

DECEMBER 2006

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## Employee Benefits

A Littler Mendelson Newsletter

### Year-End Employee Benefits and Executive Compensation Checklists

By Nancy L. Ober

Employers sponsoring retirement plans and deferred compensation arrangements should be mindful of certain actions that must take place by December 31 of this year, as well as new requirements and opportunities effective at the beginning of the 2007 plan year. Few of these action items entail major undertakings, but employers should review their plans and policies to ensure that appropriate actions are taken to comply with new requirements.

#### Qualified Plans

##### 401(k)/401(m) Final Regulations

The Internal Revenue Service issued final 401(k)/401(m) regulations, which become effective for plan years beginning on or after January 1, 2006. Plan sponsors should review their plans before the end of 2006 to determine whether plan amendments are required in three specific areas:

- Nondiscrimination testing rules – The regulations limit the use of a targeted “bottom up” method for making qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs) to correct ADP/ACP testing failures. The “bottom up” method permitted employers to target their corrective contributions to the lowest paid nonhighly compensated employees in order to minimize their total corrective contribution. The final regulations do not prohibit targeted QNECs and QMACs, but impose limits on the amount of such contributions that may be taken into account to pass nondiscrimination testing.

- Hardship withdrawal rules – Effective January 1, 2006, a plan may permit two additional reasons for hardship withdrawals: burial and funeral expenses for a parent, spouse, child or dependent and repair of damage to a participant's primary residence that would qualify for a casualty deduction on a tax return.
- Technical changes – The regulations make numerous technical changes to the 401(k)/401(m) rules. Though some of these changes may not necessitate amendments to the plan, the following is a list of changes that may require amendments:
  - “Gap period” earnings on distributed excess contributions made in connection with a failed ADP/ACP test must be distributed to plan participants (the plan may calculate earnings up to seven days before distribution);
  - If an individual has made 401(k) elective deferrals, he or she will be deemed to be “vested” for purposes of the “deemed” cash out rule and the rule of parity;
  - An individual's transfer in employment status from an employee to a leased employee (as described in Code section 414(n)) is not a severance from employment for distribution purposes; and
  - With respect to hardship distributions, plans may disregard the narrowing of the definition of dependent under Section 152 of the Internal

Revenue Code.

**Amendments that are required under the regulations must be made by the later of the end of the plan year containing January 1, 2006 (for calendar year plans, December 31, 2006) or the tax filing date of the plan sponsor for the year containing January 1, 2006. Permissive amendments must be adopted by the end of any plan year for which they are effective.**

#### *Hurricane Relief – Katrina, Rita, and Wilma*

Legislation passed by Congress in 2005 (the Katrina Emergency Tax Relief Act of 2005 (KETRA) and the Gulf Opportunity Zone Act (GOZA)) and IRS guidance eased the rules for participant loans and hardship withdrawals if the participant, his or her spouse, lineal descendants, ascendants, or dependents resided or worked principally in an area affected by Hurricanes Katrina, Rita or Wilma. Hurricane-related loans and hardship distributions had to be taken during the period August 29, 2005 through March 31, 2006 and could be approved by the plan administrator without the necessity of a plan amendment. **However, plans must be amended by the end of the 2006 plan year to take advantage of this relief.**

#### *Pension Protection Act of 2006*

Most of the changes enacted by the PPA relate to the funding of defined benefit plans and become effective in 2008. However, the PPA will also require changes in the administration of defined contribution plans (such as 401(k) plans) beginning in 2007. The most salient aspects of the Act are described below.

- **Notice of Diversification Rights:** Effective for plan years beginning after December 31, 2006, plans holding publicly traded employer stock must permit participants to divest their accounts of employer securities and to direct investment in other investment options. A notice must be furnished to participants regarding their right to diversify and the importance of diversification not later than 30 days before they become eligible to diversify. Employees are eligible to diversify employee contributions immediately and employer contributions after three years of service. **Calendar year plans will be**

**required to give the diversification notice by January 1, 2007** (the IRS has clarified that notices are not required before that date). The IRS has issued a model notice for this purpose. A penalty of \$100 per day may be assessed for failure to provide the notice.

- **Vesting:** Beginning with plan years after December 31, 2006, employer profit-sharing contributions, like matching contributions, must vest at least as rapidly as one of the following: for cliff vesting schedules, three years (0% vested until completing three years of service), and, for graded vesting schedules, a “two-to-six” year schedule, with at least 20% per year vesting after the second year of service.
- **Benefit Statements:** Beginning with plan years after December 31, 2006, individual account plans (including 401(k) plans) must provide participant benefit statements at least quarterly to participants who have the right to direct investments, and to other participants and beneficiaries who have their own account under the plan at least annually. Quarterly statements to participants who have the right to direct investments must contain information about the importance of account diversification. Defined benefit plans must furnish a benefit statement at least once every three years to a participant with a nonforfeitable accrued benefit who is employed by the employer maintaining the plan at the time the statement is to be furnished. Alternatively, at least annually, defined benefit plans must provide notice to each such participant of the availability of the pension benefit statement and how to obtain it.
- **Investment Advice:** Effective January 1, 2007, a plan’s investment advisor (registered investment advisor, bank or broker/dealer) may provide investment advice directly to plan participants and receive fees for advice if certain requirements are met. The advisor must acknowledge in writing that it is a plan fiduciary with regard to providing investment advice. The arrangement must provide that the fees received by the investment advisor do not vary depending on the investment

option selected, or the advisor must use a computer model for providing advice. The Department of Labor will publish regulations that contain an approved computer model.

- **Fiduciary Liability:** Section 404(c) of ERISA has shielded plan sponsors from lawsuits stemming from the investment choices made by plan participants provided (i) plan sponsors took the steps needed to be 404(c) compliant and (ii) the investment choices provided by the plan sponsor were prudent. This liability shield, however, did not extend to default investment elections which were made where participants failed to direct their investments. However, effective for plan years after December 31, 2006, if certain requirements are met, plan fiduciaries will be shielded from liability for certain legal actions arising out of investment results where a participant has failed to make an election and the participant’s account is invested in a default investment. The plan must provide participants with notice explaining the participant’s right to invest his account and how the account will be invested if the participant fails to make an affirmative investment election. The default account cannot be a money market or stable value fund. Rather, it must be a diversified fund of one of three types: a life-cycle or targeted retirement fund that changes asset allocations as the participant ages, a balanced fund for long-term appreciation and capital preservation, or an investment fund management service that allocates assets according to the participant’s age, retirement date and life expectancy.

## Executive Compensation

New deferred compensation rules promulgated under Section 409A of the Internal Revenue Code became effective January 1, 2005. These rules govern the timing and form of distributions of “deferred compensation” as well as how and when elections to defer pay may be made.

Many forms of compensation that are earned in one year and paid out in another will be subject to these rules. This includes severance pay, long and short-term incentive pay, stay

incentives, payments under settlement agreements and employment agreements, as well as more traditional deferred compensation, equity plans and executive pay arrangements. The IRS recently announced that the deadline to amend plans to comply with the new rules is extended to December 31, 2007, however, operational compliance is now required. Additionally, on or before December 31, 2007, a plan may be amended to provide for new payment elections. Such elections may affect both the time and form of payment, provided that they do not cause compensation to be payable in the year of the amendment that would not otherwise be payable in that year, or defer payment of compensation that would have been payable in that year.

The new deferred compensation rules will require employers to report annual deferrals of compensation on employees' W-2s, even though those amounts are not yet includible in the employee's gross income for the year. The IRS previously suspended this reporting requirement for 2005, and recently announced that it will not apply to deferrals of compensation in 2006.

Please contact any of the attorneys in Littler's Employee Benefits Practice Group if you would like assistance in implementing any of the items discussed in this newsletter.

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