Plan Sponsor Voice

A Publication of Nationwide® Retirement Solutions – a Nationwide® Financial company

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Nationwide produces this publication to provide public defined contribution plan sponsors with information about federal legislative and regulatory activity that may be relevant to plan administration and/or design.

Federal Legislative and Regulatory Report

January 2005

I. Washington Update

Congress is back in session and the President has announced an aggressive agenda for this session that includes both Social Security reform and an overhaul of the nation's federal tax system. Private or personal accounts appear to be the cornerstone of the President's proposals to reform the Social Security system.

To address tax reform, the President has appointed nine individuals to a newly created economic tax reform panel. Proposals that result from the Panel's recommendations are likely to address Lifetime Savings Accounts (LSA), Retirement Savings Accounts (RSA) and Employer Retirement Savings Accounts (ERSA) initiatives which were part of the President's 2003 and 2004 budget proposals.

Stabilizing and strengthening the nation's private sector pension system is another top priority this year for both the Administration and Congress. Recently, Elaine L. Chao, U.S. Secretary of Labor and Chairman of the Board of the Pension Benefit Guaranty Corp. (PBGC), introduced the Administration's plan to strengthen the retirement security of the 34 million workers and retirees covered by private, single employer defined benefit pension plans. The key elements of the plan include:

- ✓ a single, accurate way to measure pension fund liabilities that replaces an existing system that is overly complex, confusing and ineffective,
- ✓ funding targets that reflect a plan's real risk of termination with reasonable time periods for plans to reach these targets,
- ✓ flexibility for solvent companies to make more generous contributions to pension plans during good economic times,
- ✓ restrictions on the ability of financially strapped companies to promise more benefits than they can support,
- ✓ measures to ensure the long-term solvency of the PBGC which insures benefits under the private pension system.

II. Automatic Rollover Rules Apply to All Mandatory Distributions

The automatic (default) rollover rules, added to the Internal Revenue Code as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), affect plans that provide for mandatory distributions of participant account balances that are between $1,000 and $5,000.

These rules require plan administrators to notify participants, in writing, that the mandatory distributions in excess of $1,000 may be paid in a direct rollover to an IRA established by the employer on behalf of the participant, unless the participant requests that the distribution be rolled into another plan or IRA or paid to him/her as a direct payment.

IRS Notice 2005-5 clarifies that the automatic rollover rules apply to all qualified retirement plans, including governmental and non governmental qualified plans, 403(b) plans, governmental 457(b) plans and church plans that have a mandatory distribution provision. The automatic rollover rules will apply to non-governmental plans and electing church plans [subject to IRC 401(a)] for distributions made on or after March 28, 2005. Governmental and non-electing church plans will have a later effective date.

Mandatory Distributions from Retirement Plans (Source: IRS Notice 2005-5)

What is a mandatory distribution from a retirement plan?	A mandatory distribution is a distribution that is made without the participant's consent before the participant attains the later of age 62 or the plan's normal retirement age.
Are all retirement plans required to have a mandatory distribution provision?	No, a mandatory distribution provision is an optional plan feature.
What is the limit on the amount of mandatory distribution that is subject to the automatic rollover rule?	All mandatory distributions over $1,000 that are eligible for rollover are subject to the automatic rollover rule. There is no maximum limit. The automatic rollover rules do not apply to distributions under $1,000.
Is the plan administrator required to notify participants who are subject to the mandatory distributions rules prior to making the distribution to an automatic IRA?	Yes, the plan administrator is required to notify the participant in writing, either separately, or as part of the required 402(f) distribution notice that the distribution will be paid to an IRA unless the participant affirmatively elects to have the funds rolled over to another plan, an IRA of his/her choice or to receive the distribution in cash or property. The notice must identify the trustee or issuer of the IRA.
Is participant notification by mail considered adequate for meeting the participant notification requirement if the U.S. Postal Service returns the notice?	The plan administrator is considered as having fulfilled the notification requirements even if the notice is returned by the United States Postal Service provided it was mailed to the participant's most recent mailing address in the records of the employer and plan administrator.
When can a plan administrator establish an automatic rollover IRA for the participant?	The plan administrator may establish an automatic IRA without the participant's consent after the administrator has made a reasonable attempt to notify the participant of the automatic rollover and the participant has not directed the administrator to roll the distribution to another plan or pay the distribution directly to the participant.

Can a plan sponsor eliminate the mandatory distribution provision from the retirement plan?	Yes. Plans that have this provision may be amended to eliminate the mandatory distribution provision. **Note**: Private sector plans that eliminate mandatory distributions will not violate the anti-cut back rules of IRC 411(d)(6) that apply to ERISA covered qualified plans.
Is a distribution to a surviving spouse or alternate payee, or a plan loan offset considered a mandatory distribution for purposes of the automatic rollover rule?	No.
May mandatory distributions be made to a deemed IRA account that is part of the retirement plan?	Yes.
When does a plan that provides for mandatory distributions have to be amended to satisfy the automatic rollover rules?	**Governmental plan sponsors** will have until the close of the first regular legislative session of the legislative body with the authority to amend the plan that begins after January 1, 2006 to amend their plans. **Private sector plans** that provide for mandatory distributions and that do not already include the automatic rollover provisions must adopt a good faith plan amendment reflecting the automatic rollover requirements by the end of the first plan year ending on or after March 28, 2005. Examples: Calendar year plans would have until December 31, 2005 to amend their plans. Non-calendar plans would have to be amended sooner. If the plan year ends June 30, 2005 the plan will have to be amended by June 30, 2005.
When do government plans that have mandatory distribution provisions have to comply with the automatic rollover rules?	These rules will not apply to mandatory distributions from qualified governmental, 457(b) and 403(b) plans for distributions made prior to the close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after January 1, 2006. Non-governmental and electing church plans will have to operationally comply with these rules for all mandatory distributions made after March 28, 2005.
Has the IRS provided a sample amendment plan sponsor could use in drafting this amendment?	Yes. The Notice contains a sample good faith EGTRRRA amendment for sponsors that wish to provide for automatic rollover of mandatory distributions which they can use either as is or as a guide for drafting their own amendment.

Find more information online at

http://www.irs.gov/pub/irs-drop/n-05-05.pdf

III. Non Qualified Deferred Compensation Guidance Issued

The American Jobs Creation Act of 2004 added section 409A to the Internal Revenue Code (November, 2004 Monthly Report), which provides new rules for nonqualified deferred compensation plans. Under Code Section 409A, amounts deferred under a non- qualified deferred compensation plan are currently taxable if they are not subject to a substantial risk of forfeiture. **Section 409A does not apply to any tax exempt or governmental 457(b) plan**.

The Treasury Department and IRS recently issued Notice 2005-1 which provides plan sponsors transition period to bring their plans into compliance with the new law and which clarifies a number of important terms. This Notice is the first of several pieces of guidance the IRS is expected to issue for non-qualified deferred compensation plans.

Non Qualified Deferred Compensation Plan Guidance (Source: IRS Notice 2005-1)

What is a non-qualified deferred compensation plans for the purposes of IRC 409A? Q & As 3(a), 4(a) and 6	For the purposes of IRC 409A, a non qualified deferred compensation plan is any plan/arrangement that provides for a deferral of compensation if the plan and all relevant facts and circumstances provide for deferral of compensation that the employee/service provider has a legally binding right to during the year that has not been paid or constructively received.
When is compensation subject to a substantial risk of forfeiture? Q and A 10(a)	Compensation is subject to a substantial risk of forfeiture if the participant has to perform substantial future service in order to be entitled to compensation & the possibility of forfeiture is substantial. Once compensation is no longer subject to a substantial risk of forfeiture, it is includible in gross income and taxable.
What plans are exempt from IRC 409A? Q and A 3(b)(c)	Section 401(a), 457(b), 403(b), 415(m), SEP, SIMPLE plan, or 518 trusts are not subject to IRC 409A. Certain welfare benefit plans are not subject to IRC 409A such as bona fide vacation leave, sick leave, compensatory time, disability or death benefit plans, Archer Medical Savings Plan, Health Savings Account or any plan that is a Health Reimbursement Arrangement. **Note**: Pending further guidance, State and local governments and tax exempt entities may rely on the definitions of bona fide vacation leave, sick leave, compensatory time, disability pay and death benefit plans under IRC 457(f) for purposes of applying IRC 409A which exempts these plans from 457(f).
Does IRC 409A Apply to any type of 457 plan? Q and A 6	Yes. Section 409A rules apply only to 457(f) plans in addition to any rules already applicable to 457(f) plans. These rules also apply to non-elective deferred compensation plans for non-employees and grandfathered plans under prior 457 transition rules. Pending further guidance Length of Service Awards (LOSAPS) for bona fide volunteers are generally not subject to 409A.
What is the Effective Date for Section 409A? Q and A 16	Generally, section 409A is effective for amounts deferred in taxable years beginning in 2005 and for amounts deferred before January 1, 2005 if the plan was materially changed after October 3, 2004.

	Amounts are considered deferred before January 1, 2005 if the employee has a legally binding right to be paid the amount and the right to the amount has been earned and vested as of December 31, 2004. An earned and vested right for this purpose is the right to compensation that is not subject to a substantial risk of forfeiture or a requirement to perform further services.
When do non-qualified deferred compensation plans have to be amended to reflect the requirements of IRC 409A? Q and A 16(a) and 19(a)	Plans are not required to be amended until December 31, 2005, but must be operated in good faith compliance according to this Notice and Code section 409A during 2005.
When can deferral elections be made to a plan in existence on or before December 31, 2004? Q and A 21	Deferral elections may be made as late as March 15, 2005 that relate to compensation for services performed on or before December 31, 2005 as long as compensation that has not already been paid or payable at the time of deferral election is made.
May a plan be amended to provide for new payment elections for prior deferrals? Q and A 19(c)	Yes. The plan may be amended to provide for new payment elections for amounts deferred prior to the election if the plan is amended and the participant makes the election on or before December 31, 2005. This election will not be treated as a change in the form and timing or an acceleration of a payment under IRC 409A.
How should plans be operated for issues not addressed in the Notice? Q and A 19(b)	Plans should be operated during 2005 based on a reasonable, good faith reasonable interpretation of section 409A, according to the plan's terms provided they are not in conflict with IRC 409A and would cause the plan to fail to meet the requirements of IRC 409A. **Example 1**: If an employer retains discretion under the terms of the plan to delay or extend payments and exercises such discretion, the plan will not be considered to be operated in good faith compliance with IRC 409A with regard to any plan participant.

Find more information online at http://benefitslink.com/IRS/notice2005-1revised.pdf

IV. DOL Clarifies Fiduciary Responsibilities of Directed Trustees

Many retirement plans use directed trustees to carry out transactions according to the instructions from a named plan fiduciary. Events involving company stock and recent court decisions have focused increased attention on the role of a directed trustee's duties. The U.S. Department of Labor (DOL) released Field Assistance Bulletin (FAB) 2004-03 that outlines the duties and responsibilities of a directed trustee and with regard to publicly traded securities and employer securities in particular, under the Employee Retirement Income Security Act (ERISA). Although ERISA does not apply to government plans, it is often cited in employee benefit court decisions and is used as a basis for many state laws that govern the fiduciary obligations of governmental retirement plans.

This FAB clarifies that named plan fiduciaries, not directed trustees, are primarily responsible for ensuring the prudence of plan investment decisions. Directed trustees are still fiduciaries under ERISA and are responsible for carrying out their duties prudently and solely in the interest of the participants and beneficiaries. Directed trustees have an obligation to review all documents that govern the plan and that are relevant to the duties of the directed trustee. If the directed trustee does not request relevant documents and review them, and then follows a direction that is contrary to the terms of the plan, the directed trustee may be liable for following such direction.

For example, if a directed trustee follows an improper direction by purchasing a particular stock that is contrary to the plan's investment policy, the directed trustee may be liable for a breach of its fiduciary duty to follow only proper directions. Moreover directed trustees may not follow a direction that the directed trustee knows or should know is contrary to ERISA, such as engaging in a prohibited transaction or violating the prudence requirements of ERISA.

The duties of directed trustees are subject to the "proper" directions of a named plan fiduciary. When a directed trustee knows or should know that the directions from a named fiduciary are not made in accordance with the terms of the plan or ERISA, the directed trustee may not follow the directions from the named fiduciary.

This FAB specifically addresses the responsibilities of a directed trustee in determining whether a direction is "proper" and consistent with the terms of the plan and not contrary to ERISA when a directed trustee has non-public information regarding a security that is necessary for a prudent decision by the directing plan fiduciary. In this case, the directed trustee has a duty to inquire about the named fiduciary's knowledge and consideration of the information.

Only in extraordinary circumstances, a directed trustee would be required to question the instructions of the directing fiduciary based on public information. A directed trustee may have to question directions involving the purchase or holding of a security where there are "clear and compelling public indicators," such as an 8-K or bankruptcy filing, that call into question the issuer's viability as a going concern.

The FAB is part of the DOL's ongoing compliance assistance program to help employers, plan officials, service providers and others comply with ERISA.

Find more information online at http://dol.gov/ebsa/pdf/pr121704.pdf and http://www.dol.gov/ebsa/pdf/fab-2004-3.pdf

V. IRS Updates Priority Guidance Plan

The IRS has updated its 2004-2005 Priority Plan for published guidance that includes:

***Retirement Plan Guidance For*:**

- Procedural Guidance for group trusts
- Roth 401(k) elective deferrals
- Post severance elective deferrals for 401(k), 403(b) 415(c) and 457(b) plans
- IRA abuses
- Proposed regulations under IRC 415
- Electronic Communications
- 457(b) and 501(c)(1) for plans established by federal credit unions

Health Reimbursement Accounts and Other Guidance For:

- Retiree health accounts in a profit sharing plan
- Health Reimbursement Accounts
- Election between taxable and non-taxable benefits
- Proposed regulations on employer comparable contributions to Health Savings Accounts

Find more information online at

http://www.irs.gov. Select Tax Professionals.

VI. 401(k) final Regulations Issued

Late in 2004, the IRS released final 401(k) regulations which were originally, proposed in 2003. The bulk of the regulations deal with non-discrimination testing methodology that does not apply to government plans. Many of the definitions, contribution and distribution provisions outlined in the final regulations, however, do apply to governmental 401(k) plans.

Final 401(k) Regulations

Definition of 401(k) plan	401(k) plans are profit sharing plans, stock bonus plans, pre-ERISA money purchase plans or a rural cooperative plans that provide for the qualified cash or deferred arrangement (CODA). A qualified CODA is an arrangement that permits employees to make a voluntary election to have the employer pay the employee in cash or other taxable benefit or contribute the amount on a pre-tax basis to retirement plan where it remains tax-deferred until distribution. A qualified CODA includes designated Roth contributions but not employee after tax contributions. Deferrals under a qualified CODA are 100% vested at all times and treated as employer contributions (including designated Roth contributions) for purposes of 401(a), 401(k) and other sections of the Code. **Note**: Government employers may not adopt new 401(k) plans but may continue to maintain existing 401(k) plans. Indian Tribal governments and rural cooperatives are allowed to adopt and maintain 401(k) plans.
Roth 401(k) Plan	Beginning in 2006, section 401(k) plans will be permitted to allow employees to designate some or all of their elective contributions as "Roth" contributions. A designated Roth contribution is an elective contribution that is included in income. The Treasury and IRS expect to issue designated Roth guidance in the near future.
Effective Opportunity to Make Deferrals	The final regulations require that the plan give participants an "effective opportunity" to make or change their deferral elections at least once each year. The effective opportunity will be determined on all the facts and circumstances including adequate notice of the availability of such an election, time period for making the election and other conditions for making the election.

One time Irrevocable Elections	A one-time irrevocable election is an one-time irrevocable election to have a specified percentage or amount (including no amount) contributed a the plan. This election can be made no later than when the employee first becomes eligible to participate in the plan. Once the election is made it cannot be changed. A one-time irrevocable election therefore, is not an elective deferral that is part of a qualified CODA, nor is it counted against the elective deferral limits. Irrevocable elections can be made to governmental plans such as defined benefit plans, 403(b) plans and other qualified plans.
Matching contributions	Matching contribution are employer contributions that are made because of an employee elective deferral or an employee contribution based on all relevant facts and circumstances.
Contributions	
Pre-funding Contributions	The final regulations prohibit pre-funding of deferral and matching contributions in anticipation of future performance of service.
Exception for pre-funding contributions	Occasional early contributions can be made for bona fide reasons such as the temporary absence of a bookkeeper who is responsible for sending contributions to the trust.
Automatic Enrollment	The final regulations incorporate previous guidance for automatic enrollment and clarify that the 3% default election in previous guidance was for illustrative purposes only.
Distributions	
Distribution Events	401(k) deferrals may be distributed at age 59½, death disability, and severance from employment, hardship or plan termination. **Note**: Change in status from common law employee to leased employee is not a distribution event for 401(k) plans.
Hardship Distributions for Post Secondary Education of a Dependent	The Working Families Tax Relief Act (WFTRA) changed the definition of "dependent" for many employee benefit plan purposes by requiring that a dependent be either a qualifying child who meets residency requirement or qualifying relative who meets a gross income test. The final 401(k) regulations provide that for the purposes of a hardship distribution for post-secondary education expenses of a dependent, certain WFTRA restrictions including the income test will not apply. The preamble to the final regulations states that the plan may use the pre-2005 definition of dependent until the final regulations are applicable.
Hardship Distributions for Medical Expenses	Hardship distributions are permitted only for medical expenses that are deductible under IRC 213(d) disregarding the requirement that they exceed 7.5% of the taxpayer's adjusted gross income. The definition for the medical expenses of a dependent has been expanded to include a non-custodial child. Eligible hardship distributions for medical expenses do not include reimbursements for non-prescription drugs except for insulin. The definition of dependent for these purposes follows the definition for post secondary education expenses. The preamble to the final regulations permits plan sponsors to continue to apply the pre-2005 definition of dependent until the final regulations are applicable.

Additional Safe Harbor Events for Hardship Distribution	The final regulations have added burial and funeral expenses for employee's parent, spouse, children or dependents (without regard to the income test for dependents) and for certain expenses relating to the repair of damage to the employee's principal residence (without regard to the requirement that the loss exceed 10% of employee's gross income) to the list of safe harbor events to determine immediate and heavy financial need for hardship purposes.
Plan Termination	401(k) plans may be terminated. Assets may distributed from a terminated plan to participants provided the employer has not or does not establish an alternative defined contribution either 12 month before or 12 months after the date of termination. Alternative plans do not include 457(b), 403(b), ESOP SEP or SIMPLE IRA.
Effective Date of Final Regulations	The final regulations are effective for plan years beginning on or after January 1, 2006. Plan sponsors may voluntarily implement the changes found in the final regulations for plan years ending after December 31, 2004 only if all the applicable changes in the regulations are applied to the plan.

Find more information online at

http://www.treasury.gov/press/releases/js2171.htm and
http://a257.g.akamaitech.net/7/257/2422/06jun20041800/edocket.access.gpo.gov/2004/pdf/04-28011.pdf

VII. Treasury Stands Firm on FSA Use-It or Lose-It Rule

Last summer, Senator Charles Grassley of the Senate Finance Committee in a letter to Secretary of the Treasury, John Snow, asked the Treasury Department to change the "use-it or lose- it rule" that applies to Flexible Spending Accounts (FSAs) that help employees pay for health care needs on a tax-free basis. Under the use-it or lose-it rule, FSA unused balances for the current year must be spent by the end of the year to avoid being forfeited forever, which is one of the major reasons many employees do not participate in FSAs. Those that do participate are often forced to incur unnecessary health care expenses before the end of the year to avoid forfeiting their account balances.

In his recent reply to Senator Grassley's request, Secretary Snow stated that the Treasury does not have sufficient legal authority to modify the use-it or lose-it rule and concluded that elimination of this rule might impact other important health care priorities of Congress and the Administration. Treasury estimates that there may be as much as a 10% reduction in the number of Health Savings Accounts (HSAs) that would be established if the use-it or lose- it rule is eliminated. Contributions cannot be made to an HSA unless the taxpayer is covered under High Deductible Health Plan (HDHP) and could result in less containment of overall health care spending. Treasury did advance the concept of a grace period that would extend slightly beyond the one year period, before the use-it or lose rule would result in unused FSA amounts to be forfeited.

Legislation was introduced, but not passed, last year in Congress that would have allowed up $500 of FSA unused balances to be carried over to other years.

Find more information online at

http://finance.senate.gov/press/Gpress/2005/prg010505lett.pdf and
http://grassley.senate.gov/index.cfm?FuseAction=PressReleases.View&PressRelease_id=4865

VIII. Keeping watch

Nationwide Retirement Solutions continues to monitor SEC and various attorneys-general investigations into mutual-fund trading practices and related issues. You can find the most recent information on these issues on the Employer page of your plan Web site. In addition, we report guidance on legislative and regulatory activity relevant to government sector defined contribution plans through these publications:

- *Plan Sponsor Voice* newsletter – distributed quarterly – next edition due in February, 2004
- *Federal Legislative and Regulatory Report* – distributed monthly
- *Legislative and Regulatory Alerts* – distributed on an ad hoc basis to announce breaking news

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