Snell & Wilmer L.L.P.

EMPLOYEE BENEFITS UPDATE

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2007 End of Year Plan Sponsor "To Do" Lists

Attached are six "to do" lists that may require your attention before the end of 2007 or early in 2008. Many of the action items are a result of the Pension Protection Act of 2006 (the "PPA").

For your convenience we have broken the "to do" lists into the following six categories:

- All Qualified Plans
- Section 401(k) Plans
- Defined Contribution Plans (other than 401(k) Plans)
- Defined Benefit Plans
- Health and Welfare Plans
- Executive Compensation

The All Qualified Plans list applies to all qualified plans in addition to the specific list for each type of plan. For example, if you sponsor a 401(k) plan, you will want to review both the All Qualified Plans list and the Section 401(k) Plans list for that plan.

Following the lists are articles that describe some of the action items in more detail.

If you have any questions or need help with any of the action items, please contact any member of our Employee Benefits Group.

All Qualified Plans "To Do" List

- ❑ **Adopt Design Changes by End of Plan Year:** If you made any design changes to the plan during the year, you generally must adopt an amendment reflecting those design changes by the last day of the 2007 plan year (i.e., December 31, 2007 for calendar year plans).

- ❑ **Adopt EGTRRA Restatement if in Cycle B**: If your qualified plan is individually designed and falls in cycle B (i.e., the employer identification number associated with the plan ends in 2 or 7, or you have made a cycle B election) you must restate the plan on or before December 31, 2007 and submit the plan for an EGTRRA determination letter on or before January 31, 2008. We previously sent detailed information about EGTRRA restatements to those clients who have asked us to be responsible for keeping their plans updated.

- ❑ **Adopt Katrina, Wilma, and Rita Distribution/Loan Amendments**: If your plan permitted special distributions or loans to victims of hurricanes Katrina, Wilma, or Rita, you must adopt a conforming plan amendment by the last day of the first plan year beginning on or after January 1, 2007 (i.e., December 31, 2007 for calendar year plans). Please let us know as soon as possible if you need us to prepare this amendment.

- ❑ **Review 2008 Plan Limits**: Familiarize yourself with the 2008 plan limits and make system changes as needed. See "*Retirement Plan Limits for 2008.*"

- ❑ **Comply with the Final Section 415 Regulations**: The final regulations under Section 415 of the Code, which were issued in 2007, made a number of technical changes to the Section 415 limits. The changes are effective for limitation years beginning on or after July 1, 2007 (i.e., January 1, 2008 for calendar year limitation years). For plans that have a calendar year limitation year/plan year/tax year, an amendment must be adopted by the due date for the 2008 tax year, which would be at some point in 2009. If your limitation year and/or plan year are other than the calendar year, please let us know as soon as possible so we can determine the date by which you must adopt a conforming amendment. You should also check with your third party administrator to confirm that they are implementing the new rules. See "*IRS Issues Final Section 415 Regulations*."

- ❑ **Increase Maximum Bond if Plan Holds Employer Securities**: The PPA increases the maximum bond to $1,000,000 for plans holding employer securities. The bond was previously capped at $500,000. For purposes of this provision, a plan is not treated as holding employer securities if the only securities held by the plan are part of a broadly diversified fund of assets, such as a mutual fund. This change is effective for plan years beginning after December 31, 2007.

- ❑ **Distributions Can be Directly Rolled Over to Roth IRAs:** Effective for distributions made after December 31, 2007, individuals with less than $100,000 in adjusted gross income can rollover amounts from qualified retirement plans, 403(b) plans, and 457 plans directly into a Roth IRA. The rollover is included in income (except the amount that consists of after-tax contributions), but the 10% early distribution penalty does not apply.

Section 401(k) Plans "To Do" List

- **Comply with Items on All Qualified Plans list:** The items on the All Qualified Plans list also apply to Section 401(k) plans.

- **Provide 401(k)/401(m) Safeharbor Notice by December 2, 2007 for Calendar Year Plans:** If your calendar year plan has a 401(k)/401(m) contribution safeharbor, you must provide the safeharbor notice by December 2, 2007. Recent regulatory changes have increased the information that must be included in the safeharbor notice. If you would like for us to review or update your safeharbor notice, please let us know as soon as possible.

- **Review 401(k) Definition of Compensation**: Effective for plan years beginning on or after July 1, 2007 (i.e., January 1, 2008 for calendar year plans) 401(k) elective deferrals may only be made with respect to compensation that qualifies as compensation under Code Section 415(c)(3). Due to recent changes to the Section 415 regulations, the types of compensation from which 401(k) elective deferrals may be made has changed. As a result, you should review plan terms and administration to determine whether any post-termination compensation is impermissibly included in your 401(k) definition of compensation and, at the same time, consider whether you want to revise your definition to allow deferrals on some or all of the post-termination compensation on which 401(k) elective deferrals are now permitted (such as regular or overtime pay that is paid within a specified timeframe after termination). Making these changes could require changes to your payroll system, plan administration, and plan amendments. See "*Elective Deferrals May Only Be Made on Section 415(c)(3) Compensation*" for more details.

- **Consider New Default Investment Safe Harbor**: Final regulations on qualified default investment alternatives take effect December 24, 2007. Plan fiduciaries wanting to take advantage of this new fiduciary safeharbor as soon as possible must provide a notice to participants by November 24, 2007. See "*Employee Benefits Security Administration Issues Final Regulations on Default Investment Alternatives*" for more details.

- **Comply with New Benefit Statement Requirement**: We previously reported that for plan years beginning after December 31, 2006, defined contribution plans that do not permit participants to direct the investment of their accounts would have to provide a benefit statement within 45 days following the end of each plan year. The Department of Labor recently issued guidance extending the deadline for this annual benefit statement. The annual benefit statement for such plans must now be provided on or before the <u>earlier of:</u> (1) the date on which the Form 5500 Annual Return/Report is filed by the plan for the plan year to which the statement relates; or (2) the date, including extensions, on which the Form 5500 is required to be filed by the plan. Be sure to calendar this new deadline.

- **Consider Adding Qualified Automatic Contribution Arrangement to Plan:** Section 401(k) plans that adopt qualified automatic contribution arrangements ("QACAs") – a new design-based safeharbor created by the PPA – will be deemed to have satisfied the tax code's nondiscrimination tests that would otherwise apply to employee elective deferrals and employer matching contributions. QACAs may be added to plans for plan years beginning on or after January

Section 401(k) Plans "To Do" List (continued)

1, 2008. The IRS published proposed regulations on automatic contribution arrangements on November 8, 2007. See "*IRS Proposes Rules on Automatic Contribution Arrangements*."

- ❑ **Consider Allowing Automatically Enrolled Participants to Take Distribution within 90 Days**: The proposed automatic contribution arrangement regulations also provide guidance on returning default elective deferrals to participants. This PPA provision is available as an option to all plans with eligible automatic contribution arrangements ("EACAs"), and allows 401(k), 403(b), and governmental 457(b) arrangements to return amounts requested by a participant within 90 days of the first elective deferrals to the EACA. See "*IRS Proposed Rules on Automatic Contribution Arrangements - Permissible Withdrawals of Automatic Contributions*."

- ❑ **Consider Increasing Period During which Excess Contributions May be Returned:** The proposed automatic contribution arrangement regulations also reflect the PPA amendments that permit an EACA to distribute excess contributions and excess aggregate contributions to participants within six months (rather than two-and-one-half months) after the close of the plan year in which the contributions were made. This provision, which will affect corrective distributions made in 2009, gives plans a longer period to make corrective distributions to avoid the imposition of the 10% excise tax on the employer. See "*IRS Proposed Rules on Automatic Contribution Arrangements - Corrective Distributions of Excess Contributions.*"

Defined Contribution Plans (other than 401(k) Plans) "To Do" List

- ❑ **Comply with Items on All Qualified Plans list:** The items on the All Qualified Plans list also apply to defined contribution plans.

- ❑ **Consider New Default Investment Safe Harbor**: Final regulations on qualified default investment alternatives take effect December 24, 2007. Plan fiduciaries wanting to take advantage of this new fiduciary safeharbor as soon as possible must provide a notice to participants by November 24, 2007. See "*Employee Benefits Security Administration Issues Final Regulations on Default Investment Alternatives*" for more details.

- ❑ **Comply with New Benefit Statement Requirement**: We previously reported that for plan years beginning after December 31, 2006, defined contribution plans that do not permit participants to direct the investment of their accounts would have to provide a benefit statement within 45 days following the end of each plan year. The Department of Labor recently issued guidance extending the deadline for this annual benefit statement. The annual benefit statement for such plans must now be provided on or before the earlier of: (1) the date on which the Form 5500 Annual Return/Report is filed by the plan for the plan year to which the statement relates; or (2) the date, including extensions, on which the Form 5500 is required to be filed by the plan. Be sure to calendar this new deadline.

- ❑ **Consider Impact of Low Normal Retirement Age Regulations on Money Purchase Pension Plans**: If your money purchase pension plan permits in-service distributions before age 62, you should review the age to determine if it is lower than what is reasonably representative of the typical retirement age for the industry. If you conclude the age meets the standard, you are not required to increase the age. If you conclude the age is too low, you should raise the age by plan amendment to an age that meets the standard. In either case, you should apply for a determination letter. If you apply for a determination letter by the deadline for adopting a plan amendment and the IRS concludes the age is too low, the higher age, as determined by the IRS, will apply prospectively. If a plan permits in-service distributions before age 55, the plan sponsor must apply for a determination letter by June 30, 2008 to obtain this prospective relief. See "*IRS Issues Low Normal Retirement Age Regulations Impacting In-Service Benefits under Defined Benefit and Money Purchase Pension Plans*."

- ❑ **Add 75% Annuity Option to Money Purchase Pension Plans**: Money purchase pension plans are currently required to offer a 50% survivor annuity option. The PPA requires such plans to offer a 75% survivor annuity in addition to the 50% annuity. Alternatively, if a plan currently complies with ERISA by offering a more than 75% survivor annuity option, then the 50% survivor annuity must be added to the plan as an option. This change is effective for plan years beginning after December 31, 2007 (i.e., January 1, 2008 for calendar year plans). Collectively bargained plans have a delayed effective date.

Defined Benefit Plans "To Do" List

- ❑ **Comply with Items on All Qualified Plans list:** The items on the All Qualified Plans list also apply to defined benefit plans.

- ❑ **Comply with New Cash Balance Plan Vesting Schedule**: As previously reported, if your defined benefit plan is a cash balance plan or other type of hybrid plan, you must comply with the new vesting requirements imposed by the PPA. Each employee with at least three years of service must be fully vested in his or her plan benefit. Plans that were in existence on June 29, 2005 must comply with the new vesting requirements in years beginning after December 31, 2007 (i.e., January 1, 2008 for calendar year plans), although plan sponsors may also elect to comply earlier than is required by applying the requirements for any period after June 29, 2005. For plans established after June 29, 2005, the requirements are effective when the plan is established.

- ❑ **Consider Impact of Low Normal Retirement Age Regulations**: If your plan permits in-service distributions before age 62, you should review the age to determine if it is lower than what is reasonably representative of the typical retirement age for the industry. If you conclude the age meets the standard, you are not required to increase the age. If you conclude the age is too low, you should raise the age by plan amendment to an age that meets the standard. In either case, you should apply for a determination letter. If you apply for a determination letter by the deadline for adopting a plan amendment, and the IRS concludes the age is too low, the higher age, as determined by the IRS, will apply prospectively. If a plan permits in-service distributions before age 55, the plan sponsor must apply for a determination letter by June 30, 2008 to obtain this prospective relief. See "*IRS Issues Low Normal Retirement Age Regulations Impacting In-Service Benefits under Defined Benefit and Money Purchase Pension Plans*."

- ❑ **Add 75% Annuity Option**: Defined benefit plans are currently required to offer a 50% survivor annuity option. The PPA requires such plans to offer a 75% survivor annuity in addition to the 50% annuity. Alternatively, if a plan currently complies with ERISA by offering a more than 75% survivor annuity option, then the 50% survivor annuity must be added to the plan as an option. This change is effective for plan years beginning after December 31, 2007 (i.e., January 1, 2008 for calendar year plans). Collectively bargained plans have a delayed effective date**.**

- ❑ **Comply with PPA Interest Rate and Mortality Factors:** The PPA provides new interest rate and mortality factors for purposes of calculating lump sums and other distribution options subject to Code Section 417(e)(3). The new PPA factors are effective for plan years beginning on or after January 1, 2008. The IRS issued Revenue Ruling 2007-67 on November 6, which clarifies that changing to the new factors will not trigger the anti-cutback rules of Code Section 411(d)(6) if the plan's current actuarial factors for such purposes are the pre-PPA rates (i.e., the 30 year Treasury rate). At the same time the IRS announced that implementing these changes for a traditional defined benefit plan does not require a Section 204(h) notice. If a plan currently uses other actuarial factors for such purposes, or changes the time for determining the interest rate, the anti-cutback rules apply to such changes. The recent IRS guidance leaves open the possibility that nontraditional defined benefit plans, such as cash balance plans, may need to

Defined Benefit Plans "To Do" List (continued)

distribute Section 204(h) notices describing these changes **by November 16, 2007**. You should check with your plan actuary regarding the implementation and impact of these rules.

- ❑ **Comply with New Minimum Funding Standards**: The PPA repeals the current funding rules and replaces them with new minimum funding standards. The new minimum funding standards are effective for plan years beginning after December 31, 2007 (i.e., January 1, 2008 for calendar year plans). You should check with your plan actuary regarding the implementation and impact of these new rules.

Health and Welfare Plans "To Do" List

- **Comply with New Rules That Change Treatment of Excess Group-Term Life Insurance**: Effective for the 2007 and later tax years, the cost of the excess coverage is determined solely by looking at Table I. The proposed cafeteria plan regulations provide that the amount includible in employee income is limited to the Table I cost of the excess coverage, minus any after-tax contributions paid by the employee, even if the actual cost of such coverage was greater than the Table I amount. This could result in less imputed income for employees. You should discuss this further with members of your accounting department to make sure that they are imputing income properly. See *"IRS Issues Proposed Cafeteria Plan Regulations That Change Tax Treatment of Excess Group-Term Life Insurance."*

- **Comply with New Rules Impacting Dependent Care Assistance Programs:** The IRS issued final regulations that will impact reimbursements under dependent care reimbursement programs. The changes are generally effective for tax years ending after August 14, 2007. You should discuss the changes with your third party administrator to ensure that the changes have been incorporated in your plan administration. You should also review your dependent care assistance programs to determine if any changes need to be made to the plan documents. See *"IRS Issues Final Dependent Care Tax Credit Regulations."*

- **Comply with End of Transition Guidance for Debit Cards Use:** Notice 2007-2 provided transition relief that allowed debit cards to be used at non-health care-related merchants (i.e., supermarkets, grocery stores, discount stores, wholesale clubs, and mail order and web-based vendors), provided certain requirements were met. Effective January 1, 2008, debit cards can only be used at non-health care-related merchants if the merchants have an inventory information approval system in place. If you utilize a debit card feature in connection with your health reimbursement account or health flexible spending account, you should confirm with your third party administrator that participating merchants will comply with this requirement effective January 1, 2008. See *"Debit Card Use Restricted Effective January 1, 2008."*

Executive Compensation "To Do" List

- ❑ **Year End Deadline to Make Certain Elections under Nonqualified Deferred Compensation Plans:** Most of the transition rules for amending plans to comply with the new Section 409A deferred compensation rules have been extended through 2008. However, any election that defers a payment otherwise payable in 2008, or accelerates a payment not otherwise payable in 2008 into 2008, must be made on or before December 31, 2007.

- ❑ **Identify Plans Subject to the New Section 409A Nonqualified Deferred Compensation Rules:** To comply with the new Section 409A deferred compensation rules, an employer must identify all plans subject to these new rules. If you have not already done so, the time to identify these plans is now. Any plan that provides an employee with a current enforceable right to receive compensation in the future is potentially subject to these new rules. Examples of plans subject to these new rules include traditional deferred compensation plans, employment agreements with severance provisions, change in control agreements, multi-year bonus plans or arrangements, stock plans offering restricted stock units or performance units, and stock options or stock appreciation rights with deferral features (including below market grants).

- ❑ **Review Stock Option Grant Procedures for Upcoming Grants:** The stock option backdating scandals raise serious corporate, tax, accounting and legal issues that may be resolved by an employer carefully reviewing its stock option grant practices and procedures. An employer should carefully review its stock option plan to determine which entity is charged with making grants under the plan and put in place practices and procedures to ensure that entity takes the appropriate action on the date the options are considered granted.

Retirement Plan Limits for 2008

The IRS announced the cost-of-living adjustments to various retirement plan limits for 2008. The key 2008 dollar limits (compared to the 2007 dollar limits) are noted below.

The Social Security Administration separately announced the taxable wage base for 2008 which is noted at the end of the chart.

Maximum Qualified Retirement Plan Dollar Limits		
	2007	2008
Limit on 401(k) deferrals (Section 402(g))	$15,500	$15,500
Dollar limitation for catch-up contributions (Section 414(v)(2)(B)(i))	$5,000	$5,000
Limit on deferrals for government and tax-exempt organization deferred compensation plans (Section 457(e)(15))	$15,500	$15,500
Annual benefit limitation for a defined benefit plan (Section 415(b)(1)(A))	$180,000	$185,000
Limitation on annual contributions to a defined contribution plan (Section 415(c)(1)(A))	$45,000	$46,000
Limitation on compensation that may be considered by qualified retirement plans (Section 401(a)(17))	$225,000	$230,000
Dollar amount for the definition of highly compensated employee (Section 414(q)(1)(B))	$100,000	$105,000
Dollar amount for the definition of key employee in a top-heavy plan (Section 416(i)(1)(A)(i))	$145,000	$150,000
Dollar amount for determining the maximum account balance in an ESOP subject to a five-year distribution period (Section 409(o)(1)(C)(ii))	$915,000	$935,000
SIMPLE retirement account limitation (Section 408(p)(2)(E))	$10,500	$10,500
Social Security Taxable Wage Base	$97,500	$102,000

IRS Issues Final Section 415 Regulations

Section 415 limits the benefits that may accrue or be paid under a plan during a 12-month period referred to as the limitation year. The final regulations under Section 415 of the Code, which were issued in 2007, made a number of technical changes to the Section 415 limits. The changes are effective for limitation years beginning on or after July 1, 2007 (i.e., January 1, 2008 for calendar year limitation years).

A conforming plan amendment must be adopted by the later of: (1) the due date (including extensions) for filing the income tax return for the employer's taxable year that includes the date on which the changes become effective with respect to the plan; or (2) the last day of the plan year that includes the date on which the changes become effective with respect to the plan. For plans that have a calendar year limitation year/plan year/tax year, the amendment must be adopted by the due date for the 2008 tax year, which would be at some point in 2009. If the plan's limitation year and/or plan year are other than the calendar year, plan sponsors should determine the deadline by which the amendment must be adopted and coordinate with us to prepare a timely amendment.

Plan sponsors should also check with their third party administrator to confirm that they are implementing the new rules.

401(k) Elective Deferrals May Only Be Made on Section 415(c)(3) Compensation

Effective for plan years beginning on or after July 1, 2007 (i.e., January 1, 2008 for calendar year plans), 401(k) elective deferrals may only be made with respect to compensation that qualifies as compensation under Code Section 415(c)(3). As a general rule, amounts received following a severance from employment, such as severance pay, parachute payments under Code Section 280G, and most unfunded nonqualified deferred compensation, are not considered to be Code Section 415(c)(3) compensation.

There are two exceptions to this general rule. First, elective deferrals may be made on "regular pay" that is paid within a specified timeframe and that would have been paid had the participant remained employed (such as regular, overtime, and shift deferential pay, commissions, bonuses, and similar compensation). Second, elective deferrals may also be made on any of the following types of post-severance payments:

1. certain payments within the specified timeframe for accrued bonafide sick, vacation, or other leave (if the participant would have been able to use the leave if employment had continued);
2. certain payments within the specified timeframe under a nonqualified deferred compensation plan (if the payments are taxable and would have been made at that time if the employee had continued employment);
3. certain payments to permanently and totally disabled participants (not limited to a specified timeframe); or
4. certain differential payments to individuals in qualified military service (not limited to a specified timeframe).

The specified timeframe in which the items listed in 1 and 2 must be paid is the later of 2½ months following the participant's severance date or the end of the limitation year that includes the participant's severance date.

As a result of these changes, plan sponsors should review plan terms and administration to determine whether any post-termination compensation is impermissibly included in the 401(k) definition of compensation and, at the same time, consider whether they want to revise the definition to allow deferrals on some or all of the post-termination compensation on which 401(k) elective deferrals may now be made. Making these changes could require changes to payroll systems, plan administration, and plan amendments.

Employee Benefits Security Administration Issues Final Regulations on Default Investment Alternatives

As previously reported, the PPA added a new provision that protects plan fiduciaries when participants are allowed to direct the investment of their accounts, but fail to do so. The fiduciaries will be entitled to the protection of Section 404(c) of ERISA if they invest the accounts of such participants in a qualified default investment alternative ("QDIA") and meet certain other requirements.

On October 24, 2007, the Department of Labor's ("DOL") Employee Benefits Security Administration published final regulations on QDIAs, which become effective December 24, 2007. **Plans wanting to take advantage of this new fiduciary safeharbor on December 24th must provide a notice by November 24, 2007.**

Fiduciary Relief

The final regulations provide relief to a plan fiduciary of a participant-directed defined contribution plan for any loss or breach that arises out of: (1) investing all or part of a participant's account in a QDIA; or (2) investment decisions made in connection with the management of a QDIA. A fiduciary, however, remains liable for prudently selecting and monitoring any QDIA.

To qualify for the relief provided by the final regulations:

- Assets must be invested in a QDIA;
- The participant must have been given the opportunity to direct the assets in his or her account but did not do so;
- The participant must receive an initial notice of the plan's default investment provisions at least 30 days before the participant becomes eligible to participate in the plan, or at least 30 days before the participant's assets are first invested in the QDIA. A participant also must receive an annual notice at least 30 days in advance of each subsequent plan year;
- The participant must receive investment materials relating to the QDIA;
- The participant must be permitted to transfer assets as frequently as a participant who

affirmatively elected to invest in the QDIA, but no less frequently than quarterly; and

- The plan must offer a broad range of investment alternatives within the meaning of Section 404(c) of ERISA.

Notice Requirements

As described above, the plan sponsor must provide a participant with notice of the plan's default investment provisions within the timeframes noted above. The notice must be written in a manner calculated to be understood by the average plan participant and must contain the following information:

- A description of the circumstances under which assets may be invested in the QDIA, and, if the plan automatically enrolls participants in the 401(k) feature, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contributions, and the right of the participant to elect not to have such contributions made on the participant's behalf;

- An explanation of the right of a participant to direct the investment of assets in his or her account;

- A description of the QDIA, including a description of the investment objectives, risk and return characteristics, and fees and expenses associated with the QDIA;

- A description of the right of the participant to direct the investment of assets in the QDIA to a different investment alternative under the plan, including a description of any applicable restrictions, fees, or expenses in connection with such transfer; and

- An explanation of where participants may obtain investment information concerning other investment alternatives under the plan.

Qualified Default Investment Alternatives

The final regulations provide for a fund to be a QDIA, it must meet the following criteria:

- It must not hold or permit the acquisition of employer securities, except: (1) certain employer securities held or acquired by an investment company registered under the Investment Company Act of 1940 (the "1940 Act"); or (2) employer securities acquired as a matching contribution from the plan sponsor, or employer securities acquired prior to management by the investment management service;

- It must not impose any greater restrictions on the ability of a participant to transfer the participant's investment from the QDIA to any other investment alternative available under the plan than are imposed on participants who affirmatively elected to invest in the QDIA; and

- It must be managed by: (1) an investment manager (as defined in section 3(38) of ERISA), plan trustee, or plan sponsor who is a named fiduciary; (2) an investment company registered under the 1940 Act; or (3) a capital preservation fund that meets the requirements of the final regulations.

Categories of QDIAs

The final regulations generally permit the following types of investment products to be used as QDIAs:

- Lifecycle or targeted retirement date funds which change their asset mix over time to manage risks as participants move from youth to middle age to retirement;

- Balanced funds which are diversified funds that contain a mix of equity and fixed income exposures consistent with a target level of risk appropriate for the plan as a whole, rather than the risk tolerances of individual plan participants;
- Managed accounts in which professional investment advisors create personalized investment portfolios tailored to the specific objectives of the participant; or
- Capital preservation funds (e.g., money market funds) which are permitted only for the first 120-day period after the date of the participant's first elective contribution to the plan.

As the preamble to the regulations points out, "the plan fiduciary must prudently select and monitor an investment fund, model portfolio, or investment service within any category of qualified default investment alternatives in accordance with ERISA's general fiduciary duties."

Action Required

Plan sponsors should decide whether they want to take advantage of this new fiduciary safeharbor. Fiduciaries wanting to take advantage of the relief on December 24, 2007 need to provide notice to participants by November 24th. Plan sponsors should determine whether their current default fund is a QDIA. If plan sponsors conclude that they want to take advantage of the safeharbor, they should review their policies and procedures to determine whether they fit within the final regulations and whether any plan amendments or revised participant notices are required.

To assist plan sponsors in transitioning away from default funds that do not comply with the final regulations (such as money market funds), the DOL has clarified that any participant or beneficiary, following receipt of proper notice, may be treated as failing to give investment direction without regard to whether he or she was defaulted into, or affirmatively elected, to invest in the plan's original default fund. This rule will be helpful for plans that are unable to differentiate between participants who affirmatively elected to invest in the old default fund and those who were defaulted into the fund.

IRS Proposes Rules on Automatic Contribution Arrangements

The IRS has released proposed rules providing guidance on automatic enrollment arrangements in 401(k) plans, 403(b) tax-sheltered annuities, or 457(b) governmental plans. Section 401(k) plans that adopt qualified automatic contribution arrangements ("QACAs"), a new design-based safe harbor created by the PPA, will be deemed to have satisfied the tax Code's special nondiscrimination tests that would otherwise apply to employee elective deferrals and employer matching contributions. In addition, such plans generally will be exempt from the top heavy rules. The proposed regulations also address the PPA's new permissible withdrawal rules that permit 401(k), 403(b), or governmental 457(b) automatic enrollment plans to allow a participant to withdraw certain default elective deferrals, and include guidance on the law's provisions relating to corrective distributions.

The regulations, which were published in the November 8, 2007 Federal Register, are proposed to become effective for plan years beginning on or after January 1, 2008 and may be relied upon pending the issuance of final rules. If the final regulations' provisions are more restrictive than those in the proposed rules, they will be applied prospectively.

Overview of the PPA's Automatic Contribution Provisions

The PPA included several provisions to facilitate employer adoption of automatic enrollment in 401(k) plans, as well as similar features in 403(b) tax-sheltered annuities and 457(b) governmental deferred compensation plans. Under such arrangements, an employee is automatically enrolled in a plan unless he or she affirmatively elects not to participate, and the plan may escape some nondiscrimination testing by qualifying for a "safe harbor" by adopting specific plan design features.

For plan years beginning on or after January 1, 2008, a plan qualifying as a QACA will be deemed to satisfy the actual deferral percentage ("ADP") and actual contribution percentage ("ACP") nondiscrimination tests, as well as the top-heavy rules that generally prohibit owners and other key employees from disproportionately benefiting under the plan. This new safeharbor requires a plan to satisfy several criteria, including:

- the uniform application of a minimum and escalating percentage of automatic elective deferrals to each eligible employee who fails to elect otherwise;
- the ability of each participant to elect out of the plan or to make elective deferrals at a different level;
- minimum employer matching or nonelective contributions on behalf of each eligible nonhighly compensated employee;
- vesting requirements for employer matching or nonelective contributions;
- distribution restrictions; and
- notice to participants.

In addition, the PPA allows "eligible automatic contribution arrangements" ("EACAs") to adopt a permissible withdrawal provision to return, under certain circumstances, default elective deferrals to participants without the distributions being subject to the 10% early withdrawal tax that normally would apply. In general, to be an EACA, an arrangement must:

- allow the participant to elect to have the employer make contributions to the plan on his or her behalf;
- in the absence of such an election, make certain automatic contributions to the plan by the employer on behalf of the participant equal to a uniform percentage of compensation;
- satisfy the requirements of ERISA Section 404(c)(5) with respect to default investments; and
- provide specific information in a notice to participants.

QACAs under the Proposed Regulations

In general, to the extent that the requirements to be a QACA are the same for those for the current-law safe harbor plans , the proposed regulations apply the existing rules to the QACA. Thus, for example, a plan may limit an eligible employee's elective deferral under the QACA as long as each eligible nonhighly compensated employee may elect to defer an amount that is sufficient to obtain the plan's maximum matching amount for the plan year.

For QACAs, key areas of guidance included in the proposed regulations are:

- *Application of the uniformity requirement* – To be a QACA, a plan must uniformly apply the qualified percentage (i.e., an initial minimum automatic elective deferral of 3% of compensation through the end of the plan year following the year of initial participation, increasing by 1% for each of the next three plan years, not ever to exceed 10% of compensation) to all eligible employees. The proposed regulations clarify that the qualified percentages are minimums and that a QACA can provide for higher percentages (but not more than 10%). Additionally, the QACA will not fail the "uniformity" requirement if the plan: varies the elective deferral percentage based on the number of years an employee has participated in the plan; does not reduce the rate of elective deferral under a participant's prior election that is in effect when the QACA becomes effective; or limits the amount of elective deferrals so as not to exceed the limits on compensation, elective deferrals, or benefits and compensation (under Sections 401(a)(17), 402(g), and 415, respectively). A plan also will not fail the uniformity requirement if it suspends employees from making elective deferrals for six months after they take a hardship distribution.

- *Clarification of "affirmative election"* – The proposed regulations allow current employees who were eligible to participate in the 401(k) plan immediately before the QACA's effective date and who have an election in effect on the QACA's effective date to be excluded from the plan-specified deferral percentages.

- *Notice requirement* – Plans will satisfy the PPA's timing requirement to provide notices "within a reasonable period before each plan year" by furnishing the notice to participants at least 30 days (and no more than 90 days) before the beginning of each plan year. The notice must explain the QACA and inform participants of the opportunity to elect out of the program or to change their deferral percentages from the QACA's qualified percentages. To facilitate this notice requirement, the IRS will post a sample notice on its website.

Permissible Withdrawals of Automatic Contributions

The proposed rules also provide guidance on returning default elective deferrals to participants. This PPA provision is available as an option to all plans with EACAs, allowing 401(k), 403(b), and governmental 457(b) arrangements to return amounts requested by a participant within 90 days of the first elective deferrals to the EACA. Returned amounts must be distributed with earnings, if any, and are treated as taxable income in the year distributed (but are not subject to the early withdrawal tax). If elective deferrals are withdrawn, employees will also forfeit any applicable employer matching contributions associated with the withdrawn amounts.

Corrective Distributions of Excess Contributions

The proposed regulations also reflect the PPA amendments, which permit an EACA to distribute excess contributions and excess aggregate contributions to participants within six months (rather than two-and-one-half months) after the close of the plan year in which the contributions were made. This provision, which will affect corrective distributions made in 2009, gives plans a longer period to make corrective distributions to avoid the imposition of the 10% excise tax on the employer. The amounts so distributed need not include income allocable to the period after the end of the plan year (i.e., the "gap period income") but are included in the employee's gross income for the taxable year in which they are distributed.

Separate Department of Labor Oversight

The Department of Labor ("DOL") also exercises jurisdiction over some issues related to automatic contribution arrangements for plans that are subject to Title I of ERISA. For example, the DOL oversight extends to an individual account plan's default investment and to participant notifications describing the plan's default investment alternative to which deferrals will be contributed if an employee fails to provide investment direction under ERISA Section 404(c)(5). In this regard, on October 24, 2007 the DOL published in the Federal Register a final rule on default investment alternatives under participant-directed individual account plans.
The DOL also has jurisdiction over the participant notifications required for plans that wish to take advantage of the PPA's ERISA preemption of state laws that, in effect, prohibit or restrict automatic contribution arrangements. Accordingly, plan sponsors contemplating automatic contribution arrangements should consult the DOL's regulations.

IRS ISSUES LOW NORMAL RETIREMENT AGE REGULATIONS IMPACTING IN-SERVICE BENEFITS UNDER DEFINED BENEFIT AND MONEY PURCHASE PENSION PLANS

On May 22, 2007, the IRS issued final regulations on pension distributions (i.e., distributions from defined benefit plans and money purchase pension plans) at normal retirement age. The final regulations provide that to be qualified, a defined benefit plan or money purchase pension plan must provide benefits after retirement or attainment of "normal retirement age." The regulations indicate that reducing hours worked does not result in retirement.

The New Normal Retirement Age Standard

Under the final regulations, a plan's normal retirement age cannot be earlier than what is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. A normal retirement age of 62 or later is deemed to satisfy this requirement. A normal retirement age under 55 is presumed <u>not</u> to satisfy this requirement unless the Commissioner of the IRS determines that the facts and circumstances show otherwise. Whether a normal retirement age between 55 and 62 satisfies this requirement depends on the facts and circumstances, but a plan sponsor's good faith, reasonable determination will generally be given deference. Special rules apply to qualified public safety employees.

Temporary Relief

Notice 2007-69 provides temporary relief, until the first day of the first plan year that begins after June 30, 2008 (i.e., January 1, 2009 for calendar year plans), for certain pension plans under which the definition of normal retirement age may be required to be changed to comply with the regulations. To qualify for relief under Notice 2007-69, the IRS specifies that it must not be possible for a plan participant hired at age 18 or older to be able to attain the plan's normal retirement age before the age of 40.

In general, sponsors of plans that have to be amended to comply with the new standard, and that are eligible for relief under Notice 2007-69, will not have to adopt an interim amendment before the later of: (1) the last day of the first plan year beginning after June 30, 2008 (i.e., December 31, 2009 for calendar year plans); or (2) the due date (including extensions) for filing the employer's income tax return for the employer's taxable year that includes the first day of the first plan year beginning after June 30, 2008.

Action Required

If a plan permits in-service distributions before age 62, the plan sponsor should review the age to determine if it is lower than what is reasonably representative of the typical retirement age for the industry. If the plan sponsor concludes the age meets the standard, the plan sponsor is not required to increase the age. If the sponsor concludes the age is too low, it should raise the age by plan amendment to an age that meets the standard. In either case, the plan sponsor should apply for a determination letter. If the plan sponsor applies for a determination letter by the deadline for adopting a plan amendment (as described above), and the IRS concludes the age is too low, the higher age, as determined by the IRS, will apply prospectively. However, if a plan permits in-service distributions before age 55, the plan sponsor must apply for a determination letter by June 30, 2008, to obtain this prospective relief.

If a plan does not qualify for relief under Notice 2007-69 (because it is possible for a participant hired at age 18 or older to attain the plan's normal retirement age before 40), any required amendments are effective May 22, 2007, and must be adopted (and submitted for a determination letter) by the due date (including extensions) for filing the employer's income tax return for the employer's taxable year that includes May 22, 2007.

IRS ISSUES PROPOSED CAFETERIA PLAN REGULATIONS THAT CHANGE TAX TREATMENT OF EXCESS GROUP-TERM LIFE INSURANCE

The IRS issued new proposed cafeteria plan regulations under Code Section 125 and withdrew proposed regulations that were issued from 1984 though 2000, as well as temporary regulations that were issued in 1986. The new proposed regulations reflect changes in the law since the prior regulations were proposed and provide additional guidance concerning the basic framework and requirements for cafeteria plans and elections under cafeteria plans.

Generally speaking, the proposed regulations apply for plan years beginning on or after January

1, 2009, although taxpayers may rely on these regulations for guidance pending the issuance of final regulations. Notwithstanding the general effective date, the proposed cafeteria plan regulations change the tax treatment of group-term life insurance effective August 6, 2007.

Generally, under Code Section 79(a), the cost of $50,000 or less of group-term life insurance on the life of an employee provided under a policy (or policies) carried directly or indirectly by an employer is excludible from the employee's gross income. Special rules apply to key employee if the group-term life insurance plan fails the nondiscrimination rules in Code Section 79(d).

However, if the group-term life insurance provided to an employee by an employer exceeds $50,000, the cost of coverage exceeding $50,000, less all after-tax contributions paid by the employee for such coverage, is includible in the employee's gross income. Previously, the cost of the excess coverage that was imputed as income to the employee was calculated as the *greater of:* (1) the cost of group-term life insurance as shown in Treasury Regulation Section 1.79-3(d)(2), Table I (Table I); and (2) the employee's pre-tax salary reductions and employer contributions toward the actual cost of coverage.

Effective for the 2007 and later tax years, the cost of the excess coverage is determined solely by looking at Table I. The proposed regulations provide that the amount includible in employee income is limited to the Table I cost of the excess coverage, minus any after-tax contributions paid by the employee, even if the actual cost of such coverage was greater than the Table I amount. This could result in less imputed income for employees. Employers should discuss this further with members of their accounting department to make sure that they are imputing income properly.

IRS ISSUES FINAL DEPENDENT CARE TAX CREDIT REGULATIONS

The IRS issued final regulations regarding the credit for expenses for household and dependent care services necessary for gainful employment under Section 21 of the Code. Section 129 of the Code allows employers to exclude from income amounts paid by the employer for such employment-related expenses under Section 21 of the Code. Employers can also allow employees to pay for such employment-related expenses on a pre-tax basis under a flexible spending account.

The final regulations generally apply to tax years ending after August 14, 2007, and contain the following clarifications.

Qualifying Expenses

To qualify as employment-related expenses, the expenses must be for the care of a qualifying individual. Expenses are for the care of a qualifying individual if the primary function is to assure the individual's well-being and protection. The final regulations clarify that the determination of whether expenses qualify as employment-related expenses must be made at the time services are performed. The final regulations provide the following guidance concerning what types of expenses are considered to be employment-related expenses:

- *Pre-school expenses* - Expenses for nursery or pre-school may be employment-related expenses; expenses for kindergarten or higher are not for care and therefore, are not employment-related expenses.

- *Specialty day camps* - Expenses for day camps may be employment-related expenses, even if the day camp specializes in a particular activity. However, the final regulations clarify that summer school and tutoring programs are not for care and therefore, are not employment-related expenses.

- *Overnight camps* - Expenses for night camps are not employment-related expenses.

- *Sick child centers* - Depending on the facts and circumstances, expenses incurred for utilizing a sick child center that provides care for children with illnesses can either be treated as a employment-related expense under Section 21 of the Code or an expense for medical care under Section 213 of the Code, but not both.

- *Transportation* - The cost of transportation by a dependent care provider may be employment-related expenses, however, the cost of transportation by the individual taxpayer is not.

- *Employment taxes* - Employment taxes paid on wages for a care provider may be employment-related expenses.

- *Room and board* - The additional cost of providing room and board for a care provider over usual household expenditures may be employment-related expenses.

- *Application fees, agency fees, and deposits* - Expenses that relate to, but are not directly for, the care of a qualifying individual (such as application fees, agency fees, and deposits) may be employment-related expenses if the taxpayer is required to pay the expenses to obtain the related care. However, forfeited deposits and other payments are not for care and therefore, are not employment-related expenses.

Expenses Enabling a Taxpayer to be Gainfully Employed

Expenses are employment-related expenses only if they are for the purpose of enabling the taxpayer to be gainfully employed or to actively search for gainful employment. In general, expenses paid for a period of time during only part of which the taxpayer is gainfully employed or in active search of gainful employment must be allocated on a daily basis.

- *Short, temporary absences* - The final regulations provide an exception for short, temporary absences. A taxpayer who is gainfully employed is not required to allocate expenses during a short, temporary absence from work (such as for vacation or minor illness) provided that the taxpayer is required to pay for care during the absence. Whether the absence is a short, temporary absence is determined based on all the facts and circumstances. The regulations include a safeharbor that treats an absence of no more than two consecutive calendar weeks as a short, temporary absence.

- *Part-time work* - In general, a taxpayer who works part-time must allocate expenses between days worked and not worked. The final regulations provide that a taxpayer who works part-time but is required to pay for dependent care on a weekly or longer basis is not required to allocate the expenses between days worked and not worked. A day on which the taxpayer works at least one hour is considered a day of work.

- *One parent works during the day and the other parent works at night* - The final regulations clarify that expenses for care while one parent is working and the other parent is sleeping is considered employment-related expenses.

Other Changes

- *Definition of "qualifying individual"* - The definition of "qualifying individual" has been revised to conform with changes made under the Working Families Tax Relief Act of 2004. As a result, for tax years beginning after December 31, 2004, a qualifying individual is: (1) the taxpayer's "qualifying child" (as defined in Section 152 of the Code) who has not attained age 13; or (2) the taxpayer's spouse, "qualifying child" or "qualifying relative" (as defined in Section 152 of the Code, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B)) who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year.

- *Special rule for divorced or separated parents or parents living apart* - In the case of a child of divorced or separated parents or parents living apart during the last six months of the year, the child is treated as the qualifying child of the custodial parent even if the noncustodial parent may claim the dependency exemption for the child for the taxable year. The custodial parent is the parent having custody for the greater portion of the calendar year.

- *Deemed earned income of spouses who are students* - For purposes of the deemed earned income of a spouse who is a full-time student, a "student" is defined as an individual who, during each of give calendar months during a taxable year, is a full-time student at an educational organization described in Section 170(b)(1)(A)(ii) of the Code. Section 170(B)(1)(A)(ii) provides that an "educational organization" normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. The final regulations clarify that an individual enrolled in a program provided by an organization that offers only on-line instruction is not a student for purposes of the deemed earned income rule. However, an individual who takes on-line courses through an organization that has traditional classroom instruction as well as on-line courses, and otherwise meets the definition of education organization, may be a student for purposes of the deemed earned income rule.

Action Items

Plan sponsors should discusses these changes with their third party administrator to ensure that the changes have been incorporated within their plan administration. Plan sponsors should also review their dependent care assistance programs to determine if any changes need to be made to the plan documents.

DEBIT CARD USE RESTRICTED EFFECTIVE JANUARY 1, 2008

Revenue Ruling 2003-43 approved the use of debit cards for health reimbursement accounts and health flexible spending accounts if the merchant or service provider uses a merchant category code ("MCC") related to health care (i.e., physicians, pharmacies, dentists, vision care offices, hospitals, and other medical care providers). Every claim must be substantiated and adjudicated. Claims are automatically substantiated if: (1) the expense matches a co-payment under the health plan; (2) the expense is a recurring expense, the first of which was substantiated and approved; or (3) the expense is substantiated by the merchant or provider at the point of sale.

Notice 2006-69 expands the flexibility of the substantiation requirements for transactions with merchants or service providers with MCC codes related to health care. The Notice provides that co-payments that equal a multiple of a single co-payment or a combination of multiple co-payments will be automatically adjudicated provided certain requirements are met.

Notice 2006-69 also allows the use of debit cards at merchants without MCCs related to health care and provides that the claims are automatically substantiated if the merchant uses stock keeping units ("SKUs") to identify which items purchased qualify as medical expenses under Section 213(d) of the Code.

Notice 2007-2 provides transitional relief for non-health care-related merchants by providing that supermarkets, grocery stores, discount stores, wholesale clubs, and mail order and web-based vendors that sell prescription drugs that do not operate under health care-related MCCs will be treated as if they do until January 1, 2008, provided that substantiation and correction procedures were followed. **The transition period ends on December 31, 2007. As a result, effective January 1, 2008, debit cards can only be used at non-health care-related merchants if the merchant uses SKUs to identify which items qualify as a medical expense under Section 213(d) of the Code.**

Notice 2007-2 also imposes additional restrictions at drug stores and pharmacies, even if they operate under a health-care related MCC. Effective January 1, 2009 debit cards may no longer be used at drug stores or pharmacies unless: (1) at least 90% of the store's gross receipts during the prior taxable year consist of items which qualify as "medical care" under Section 213(d) of the Code; or (2) the store participates in the inventory information approval system. Plans have an additional year to comply with this requirement.

Plan sponsors that utilize a debit card feature in connection with their health reimbursement account or health flexible spending account should confirm with their third party administrator that any non-health care-related merchants that participate in the debit card program will have inventory information approval systems in place effective January 1, 2008.

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