Federal Legislative & Regulatory Report

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Inside this issue

- Washington Update ..... Below
- Retiree Medical Plan Design Causes Contributions To Be Taxable ..... Page 4
- Rollovers of FSA-HRA Balances to HSAs ..... Page 6
  - TABLE: Major Provisions of IRS Notice 2007-22 ..... Page 7
- Refunds for Telephone Federal Excise Tax ..... Page 9
- Resources for Selected Plan Sponsors and Employees ..... Page 10

I. Washington Update

After returning from their President's Day recess, Congress scheduled several hearings on various issues including 401(k) plan fees and the aging workforce.

401(k) Plan Fees

The House Education and Labor Committee, chaired by Rep. George Miller (D-CA), held its first hearing on March 6 to explore 401(k) plan fees and disclosures as well as how plan costs impact the ability of workers to save and invest for retirement.

Although public sector plans were not specifically addressed (and this committee

At the end of last year, the Government Accountability Office issued a report entitled "Changes Needed to Provide 401(k) Plan Participants and DoL with Better Information on Fees." This report was discussed in the Jan. 2007 issue of the Federal and Legislative Report that can be found at www.nrsforu.com. A copy of the report can be found here: www.gao.gov/new.items/d0721.pdf

does not have oversight responsibility for state and local government employers), they may be indirectly affected by this hearing and its outcome.

The subject of this hearing was "Are Hidden 401(k) Fees Undermining Retirement Security." Testimony from witnesses focused on the inadequacies of disclosures of plan fees and costs to plan sponsors and participants. Committee members appeared to agree that what is needed is better fee transparency to both sponsors, to allow them to compare and evaluate plan providers, and participants, to help them make educated decisions about investing.

Additional hearings on plan fees are expected to be scheduled by this committee later this spring. Representatives from the Department of Labor (DoL) will testify at future hearings about their oversight of private sector plans covered by ERISA. It is anticipated that other witnesses will discuss specific problems and best practices within the 401(k) industry regarding fee disclosures.

On March 7, the DoL issued a press release announcing their intention to soon publish a Request for Information in the Federal Register to invite the public to provide suggestions for improving the current disclosures that are applicable to participant-directed individual account plans. This is their first step in producing regulations to mandate full disclosures to ERISA plan fiduciaries.

The GAO is continuing to explore the issue of plan fees and their transparency which should lead to follow-up reports in the coming months. Other congressional committees with interest in examining retirement plan costs and their impact on the workforce may also schedule hearings on this issue in the future.

The Aging Workforce

The Senate Special Committee on Aging, chaired by Senator Herb Kohl (D-WI), held its first hearing on Wednesday, February 28 on the topic, "The Aging Workforce: What Does it Mean for Businesses and the Economy." The committee heard testimony from government and academic witnesses on the special challenges of an older workforce.

Although this committee does not have authority to introduce legislation, its work is likely to be instrumental in legislative proposals addressing the issues of the changing retirement environment and helping workers who are nearing and entering retirement.

For example, Senators Kohl, Gordon Smith (R-OR) and Kent Conrad (D-ND) are expected to introduce legislation focusing on the needs of older workers, such as encouraging employers to adopt phased retirement programs.

Women and Retirement Security Bill

Senators Gordon Smith (R-OR), Kent Conrad (D-ND) and John Kerry (D-MA) are expected to reintroduce the *Women and Retirement Security* bill initially proposed at the end of the 2006 legislative session. This bill is expected to be similar to last year's bill, and include:

- A requirement for employers that do not offer a retirement plan to provide workers with a payroll deduction IRA.

- An expansion of the Saver's Credit to
  - Increase the amount of the credit,
  - Make it fully refundable — the worker does not need to owe taxes to receive this, and
  - Require a certain percentage to be deposited directly into a qualified retirement account.
- A tax incentive for individuals to take distributions from their retirement accounts as lifetime annuities.
- New rules pertaining to the administration of qualified domestic relations orders (QDRO) that require:
  - Expenses associated with processing QDROs to be allocated to the plan as a whole instead of to the affected participant and/or alternate payee;
  - One-half of the participant's account segregated when notified of a pending QDRO;
  - Prospective alternate payees to be provided a copy of the plan document when requested or the plan would be subject to a financial penalty.

Update on Regulatory Activity

Representatives from the Treasury, IRS and DoL have provided updates on their activities at recent benefit conferences.

- **Section 403(b) final regulations** should be out this summer. The general effective date of these new rules is expected to be January 1, 2008. Along with the regulations, the IRS indicated that it will publish a revenue procedure to provide sample language for employers to use in their plan documents.
- **Defining governmental plans** is another project that the Treasury and IRS are conducting, in coordination with the DoL and the Pension Benefit Guaranty Corporation (PBGC). Correctly identifying government entities is important as their retirement plans are exempt from certain qualification requirements and ERISA. The new regulations are expected to identify the entities that can be considered a federal or state agency or instrumentality.
- **Final guidance on qualified default investment alternatives** (QDIA) is delayed. The Pension Protection Act mandated that the DoL issue this guidance, which was expected to be finalized in February. Reports suggest that the forthcoming final rules expand and clarify the types of investments that will be considered a QDIA and the steps that fiduciaries must take to monitor them.

II. Retiree Medical Plan Design Causes Contributions To Be Taxable

The Internal Revenue Service recently issued Private Letter Ruling (PLR) 200704005 to a governmental employer that addresses the taxation of "elective mandatory" contributions as a result of an irrevocable election to a proposed retiree medical plan. This PLR demonstrates the importance of understanding the federal tax code when designing benefit programs, and how failure to comply can result in an adverse tax consequence for all participants.

Background

In the PLR submission, the proposed plan has been designed as follows.

- Employees could irrevocably elect to have the employer contribute a percentage of their regular pay, up to 500 hours of accrued leave, or a combination of the two, to the proposed plan instead of receiving regular pay or accrued leave. This employee election could not be reversed or revoked. All contributions to the plan would be fully vested and held in a plan trust. No cash refunds would be available for amounts contributed to the plan.
- Employees would have 30 days from initial eligibility to make this one-time irrevocable election to participate in the plan. Employees who had not previously elected to participate in the plan would have an annual period in which to make a one-time irrevocable election to participate.
- The employer contributions of regular compensation, based on the employee's election, would begin either on the first day of the month following the initial 30 day election period or the first day of the calendar year following the annual 30-60 day election period. Employer contributions would reduce the compensation payable to the employee.
- When employees elect to contribute accrued leave, employer contributions representing the value of their accrued leave would be made to the plan upon the employees' termination of employment or retirement with the employer.
- Retirees would be able to use the value of their plan accounts to pay for medical expenses described in section 213(d) of the Internal Revenue Code (IRC), except for long term care expenses. Amounts remaining after a participant's death may be used by the surviving spouse, dependent or other beneficiaries.

PLR Findings

The IRS concluded these types of contributions would be considered taxable income to all plan participants, citing the IRC and previous guidance as the bases for its conclusion.

- Gross income includes compensation for services, including fees, commissions, fringe benefits and similar items [IRC section 61(a) (1)]. Gross income does not include coverage under an accident or health plan that the employer provides to

the employee, the employee's spouse or dependents, through insurance or other arrangement, for personal injury or sickness (IRC section 106).

- IRS Revenue Ruling 75-539 discusses two contracts, A and B. Under Contract A, the employee has the option to receive the unused leave value as cash payment or to elect to use the value of unused leave credit to continue health coverage. Under this arrangement, the value is constructively received by the retiree and includible in retiree's gross income because the contribution is considered an employee contribution from salary and not a contribution by the employer under IRC 106. Under contract B, the value of unused leave credits cannot be received in cash. Under this arrangement, the value is not constructively received by the retiree and is considered an employer contribution to the health plan and excludable from the retiree's gross income.
- IRS Notice 2002-45 identifies an example of tax-favored health reimbursement arrangements (HRA) paid solely by the employer and not pursuant to a salary reduction election under a cafeteria plan. This plan reimburses the employee for medical expenses as defined in section 213(d) that are incurred by the employee, employee's spouse or dependents. The HRA provides reimbursement up to a maximum dollar amount and carries any unused amount forward for future coverage periods. This notice further clarifies that employer contributions to an HRA may not be attributable to salary reduction or otherwise provided under a section 125 cafeteria plan, which does not permit unused amounts to be carried forward for subsequent coverage periods.
- IRS Revenue Ruling 2005-24, based in part on Revenue Ruling 75-539 (discussed above), states that an HRA will meet the requirements for tax favored treatment when an employee retirees and the employer **automatically and on a mandatory basis**, as determined under the plan, contributes an amount to the HRA equal to the value of all or a portion of an employee's accumulated leave and sick leave, which is not included in gross income of the retiree.
- Revenue Ruling 2006-36 details a flawed HRA plan design that permits unused amounts to be used after an employee's death to reimburse substantiated medical expenses of a non-spouse, non-dependent beneficiary. This ruling clarified that this plan design results in all contributions being includible in gross income for all employees. In other words, the fact that the plan design permits reimbursement of medical expenses to non-dependent beneficiaries taints the entire HRA and makes all reimbursements taxable. This ruling is effective for plan years beginning after December 31, 2008.

This PLR, which can be reviewed at www.irs.gov/pub/irs-wd/0704005.pdf, did not address other federal tax consequences of these elective irrevocable contributions. The PLR is directed only to the employer that requested the ruling and may not be cited as a precedent.

***Nationwide Comment**:* Although private letter rulings are directed only to the parties requesting them, they offer insights into the IRS could view similar situations. This particular ruling provides another good example of how a flawed plan design can have adverse tax consequences to all plan participants.

III. Rollovers of FSA-HRA Balances to HSAs

The Tax Relief and Health Care Act of 2006, enacted late last year, contains a number of provisions designed to increase the appeal of health savings accounts (HSAs) to encourage enrollment in high deductible health plans. One of the most significant provisions permits employers to offer employees a one-time election to roll balances from their health flexible spending account (FSA) or health reimbursement arrangement (HRA) to an HSA. Notice 2007-22, recently issued by the Treasury and IRS, provides comprehensive guidance to employers that want to offer this one-time rollover option.

HSA Basics

HSA contributions may be made by an eligible individual, or any other person including an employer on behalf of an eligible employee, who is covered under a high deductible health plan (HDHP). To be eligible for HSA contributions, individuals:

- Must be enrolled in a high deductible health plan on the first day of the month.
- Cannot have any other non-HDHP except for permissive coverage such as insurance for specific diseases, hospitalization for a fixed amount per day or other period, disability, dental, vision and long term care insurance. Employees who participate in general purpose health FSAs and HRAs that pay all medical expenses listed under IRC 213(d) would not be eligible to make HSA contributions. However, employees participating in limited purpose health or post- deductible FSAs and HRAs, including retirement HRAs, and meet all other requirements for making HSA contributions would be eligible.
- Cannot be enrolled in Medicare or claimed as a dependent on someone else's tax return.

HSA contribution limits for 2007 are $2,850 for self coverage and $5,650 for family coverage. Contributions made by individuals are tax deductible. Employer HSA contributions are excluded from an employee's gross income and not subject to FICA taxes. Individuals own their HSAs and can take them with them when they leave employment or the workforce.

Contributions and earnings remain in the HSA until they are used and may be distributed tax free only if they are used to pay medical expenses that qualify under IRC 213(d)). HSA distributions that are not used to pay qualified medical expenses or HSA contributions that are made for ineligible individuals are includable in that individual's gross income and subject to a 10% additional tax.

Guidance under Notice 2007-22

Notice 2007-22 provides both permanent rules for FSA/HRA rollovers and transitional rules that apply to rollovers made prior to March 15, 2007. The guidance specifically addresses rollovers to HSAs from general purpose health FSAs and HRAs.

Nationwide comment: This guidance, although helpful, still imposes enough additional administrative complexities to make it less attractive for many employers to offer this rollover option to their employees. This notice is available at: www.irs.gov/pub/irs-drop/n-07-22.pdf

The following table outlines the major provisions of this guidance.

TABLE: Major Provisions of Notice 2007-22 Guidance

Provision	Requirements under IRS Notice 2007-22	Comment
Implementation of FSA/HRA rollovers to HSAs (Qualified HSA distributions)	The following three steps must be completed by the end of the FSA/HRA plan year for tax-free rollovers or "qualified HSA distributions" to employee HSA accounts. 1. The employer must amend the FSA or HRA written plan to permit the one-time rollover to employees' HSA. Employers must offer this option to all employees who participate in the health FSA or HRA. 2. The employee must elect the rollover from the FSA or HRA to the HSA. 3. The year-end balance in the health FSA or HRA must be frozen and employees cannot receive reimbursements from the health FSA or HRA after the end of the FSA/HRA plan year. ***Next Step*** The employer must directly transfer FSA/HRA funds to the HSA trustee or custodian within 2½ months after the end of the plan year.	*Transition rule for 2006 plan year only:* For the 2006 plan year the amendment, election and rollover to the HSA trustee or custodian must be completed by March 15, 2007, provided the employee is eligible for an HSA. There is no requirement to freeze the year-end FSA or HRA balance.
Health FSA with reimbursement made during the grace period	A general purpose health FSA must have a "grace period" to take advantage of the HSA rollover option. A health FSA grace period reimburses medical expenses incurred during this period (2½ months after the end of the plan year). Employees would not be eligible for HSA rollovers until the first day of the month following the grace period. ***Example:*** If the FSA is a calendar year plan that provides for a 2½ month grace period to incur expenses for that plan year, employees will not be eligible for rollovers to HSAs until April 1 of the following year.	*Health FSAs without a Grace Period* Unused amounts at the end of the plan year in a health FSA without a grace period must be forfeited and cannot be transferred to an HSA after the end of the plan year. Amounts rolled from a health FSA to an HSA before the end of the FSA plan year will be included in an employee's gross income and subject to an additional 10% tax penalty.

Provision	Requirements under IRS Notice 2007-22	Comment
Timing of health FSA/ HRA rollover and HSA participation	After the FSA/HRA rollover to an HSA, there must be a zero balance in the general purpose health FSA or HRA, determined on a cash basis on the last day of the FSA/HRA plan year. Employees can be HSA eligible the first day of the first month of the next plan year if the employee has HDHP coverage on the first day of the month that the FSA/HRA rollover is made to the HSA, and if: • After the rollover there is a zero balance in the health FSA or HRA and the employee no longer participates in any non HSA compatible health FSA or HRA **or** • The employer converts the written general purpose FSA or HRA for all employees to an HSA compatible health FSA or HRA on or before the date the first rollover is made to an HSA.	**Cash Basis Balances** — An FSA or HRA account balance as of any date does not include pending claims, submitted claims or claims under review that have not been paid as of that date.
Health FSA and HRA rollover limitations	Rollovers to HSAs may be made from both general purpose health FSAs and HRAs and from HSA compatible health FSAs and HRAs. The rollover must be completed before January 1, 2012, will not count in the annual HSA contribution limits and is not deductible. Eligible employees are allowed only one rollover to an HSA for each health FSA or HRA and must have been covered under an FSA/HRA on September 21, 2006. FSA/HRA rollovers to an HSA may not exceed the *lesser of* the health FSA or HRA balance as of September 21, 2006 or the account balance on the date of distribution.	***Example:*** Acme Manufacturing amends its health FSA to allow for FSA rollovers to employee HSAs for employees electing HDHP coverage. Bill has a balance of $950 in his health FSA on September 21, 2006 and a balance of $700 on December 31, 2007. On or before December 31, 2007, Bill elects HDHP coverage beginning January 1, 2008 and also elects to have Acme rollover the balance remaining in his health FSA on December 31, 2007. The maximum amount that could be rolled over for Bill would be $700.
Tax implications of FSA/HRA Rollovers	A tax free rollover from a health FSA or HRA requires that the employee be HSA eligible during the entire 12-month testing period that begins with the month the rollover is contributed to the HSA. If the employee does not remain HSA eligible during this entire testing period, the amount of the rollover is included in his or her gross income and subject to an additional 10% penalty tax.	The rollover is not required to be withdrawn from the HSA and is not treated as an excess HSA contribution even if the individual does not remain HSA eligible during the entire 12-month testing period.
Employer Reporting	FSA/HRA rollovers to HSAs are not reported on an employee's W-2 but are reported to the HSA trustee. The HSA trustee is required to report the distribution as a rollover contribution on Form 5498-SA.	

IV. Refunds for Telephone Federal Excise Tax

The Internal Revenue Service announced in May 2006 (IR 2006-82 and Notice 2006-50) that it would stop collecting the federal excise tax on long-distance telephone service. Taxpayers (individuals, businesses and tax exempt organizations, including governments) are eligible to file for a refund of all excise taxes on long-distance or bundled phone services billed to them after February 28, 2003 and before August 1, 2006.

Refunds for Government Entities

The Internal Revenue Service recently clarified the procedure for government entities to request a refund of federal excise tax on long-distance service. The refund is for the federal excise taxes paid on long distance service that was billed after February 28, 2003 and for federal excise tax on all phone service that was billed after December 31, 2003.

Refund requests for the entire period should be on one form and filed during the 2007 year. In addition, there are statutory deadlines that are applicable to requests for calendar year 2004. The following table illustrates the deadline for filing refund requests for calendar quarters in 2004:

2004 Calendar Year Quarter	Refund request must be filed by:
January-March 2004	April 30, 2007
April-June 2004	July 31, 2007
July-September 2004	October 31, 2007
October-December 2004	January 31, 2008

Note: The initial refund procedure required tax exempt organizations (including governments) to request the refund on Form 990-T, making the calculation of the refund on new Form 8913. However, government entities are exempt from all telephone taxes for their governmental functions and should not use Form 990-T to request a refund of telephone excise tax (local or long distance). Government entities may request a refund using IRS form 8849 or make a refund request directly from their telephone service provider.

Refunds for Individual Taxpayers

The Internal Revenue Service is urging individual taxpayers to determine if they qualify for the telephone excise tax refund (discussed above) after learning that more than 10 million early filers did not request this one-time refund.

Complete details and instructions for requesting a refund are available at:
www.irs.gov/govt/fslg/article/0,,id=168262,00.html.
www.irs.gov/newsroom/article/0,,id=168058,00.html

For more information about this refund go to:
www.irs.gov/newsroom/article/0,,id=161506,00.html

V. Resources for Selected Plan Sponsors and Employees

New 401(k) and 403(b) Checklists Available

In February, the Internal Revenue Service published new 403(b) and 401(k) checklists to help employers and sponsors keep their plans in compliance with governing laws and regulations. The 401(k) checklist, although mostly pertaining to plans covered by the Employee Retirement Income Security Act (ERISA), includes a specific reference to remitting deferral contributions to the plan trust *as soon as they can be segregated from the employer's assets*.

The 403(b) proposed regulations [1.403(b)-8(b)] and 457 final regulations [1.457-8(a)(2)(ii)] contain similar references to timely remittance of deferral contributions. A plan may provide that participant deferrals are to be transferred to the plan within a reasonable period, which is no later than 15 business days after the date the amounts would have otherwise been paid to the participant had they not been deferred. State laws may be more restrictive. Failure to remit deferrals in a timely manner may require an employer to make up lost earnings.

- The 403(b) checklist is available at: www.irs.gov/pub/irs-pdf/p4546.pdf
- The 401(k) checklist is available at: www.irs.gov/pub/irs-tege/pub4531.pdf

Additional information about the timely deposit of deferrals may be found in the document, "Meeting Your Fiduciary Responsibilities," by going to www.dol.gov/ebsa/publications/fiduciaryresponsibility.html.

EBSA Releases Spanish Version of Web Page on Retirement Plans

The DoL recently announced a new Web resource to help Hispanic Americans plan, save and invest for a secure retirement. This resource, *Su Dinero Y Futuro Economico*: *Una Guia Para Ahorrar*, is the Spanish-language version of the DoLs popular publication *Savings Fitness: A Guide to Your Money and Your Future.* This can be found on the DOL's website at www.dol.gov/ebsa/pdf/savingsfitnesssp.pdf,

This publication provides information about:

- The importance of saving early
- How retirement plans work
- Ways to develop a savings plan and setting realistic retirement goals
- Simple principles of investing and establishing savings habits at a young age

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.

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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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