

KFTR EMPLOYEE BENEFITS UPDATE — JUNE, 2007



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FINAL 409A REGULATIONS

The IRS has issued the long awaited final regulations under Internal Revenue Code (Code) Section 409A, which established new rules applicable to nonqualified deferred compensation plans. Failure to comply with Code Section 409A subjects participants in deferred compensation plans to substantial tax liability including an additional 20% penalty tax on top of normal income tax and a possible interest payment. Some of the key points of the final regulations are:

- All plans providing non-qualified deferred compensation must be in writing and must comply with the provisions of Code Section 409A.
- Where applicable, current participants in a deferred compensation plan must make an election regarding the date on, and form in, which their benefits will be distributed before the year in which the services are performed.
- New participants must make an election as to the form and timing of their plan distribution within 30 days of plan eligibility.
- If the deferred compensation is performance based and the measurement period is at least one year, the form and timing election must be made at least six months before the end of the measurement period.
- Separation payments or payments resulting from a window program of forced reductions made by the end of the second calendar year, after an involuntary termination and which do not exceed two times compensation up to the Code Section 401(a)(17) limit (\$450,000 in 2007), are exempt from Code Section 409A even if the entire payment exceeds the two times compensation limit.
- Under certain circumstances, severance payments made upon an executive's voluntary termination can be considered to be for "good reason," so that the payment would be subject to the 409A exemption.
- The final regulations provide a safe harbor under which a payment upon a voluntary separation from service for good reason can be considered for Code Section 409A purposes, to be a payment upon an actual involuntary separation from service and thus qualify for an exemption under Code Section 409A.
- A short-term deferral rule contained in the proposed regulations is adopted. Under the short-term deferral rule, in general, payments made no later than 2 ½ months after the end of an employee's taxable year are not considered to involve a deferral of compensation and therefore are exempt from Code Section 409A.

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- Additional rules are set forth to identify “specified employees” to whom distributions must be delayed for at least six months after they separate from service (except if such separation is due to their death). “Specified employees” are “key employees” of publicly traded companies, as defined under Code Section 416(i).
- The extension of the time to exercise a stock option or a stock appreciation right (SAR) is not considered to be a modification of the stock option or SAR, and thus subject to Code Section 409A, as long as the extension is to a date no later than the original option period (not to exceed 10 years).
- Post-employment health coverage or reimbursement which is taxable to the former employee is not subject to Section 409A as long as the coverage or reimbursement does not extend beyond the COBRA coverage period.
- The final Code Section 409A regulations are effective January 1, 2008, and all plans that are subject to the regulations must be amended by December 31, 2007.

Code Section 409A applies to a broad range of plans including employment agreements, plans subject to Code Section 457 (f) maintained by governmental or tax exempt employers, long-term incentive plans, severance arrangements and supplemental executive retirement plans (“SERPS”). These plans need to be reviewed and in all likelihood modified by December 31, 2007 in order to comply with Code Section 409A.

PARTICIPANT STATEMENT DEADLINE

May 15, 2007 was the deadline when employers were required to meet the new Pension Protection Act of 2006 (PPA) quarterly benefit statement requirement, which applies to 401(k) plans and other defined contribution plans that allow participants to direct investments. The PPA mandates the new quarterly reporting for defined contribution plans, which allows participant investments and requires that the benefit statement include information that may not have been included in statements provided to participants in the past. For example, PPA now requires that the statement must contain advice about the need for participants to diversify their portfolio, including language pointing out that holding more than 20 percent of a portfolio in one entity may not be adequately diversified. If for some reason your plan did not meet the May 15, 2007 deadline, the required statements should be provided to participants as soon as possible.

FINAL INTERNAL REVENUE CODESECTION 415 REGULATIONS

The Internal Revenue Service (IRS) recently issued final regulations under Code Section 415. Code Section 415 places limits on the annual benefit that a participant may receive from a IRS qualified defined benefit plan and on the annual additions that may be made to an IRS qualified defined contribution plan. The current annual defined benefit plan limit is the lesser of \$180,000 or 100% of the participant’s average annual compensation. A participant’s average an-

nual compensation is based on his or her highest three years of earnings. The current defined contribution limit is the lesser of \$45,000 or 100% of the participant’s compensation.

Also, the final Code Section 415 regulations contain new rules regarding the definition of compensation that is used for purposes of determining the Code Section 415 maximum limits, as well as for various other provisions of the Code that apply to qualified retirement plans. Under these new rules, amounts that are paid after severance from employment are not considered compensation except for certain payments; such as, unused vacation pay which is paid by the later of 2 1/2 months following the severance date or the end of the limitation year (generally the calendar year) in which the severance occurs. The final Code Section 415 regulations also extend these new rules on compensation paid after severance from employment to 401(k) plans. Thus, deferrals no longer will be allowed on payments made after severance from employment unless the payments are covered by the 2 1/2 month/year end exception discussed above.

The final Code Section 415 regulations apply to limitation years beginning or after July 1, 2007. The changes made to the 401(k) regulations apply to plan years beginning or after July 1, 2007.

EGTRRA REMEDIAL AMENDMENT PERIOD

IRS qualified single-employer retirement plans (as opposed to master or prototype plans that a third party institution has developed) that have an Employer Identification Number (EIN) ending in a “2” or a “7” must be amended to meet the requirements of

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the Economic Growth and Tax Reconciliation Act of 2001 (EGTRRA) and subsequent legislation and rulings by January 31, 2008. Although January 31, 2008 is approximately eight months away, the IRS has requested that employers do not wait until the last minute to update their plans and file with the IRS for a favorable determination letter. Also, as the last major revisions to most single-employer retirement plans occurred more than five years ago, the task of updating a current retirement plan document will be a substantial undertaking. Therefore, all employers who maintain one or more single employer retirement plans that must be amended by January 31, 2008 should start the update process sooner rather than later.

ILLINOIS CIVIL UNION BILL

Under Illinois House Bill 1826, adult same-sex and different-sex couples could enter into a civil union, and by doing so could be under the same obligations, responsibilities, protections, and benefits afforded or recognized by the law of Illinois to spouses. If House Bill 1826 becomes law, employers will have to determine whether they will extend the coverage of their employee benefits programs to the partners of participants who have entered into a civil union with the participants. Employers who do not offer employee benefits to partners of participants joined through a civil union may face employee benefits claims and possible litigation. The employee benefits claims and possible litigation will arise from the conflict between House Bill 1826, which states that employers must treat those joined through a civil union the same as two individuals of the opposite sex joined through marriage, and

the provisions of the Employee Retirement Income Security Act of 1974 (as amended) and the Internal Revenue Code, which provide in general that the administration of employee benefits matters is a federal issue. In addition, under the 1996 Defense of Marriage Act, the federal system is prevented from recognizing any status "between persons of the same sex that is treated as a marriage." If House Bill 1826 becomes law, the end result almost certainly will be to increase the cost of the employee benefits offered by employers or require employers to drop the coverage of dependents under their health care plan.

CHANGES IN TRICARE COVERAGE

TRICARE is the health care program for active duty and retired members of the uniformed services, their families and survivors. Employers that employ individuals who previously served in the military may choose to offer TRICARE coverage to eligible employees in addition to the employer-sponsored group health care plan. The John Warner National Defense Authorization Act For Fiscal Year 2007 includes a provision under which employers who have an employer-sponsored group health care plan and offer TRICARE to TRICARE eligible employees cannot provide a financial or other incentive to their TRICARE eligible employees to use TRICARE coverage. Furthermore, the employer-sponsored group health care plan must be primary to TRICARE. There is a civil penalty of \$5,000 per violation for the failure to follow the revisions to TRICARE.

At this point regulations have not been issued on this modification. However, the Department of Defense, which is

responsible for issuing regulations under the Act, has indicated that the interim final rule will allow broad based cafeteria plans to continue to exist but will prohibit "TRICARE Supplement" plans where TRICARE would be primary and the supplement would offer gap coverage. Until regulations are issued it will not be 100% clear what action employers who offer TRICARE to eligible employees must take. However, employers need to monitor developments to determine if they still will be able to continue to offer TRICARE and if so under what terms.

CAFETERIA PLAN REQUIREMENT UNDER MASSACHUSETTS HEALTH CARE REFORM ACT

The Massachusetts Health Care Reform Act requires that, effective July 1, 2007, all employers who have at least eleven (11) employees in Massachusetts must offer their employees a cafeteria plan that meets the requirements of Internal Revenue Code Section 125. Under the law, employers must allow employees the right to elect one or more medical coverage options and pay for the premiums on a pre-tax basis. In addition, the law requires that a written document meeting certain requirements be prepared, if it does not already exist. The written document must be filed with the Massachusetts Commonwealth Health Insurance Connector Authority by July 1, 2007 in a manner to be described by the Connector Authority in future guidance.

Please call us if you have any questions or would like to discuss any of these developments.

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