Federal Legislative & Regulatory Report

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I. Washington Update

State of the Union and 2008 Budget

The main themes of the President's State of the Union address on Tuesday, January 23, 2007 were Iraq and the war on terror, immigration and the environment. Bush announced a major health care proposal to address the needs of the uninsured. As proposed, the federal tax code would be amended to provide a standard deduction to taxpayers who have health insurance coverage. At the same time, employer-paid health-insurance premiums would become taxable income to the employee. The proposal placed the standard deduction at $15,000 for families and $7,500 for single tax payers.

On Monday, February 5, 2007, the President released his proposed budget for fiscal year 2008. In addition to the health care proposal announced in the State of the Union, the budget again included the Employer Retirement Savings Account (ERSA), Retirement Savings Account (RSA) and Lifetime Savings Account (LSA) proposals. The only significant change to these provisions from previous years is the maximum contribution to an LSA has been reduced from $5,000 to $2,000. This likely is to address concern that the LSA potentially reduces the amount that Americans contribute to their retirement accounts. The ERSA proposal again combines all defined contribution plans into a single plan type, generally following 401(k) rules, and retains the exemption for public sector plans for non-discrimination testing.

Other proposals in the President's budget would:

- Make permanent the earlier Bush tax cuts that are scheduled to sunset.
- Make permanent the charitable IRA rollovers that were enacted in the Pension Protection Act of 2006 (PPA).
- Extend for one year the qualified reservist provisions (also from the PPA) to allow penalty-free distributions from IRAs, 403(b) and 401(k) accounts.
- Allow contributions to a Section 529 account to be considered for the Saver's Credit for low- and moderate-income taxpayers.
- Create Social Security private accounts.

Prospects for adoption dim

With Democrats now being in control of Congress, it appears unlikely that the President's proposals will go far in the legislative process this year. There also appears to be little support for the Administration's health care proposal. One reason may be that there are several negative outcomes to employers if health-insurance premiums are considered taxable income.

For example, payroll taxes on these amounts, including Social Security taxes, would result in increased costs to employers. Also, because employee income would be increased by the amount of the health-insurance premiums, other benefits that are based on annual earnings may also be impacted, further increasing payroll and benefits costs for employers.

Of the budget initiatives, the two most likely to receive bipartisan support during this year's legislative session are:

1. Extending the qualified reservist tax break, and
2. Including 529 contributions in the Saver's Credit.

Oversight of 401(k) plan fees and costs

Congressional observers note that the House Committee on Education and Labor are expected to begin holding hearings in March regarding the appropriateness and transparency of 401(k) plan fees and costs as well as to examine the oversight provided by the Department of Labor (DoL). These hearings are also expected to examine the role of annuity products and wrappers in defined contribution plans and their associated cost.

II. Legislators Propose Bills That Would Affect Social Security, Medicare

Although several bills focusing on Social Security issues have been introduced during this session of Congress, two bills should be of special interest to government employees.

The Social Security Fairness Act

This bill (S. 206), introduced by Senator Diane Feinstein (D-CA) would repeal the Government Pension Offset (GPO) and Windfall Elimination Provisions (WEP) for months after December 2007. These two provisions have been extremely unpopular since they were introduced in 1983 as a way to "save the Social Security program."

WEP and GPO Basics

The WEP may reduce Social Security benefits of public employees who earn a pension in a job that was not covered by Social Security and are also entitled to Social Security or disability benefits from other employment. The WEP may apply to individuals who:

- Reached age 62 after 1985, or became disabled after 1985, and
- First became eligible for a monthly pension based on work where they did not pay Social Security taxes after 1985, even if they are still working.

The WEP does not apply to Social Security survivor benefits or to:

- Individuals who have 30 or more years of substantial earnings under Social Security;
- Individuals who did not pay Social Security taxes prior to 1957;
- Federal workers first hired after December 31, 1983;
- Individuals employed on December 31, 1983 by a nonprofit organization that did not withhold Social Security taxes from wages but began withholding Social Security taxes from employees' wages after 1983;
- Individuals whose only pension is based on railroad employment.

A Social Security recipient's benefits cannot be reduced by more than one-half of the amount of retiree's pension based on non-covered Social Security earnings paid after 1956. This reduction would still apply to Social Security recipients who take their government pension annuity in a lump sum.

Although the WEP does not affect spouses, widows or widowers, the GPO may reduce the Social Security benefits of spouses, widows and widowers who receive a pension from a federal, state or local government based on work that was not covered by Social Security.

Spouses', widows' and widowers' Social Security benefits will be reduced by two-thirds of their government pension. For example, if this individual gets a monthly government pension of $600, two-thirds of that ($400) must be deducted from their Social Security benefits. If an individual is eligible for a $500 spouse's, widow's or widower's benefit from Social Security, (s)he will receive $100 monthly from Social Security ($500 – $400 = $100).

Generally, Social Security benefits as a spouse, widow or widower will not be reduced for individuals who:

- Receive a local government pension that is not based on their own earnings;
- Are a state or local employee whose government pension is based on a job covered under Social Security:
    - on the last day of employment and whose last day was before July 1, 2004;
    - during the last five years of employment and whose last day of employment was July 1, 2004, or later (Under certain conditions, fewer than five years may be required for people whose last day of employment falls between July 1, 2004, and March 2, 2009.);
- Receive or were eligible to receive a government pension before December 1982 **and** met all the requirements for Social Security spouse's benefits in effect in January 1977; or
- Received or were eligible to receive a federal, state or local government pension before July 1, 1983, and were receiving one-half support from a spouse.

NOTE: Other conditions apply to federal employees.

Calculators and additional information about the WEP and GPO are available from the Social Security Administration at http://www.ssa.gov/gpo-wep/. This bill is available at http://thomas.loc.gov/cgi-bin/query/C?c110:./temp/~c110ZODOLq. If that link fails, go to http://thomas.loc.gov and enter S. 206 in the Search Bill Text box.

Social Security and Medicare Solvency Commission Act

This bill (S. 355), a bipartisan measure introduced by Senators Pete Domenici (R-NM) and Diane Feinstein (D-CA), would create a permanent 15-member commission to make recommendations on how best to save the Social Security and Medicare programs. This commission would make recommendation and create legislation to ensure the solvency of both Social Security and Medicare. The bill, if enacted, would require Congress to act on the commission's recommendations within a fixed timeframe.

This bill is available at http://thomas.loc.gov/cgi-bin/query/C?c110:./temp/~c110OtMQNS or go to http://thomas.loc.gov and enter S. 355 in the Search Bill Text box.

Nationwide Comment: Yearly efforts to repeal the WEP and GPO have been unsuccessful since these two onerous provisions were adopted in 1983. Let's hope that the proposed commission on saving Social Security this time will come up with more reasonable solutions than the WEP and GPO which apparently have not been very effective in addressing Social Security solvency.

III. Rollovers and Non-Spouse Beneficiaries — A Closer Look

Last month, the Department of the Treasury and the IRS issued Notice 2007-7 to provide guidance on certain distribution provisions of the Pension Protection Act of 2006 (PPA). For more information, see the January 2007 edition of the Nationwide Federal Legislative and Regulatory Report.

On February 13, 2007, the Internal Revenue Service used a special edition of *Employee Plans News* to clarify the guidance in Notice 2007-7 pertaining to the non-spousal beneficiary rollover option. In addition to this much-discussed point, there is current debate on whether or not other points in the guidance are more restrictive than the PPA intended. These questions may need to be resolved in follow-up legislation, such as a technical corrections package, or in subsequent regulations. A copy of this issue can be found at www.irs.gov/pub/irs-tege/se_021307.pdf.

> On Feb. 7, 2007, Nationwide conducted a governmental plan sponsor webcast on the PPA 2006 and Notice 2007-7. A recording of this session can be found from the Plan Sponsor Corner of our website, www.nrsforu.com. You can also find additional material to explain the PPA and Notice 2007-7.

Under Section 829 of the PPA, non-spousal beneficiaries may be permitted to directly rollover the 401(a), 401(k), 403(b) or governmental 457(b) account balance of a deceased participant into an IRA. The IRA will be treated as an "inherited IRA" for these distributions, beginning in 2007.

Notice 2007-7 clarified that retirement plans are not required to offer rollovers to non spousal beneficiaries. However, if plans intend to adopt this flexibility, sponsors should review how Internal Revenue Code rules on required minimum distributions (RMDs) affect rollovers from their plans to an inherited IRA.

Rollovers for Non-Spousal Beneficiaries

Topic	Requirements
Limitations of an inherited IRA	Inherited IRAs act as a placeholder for inherited assets and do not provide the same flexibility as regular IRAs. Beneficiaries of an inherited IRA cannot: • Make contributions to the inherited IRA. • Roll money in or out of an inherited IRA to retirement plan or other IRA. • Convert a traditional IRA to a Roth IRA. • Postpone taking distributions from the inherited IRA until age 70½. **Note:** A non-spousal beneficiary may, via a direct-trustee transfer (not a direct rollover), move funds from one inherited IRA to another if the new IRA custodian agrees to register the new inherited IRA in the same decedent's and beneficiary names as the as the prior inherited IRA. **Note:** Direct trustee-to-trustee transfers are not subject to the one-year waiting period required between IRA rollovers.

Topic	Requirements
Establishing and titling the "inherited IRA"	The IRA must be established to identify both the decedent and the beneficiary. **Example:** John Jones as beneficiary of June Smith, decedent.
Inherited IRAs for Trust beneficiaries	Retirement plans may make direct rollovers to an inherited IRA for a trust that is named as a beneficiary of a decedent's retirement plan account. The beneficiaries of the trust must meet the same requirements for "designated beneficiaries" for required minimum distribution (RMD) purposes as the retirement plan.
Application of the required minimum distribution rules (RMD)	The RMD rules apply to both the retirement plan and the inherited IRA. The amount that is subject to the RMD rules from either the retirement plan or the inherited IRA is not eligible for rollover.
Required beginning date for minimum distributions	The required beginning date (RBD) is the latest date a participant or IRA owner can delay taking required minimum distributions. ***Retirement plans*:** Unless the retirement plan specifies otherwise, the RBD is April 1 of the year following the year age 70½ has been attained or retirement. ***IRAs*:** The RBD for an IRA (not Roth IRAs) is the April 1 following the year age 70½ has been attained.
Rules for making RMDs	RMDs from the retirement plan may be made to beneficiaries under the Life Expectancy Rule or the Five-Year Rule as provided in the plan document. ***Life Expectancy Rule*:** Required minimum distributions must begin, no later than December 31 of the year following the year of the plan participant's death based on the life expectancy of the participant's designated beneficiary. • RMDs must include all undistributed required minimum distributions for the year in which the direct rollover occurs and any prior years even if excise tax has been paid for missed RMDs. ***Five-Year Rule*:** Distributions are not required to be distributed from the plan until December 31 of the fifth calendar year following the year of the participant's death. • Any amount paid within four years of the participant's death is eligible for rollover to an inherited IRA. • Any amount paid between January 1 and December 31 of the fifth calendar year following the participant's death is not eligible for rollover to an inherited IRA.
Death of plan participant before the RBD and non-spousal beneficiary rollovers	No distributions are required from the plan in the year of the participant's death if the participant dies before his or her required beginning date. RMDs will be required from the plan in the years following a participant's death. Therefore, the deceased participant's entire account balance is **eligible for direct rollover in the year of the participant's death to an inherited IRA.** **Special rule:** If the plan permits each designated beneficiary to individually choose either the Five-Year Rule or the Life Expectancy Rule, a designated beneficiary must make the election no later than the end of the calendar year following the participant's death for the life expectancy rule to apply.
Death of participant on or	If, in year of participant's death, an RMD is due from the plan and is not eligible for rollover to an inherited IRA, the rest of the account balance, minus the RMD, would

Topic	Requirements
after the participant's RBD and non-spousal rollovers	be eligible for rollover to an inherited IRA. In all years after a participant's death, RMDs from the plan will be based on either the Life Expectancy Rule or the Five-Year Rule.
RMDs from inherited IRAs	The RMD rules that applied to the plan apply to the inherited IRA. If the plan used the Five-Year Rule for payments to non-spousal beneficiaries the inherited IRA will use the Five-Year Rule. Likewise, if the Life Expectancy Rule is used under the retirement plan for non-spousal beneficiaries, the Life Expectancy Rule is used for determining the RMD from the inherited IRA using the same applicable distribution period that would have been used under the plan if the direct rollover had not occurred. **An exception was provided in the guidance as** follows: If the five-year rule applies, a non-spouse beneficiary may treat the plan as using the life expectancy rule **if the rollover to the inherited IRA is made prior to the end of the year following the year of the participant's death**. This determination applies to the amount that can be rolled over and the required minimum distributions under the inherited IRA.
Taxation of distributions	The 20% mandatory withholding tax does not apply to distributions made from the plan or inherited IRA to a non-spousal beneficiary. Distributions from the plan or inherited IRA to a non-spousal beneficiary will be subject to the withholding rules that apply to periodic and non-periodic distributions. The 10% early distribution tax will not apply to distributions from the plan or from the inherited IRA for distributions to a non-spousal beneficiary prior to age 59½.

Note: Content concerning RMD rules is considered general in nature. Your plan document may apply more restrictive rules to your plan.

IV. EBSA Issues Guidance on Investment Advice

The U.S. Department of Labor's (DoL) Employee Benefits Security Administration (EBSA) has released Field Assistance Bulletin (FAB) 2007-01. This guidance is provided to assist DoL field investigators in interpreting the statutory exemption for investment advice in the Pension Protection Act of 2006 (PPA) that pertains to defined contribution plans subject to ERISA.

> Although governmental plans are not directly affected by ERISA or its prohibited transaction exemption rules, this guidance may be useful to employers as they select and monitor investment advice providers in their retirement plans.

In general, FAB 2007-1 clarifies the following three issues.

1. **Does the PPA investment advice exemptions "invalidate or otherwise affect" prior guidance that has been released on this issue?**

No, the Act does not invalidate prior guidance that has been provided on the issue of investment advice. Past guidance from the DoL continues to apply and can be relied upon now and in the future. This includes Interpretive Bulletin 96-1 that clarified investment guidance versus advice, Advisory Opinion 2001-09A (often referred to as the Sun America opinion) that provided guidance on independent advice arrangements, as well as other interpretive guidance that has been released on this issue.

2. **Are the standards for selecting and monitoring a fiduciary adviser different than the standards for any other investment advice arrangement?**

No, fiduciary duties and responsibilities in selecting and monitoring a fiduciary investment adviser are generally the same as under past guidance and the new investment advice exemption of the PPA. The plan sponsor's fiduciary duty is to prudently select the fiduciary adviser and periodically monitor the advice program. The sponsor's fiduciary duty does not extend to the specific investment advice that is provided by the fiduciary adviser to participants or beneficiaries.

> What this means is that a plan fiduciary who prudently selects and periodically monitors the investment advice program will not be liable for the specific advice that is furnished to participants and beneficiaries by the fiduciary adviser.

FAB 2007-1 identifies that the prudent selection of providers should avoid self-dealing, conflicts of interest or other improper influence. The selection process also should involve an objective analysis that compares and evaluates the provider's:

- Qualifications, including experience and compliance with all required licenses and registrations in accordance with applicable federal and state securities laws;

- Willingness to assume fiduciary status and responsibility under ERISA with respect to the advice that is given;
- Quality of services, specifically to determine that the advice to be furnished will be based on generally accepted investment theories; and
- Reasonableness of fees to be charged for the advice services.

In regard to periodic monitoring of investment advisers, FAB 2007-1 identifies that fiduciaries should determine whether:

- There have been any substantive changes in the information that was used as the basis for initially selecting the investment adviser, such as to determine if the adviser continues to meet applicable federal and state securities law requirements;
- The advice being furnished to participants and beneficiaries continues to be based on generally accepted investment theories;
- The investment adviser continues to comply with contractual provisions of the advice agreement;
- Participants are continuing to receive good value for the associated cost of the investment advice services;
- Participants are satisfied with the adviser based on comments and complaints about the quality of the furnished advice; if the comments or complaints raise questions about the quality of the advice that is given, the fiduciary may need to review the specific advice at issue with the investment adviser.

3. Does the level-fee requirement of an "eligible investment advice arrangement" apply to affiliates of the fiduciary adviser?

No, in general the level-fee requirement will not extend to affiliates of fiduciary advisers such as banks, insurance companies or other financial institutions. However, if the financial adviser acts through an individual such as an agent or registered representative of an affiliate, or if the affiliate is also providing investment advice to participants and beneficiaries, both will be subject to the level-fee requirement under ERISA.

The level-fee investment advice requirement in the PPA applies to fiduciary investment advisers who do not use a computer model that has been certified by an independent expert. In the level-fee arrangement, the adviser's compensation (including commissions and other fees) cannot vary based on the investment options that are recommended to participants or beneficiaries and chosen for their retirement portfolio.

FAB 2007-01 is part of DoL's ongoing compliance assistance program to help employers, plan officials, service providers and others comply with ERISA. It is available at http://www.dol.gov/ebsa/regs/fab_2007-1.html.

V. FMLA Revisited

Recent court rulings have raised new questions about the administration of the Family and Medical Leave Act (FMLA). The Department of Labor (DoL) has issued a request for information (RFI) to seek comments from the public about certain questions relating to the FMLA and how it is applied to employees.

Under the FMLA, a federal law that applies to private and public sector employers, eligible employees are entitled to 12 weeks of unpaid leave during any 12 month period. This leave is granted for employees who:

- Are suffering from serious health conditions or caring for ill family members.
- Are caring for a new child in the household, by birth or adoption.

Employers are required to grant FMLA leave to all employees who have:

- Been employed by the employer for at least 12 months and
- Worked at least 1,250 hours during the previous 12 month period.

The 12-month period is not required to be 12 consecutive months. Employees who take FMLA leave must be reinstated to their position or its equivalent when they return to work. The DoL is responsible for regulation and enforcement of the FMLA.

Background

We first reported on Rucker v. Lee Holding in the May 2006 edition of the Nationwide Federal Legislative and Regulatory Report.

Kenneth Rucker worked for Lee Holding for approximately five years, terminated employment and then was rehired. Seven months after being rehired, he took intermittent medical leave for an injured back. Lee Holding subsequently fired him for excessive absenteeism.

Mr. Rucker then filed a court action claiming that Lee Holding had violated the FMLA by wrongfully terminating his employment for taking medical leave. He contended that he met FMLA eligibility requirements for the 12 months of employment and 1,250 hours because his previous five years of employment with this company should be counted.

The District Court for the First Circuit disagreed and ruled that Mr. Rucker was not wrongfully terminated because

- Current employment cannot be combined with prior employment periods with the same employer to meet FMLA eligibility requirements; therefore
- He was not an eligible employee for FMLA purposes.

Mr. Rucker then took his case the United States District Court of Appeals for the First Circuit. The appeals court reversed the judgment, finding that all previous periods of employment with the same employer **could be counted** toward meeting the FMLA 12 month eligibility requirement because:

- The language in the FMLA is ambiguous about what periods of employment count toward the 12 month eligibility requirement; and
- The regulations and interpretations from the DoL have established that prior employment periods with the same employer are counted in meeting the 12 month eligibility requirement for FMLA leave.

DoL Issues RFI

Rucker v. Lee Holding is one major court case that has prompted the DoL to issue a Request for Information (RFI), soliciting comments on the application of the FMLA. It has been nearly a dozen years since regulations were first issued and, through the RFI, the DoL would like information on a number of topics, including:

- Clarification of the 12-month requirement for employee eligibility (see Background, page 11 of this report).
- Determination of serious health conditions versus minor illnesses such as colds and earaches.
- Definition of “day” for determining 12 weeks of leave:
    - Should scheduled holidays count against an employee’s 12 weeks of FMLA leave?
- Difference between scheduled and non-scheduled FMLA:
    - Does leave that is scheduled in advance present different problems or benefits than non-scheduled leave?
- Coverage issues:
    - How do employers cover the work of employees taking FMLA leave?

The DoL is accepting comments until February 16, 2007. The complete FMLA RFI is available at http://www.dol.gov/esa/whd/06-9489.pdf.

VI. Keeping watch

You can find the most recent information on issues affecting governmental defined contribution plans, plan sponsors and plan participants on the Employer page of our plan Web site, NRSforu.com. In addition, we report guidance on legislative and regulatory activity relevant to government sector defined contribution plans through:

- *Plan Sponsor Voice* quarterly newsletter, available online on the Hot Topics / News page of NRSforu.com.
- *Federal Legislative and Regulatory Report* — distributed monthly and posted on the Legislative / Regulatory tab on the Employer section of NRSforu.com. It's available online and for download.
- *Plan Sponsor Alerts* — published as needed to announce breaking news, and distributed by e-mail and posted in the Plan Sponsor Corner of NRSforu.com.

About this report

JOANN ALBRECHT, CPC, QPA, Plan Technical Consultant, our resident expert on legislative and regulatory issues, prepares this report. As a leading member of the Nationwide Legislative Task Force, She identifies how federal actions may affect your plan and its participants.

Albrecht is a member of American Society of Pension Professionals and Actuaries (ASPPA), currently serving on its Government Affairs Committee and is immediate past chair of its Tax Exempt and Government Plans Subcommittee. She also is a member of the National Association of Governmental Defined Contribution Administrators.

BOB BEASLEY, CRC, CIC, Communications Consultant, edits it. Beasley brings 17 years of financial services communications experience to your plan. He helped prepare the *457 Guidebook* and *Fiduciary Fundamentals,* edited countless newsletters and plan sponsor communications, and in 2001 authored "What you should know about the Economic Growth and Tax Relief Reconciliation Act of 2001."

Beasley serves on the Education and Communication Committee for the Profit Sharing / 401(k) Council of America and is a member of the National Association of Governmental Defined Contribution Administrators.

MARY WILLETT, President of Willett Consulting, lends plan sponsor perspective to this report. Willett served 14 years as Director of the Wisconsin Deferred Compensation Plan and was 2001/2002 President of the National Association of Government Defined Contribution Administrators (NAGDCA). She serves on the Board of Standards for the International Foundation for Retirement Education (InFRE).

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