is **not** providing any legal advice to any employers to whom this Summary is provided, as a courtesy. Employers are strongly encouraged to work with their own legal counsel in reviewing these important issues.

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