

This is an advertisement.

Benefits Review

Definition of “Dependent” for HSA and Dependent Care Code Provisions is Expanded by Technical Corrections

Technical corrections in the recently signed Gulf Opportunity Zone Act will result in more individuals being treated as dependents for health savings accounts (“HSAs”) and dependent care plans. These corrections are effective for calendar year 2005 and, for dependent care plans, may require employers to issue corrected 2005 W-2 Forms or

offer a special enrollment period if the 2006 open enrollment period for such plans has been completed.

The need for these corrections arose when the Working Families Tax Relief Act of 2004 changed the definition of “dependent” for a number of purposes under the Internal Revenue Code (“Code”). In the case of the HSA and dependent

care Code provisions, the result was to restrict the definition of “dependent” by placing an income limit of \$3,200 on the “qualifying relative” component of the definition. As a result, older dependents (including a disabled spouse) could not meet the “qualifying relative” component and could not be covered as eligible dependents under HSAs or

Continued on page 3 ▶

Government Clarifies Interaction Between FSA Grace Period and HSA Eligibility

The U.S. Treasury Department and the Internal Revenue Service (IRS) recently issued joint guidance clarifying that individuals who would otherwise be eligible to contribute to a Health Savings Account (HSA) are not eligible to do so while they are covered by a grace period at the end of a health Flexible Spending Account (FSA) plan year. Such individuals, if otherwise HSA eligible, can contribute to an HSA beginning on the first day of the month following the end of the health FSA grace period. See Notice 2005-86, issued November 23, 2005.

A health FSA permits individuals to defer compensation for certain health care expenses and receive reimbursement for those expenses when they are incurred. Generally, only expenses incurred before the end of the plan year may be reimbursed. However, employers can allow a grace period of up to two and one-half months following the end of the health FSA plan year, during which individuals who incur qualified expenses may be reimbursed for those expenses.

An HSA permits individuals to contribute funds to an account and use those funds to pay for certain health care expenses. Only individuals who are covered by a high deductible health plan (HDHP), and who are not covered by any health plan that is not a HDHP, can make contributions to

Continued on page 3 ▶

IN THIS ISSUE

-
-
-
- DEFINITION OF DEPENDENT FOR HSA AND DEPENDENT CARE CODE PROVISIONS 1
- GOVERNMENT CLARIFIES INTERACTION BETWEEN FSA GRACE PERIOD AND HSA ELIGIBILITY 1
- NEW GUIDANCE ISSUED ON APPLICABILITY OF DEFERRED COMPENSATION RESTRICTIONS TO NONQUALIFIED STOCK OPTIONS AND STOCK APPRECIATION RIGHTS 2
- 2006 F&H ANNUAL LABOR & EMPLOYMENT CONFERENCE 3
- HEALTH CARE AND PENSION PLAN COVERAGE UNDER USERRA 4
- INTERNAL REVENUE SERVICE CONSOLIDATES RULES REGARDING ELECTRONIC NOTICES 5

New Guidance Issued on Applicability of Deferred Compensation Restrictions to Nonqualified Stock Options and Stock Appreciation Rights

The Internal Revenue Service (“IRS”) recently issued interim guidance in Notice 2006-4 (the “2006 Notice”) on how the new deferred compensation restrictions apply to nonqualified stock options and stock appreciation rights (“SARs”).

The American Jobs Creation Act enacted new Section 409A of the Internal Revenue Code, which became effective January 1, 2005 and imposed a number of restrictions on nonqualified deferred compensation arrangements. Failure to comply with the requirements of Code Section 409A could result in immediate taxation of all amounts deferred under the arrangement, payment of imputed interest, and imposition of a 20% excise tax.

The IRS issued its initial guidance on Code Section 409A in Notice 2005-1 (the “2005 Notice”) in December, 2004. Proposed regulations under Code Section 409A were issued in October, 2005. Both the 2005 Notice and the Proposed Regulations treat most nonqualified stock options or SARs as being subject to Code Section 409A. (Incentive stock option plans that satisfy the requirements of Code Section 422 are exempt from the new restrictions.)

A nonqualified stock option will generally escape the application of Code Section 409A if the exercise price of the option can never be less than the fair market value (“FMV”) of the stock at the time the option is granted. Similarly, a SAR will generally not be subject to Code Section 409A if the amount payable cannot be greater than the difference between the FMV of the underlying stock on the date the right is granted, and the FMV of the underlying stock on the date of exercise, and further, that the exercise price of the right can never be less than the FMV of the underlying stock on the date of grant. In both of these cases, the stock option or SAR will not be treated as “deferring compensation,” and therefore will not be subject to Code Section 409A.

To meet the exception to the new restrictions, it is crucial that the FMV of the stock underlying the nonqualified stock option or SAR be properly determined. This is particularly important for those stock options or SARs that already have been granted, or which will be granted before the date of the final regulations under Code Section 409A.

The 2006 Notice provides interim guidance for determining whether such FMV determinations have been done in a manner which will avoid the application of Code Section 409A:

- For stock options and SARs that were granted prior to January 1, 2005 (the effective date of Code Section 409A), the rules for determining FMV for incentive stock options under Code Section 422 will be applied. These rules provide that a good-faith attempt to set the FMV will suffice, but that all the facts and circumstances will be taken into account in determining whether there was a “good-faith attempt.” In the case of a privately held company, using an average of FMVs determined by completely independent and well-qualified experts will generally be considered a good-faith attempt.

- For stock options and SARs granted on or after January 1, 2005, and prior to the effective date of the Code Section 409A regulations (expected to be January 1, 2007), the guidance provided in the 2005 Notice and in the proposed regulations under Code Section 409A may be relied on. In particular, the 2006 Notice makes clear that in applying that other guidance, the applicable FMV may be determined using any “reasonable valuation method.”

For more information regarding the interim guidance, please contact Dave Pearson at dpearson@fordharrison.com or 813-261-7811 or any member of the Ford & Harrison Employee Benefits Group. ■



2006 Labor and Employment Law Conference

Ford & Harrison's 2006 Labor and Employment Law Conference will be held Thursday, May 4 and Friday, May 5, 2006, at the Gaylord Palms Resort & Convention Center in Orlando, Florida. Conference brochures will be mailed in 2006. If you would like more information about the Conference, please contact Lee Watts, lwatts@fordharrison.com, 404-888-3981. ■

► *Definition of Dependent - Continued from page 1*

dependent care plans if their 2005 income exceeded \$3,200.

The Gulf Opportunity Zone Act removed this restriction by changing both Code section 223 pertaining to HSAs and Code section 21(b)(1) pertaining to dependent care benefits so that an individual can be treated as a "qualifying relative" and eligible dependent regardless of his or her gross income. Another change under the Act allows an individual to be treated as a "qualifying relative" or "qualifying child" even if the individual claims a dependent for tax purposes or the individual is married and files a joint return.

Employer action should not be needed with respect to HSAs because employers do not monitor the tax treatment of distributions under those arrangements. However, employers may have to take action with respect to their dependent care plans. If plan documents or employee communications were revised in accordance with the more restrictive definition in the Working Families Tax Relief Act, then modifications to the documents and communications may now be needed. Employers may also want to consider offering a special enrollment period if the 2006 open enrollment period has been completed and plan documents or

employee communications based on the Working Families Tax Relief Act were used in that process. In addition, employers should issue corrected W-2 Forms if dependent care reimbursements were originally reported as taxable income based on the more restrictive definition of "dependent" in the Working Families Tax Relief Act.

For more information regarding the revised definition of dependent, please contact Karin Verdon at kverdon@fordharrison.com or 303-592-8860 or any member of the Ford & Harrison Employee Benefits Group. ■

► *Government Clarifies - Continued from page 1*

not covered by any health plan that is not a HDHP, can make contributions to an HSA. Because of this rule, an individual who is covered by a general-purpose health FSA (including a spouse's general-purpose health FSA) is not eligible to contribute to an HSA until the first month following the expiration of the grace period. If desired, employers can amend their health FSA documents to provide that coverage during the grace period is limited to expenses not covered under the HDHP or is limited to expenses incurred after the deductible for the HDHP has been reached. By amending their health FSA document in this way, individuals who are covered by the "limited purpose" or "post-deductible" health FSA during the grace period will still be eligible to contribute to an HSA.

As part of transitional relief, for plan years ending before June 5, 2006, an individual participating in a general purpose health FSA can contribute to an HSA during a health FSA grace period if (i) the individual would otherwise be eligible to participate in an HSA, if not for the health FSA coverage, and (ii) either the health FSA has no unused funds at the end of the plan year, or the individual's employer amends its health FSA to provide that the grace period does not provide coverage to an individual electing HDHP coverage and the individual is not covered under a health FSA of a spouse that provides a grace period.

For more information on the interaction of health FSAs and contributions to HSAs, please contact Penny Wofford at pwofford@fordharrison.com or 864-699-1131 or any member of the Ford & Harrison Employee Benefits Group. ■

Health Care and Pension Plan Coverage under USERRA

The Uniformed Services Employment and Reemployment Rights Act ("USERRA" – 38 U.S.C. 4301-4334) was enacted in 1994 to protect the rights of employees and their dependents who leave employment for duty in the uniformed services. The final regulations, which went into effect on January 18, 2006, instruct employers on their responsibilities relating to the provision of health care and pension plan benefits to certain military service personnel.

Health Plan Coverage

USERRA affords health plan continuation for employees and their dependents, even if their employers are exempt from COBRA because they have fewer than 20 employees. Employees completing more than 30 days of military duty may elect to continue employer-sponsored health care for up to 24 months after the absence begins or for the period of service (plus the time allowed to apply for reemployment), whichever is shorter. The employee, however, may be required to pay up to 102 percent of the full premium for the coverage. If service is less than 31 days, coverage is provided as if the employee had remained employed, and the employee cannot be required to pay more than the usual employee share of any premium.

Upon reemployment, a waiting period or exclusion cannot be imposed upon reinstatement of coverage of any person whose coverage was terminated as a result of the military service (unless such a waiting period or exclusion would have been imposed absent the military service). There is an exception for service-connected disabilities as determined by the Secretary of Veterans' Affairs.

Pension Plan Coverage

Any pension plan that provides retirement income to employees until the termination of employment or later must comply with USERRA, including defined benefits plan, defined contribution plans, and profit sharing plans that are retirement plans.

Absence for a returning employee's military service must not be considered a break in service with the employer. In addition, military service must be treated as service with the employer for purposes of vesting and accrual of benefits. The employer is responsible for funding any resulting obligations. The employee is only entitled to accrued benefits from employee contributions to the extent that he or she repays these employee contributions, which can be repaid over a period three times the duration of military service but not more than five years. Unlike the proposed regulations, the final regulations do not require that an employee be permitted to repay these contributions even after the employment relationship has ended.

For purposes of calculating an employer's liability or an employee's contributions, the employee's compensation during the period of military service will be determined by the rate of pay the employee would have received but for the absence for military service. If the employee's compensation is not based on a fixed rate, or the determination of such rate is not reasonably certain, the employee's compensation during the period of military service is computed on the basis of the employee's average rate of compensation during the 12-month period immediately preceding such period, or if shorter, the period of employment immediately preceding such period.

To comply with USERRA requirements, employers should review and, if necessary, amend plan documents, summary plan descriptions, employee handbooks, and any other materials that describe benefits and leave policies (including Web sites) to assure that proper reference to USERRA rights and applicable procedures are addressed.

For more information regarding the employee benefits provisions of USERRA, please contact Mike Munoz at mmunoz@fordharrison.com or 214-256-4706 or any member of the Ford & Harrison Employee Benefits Group. ■

Internal Revenue Service Consolidates Rules Regarding Electronic Notices

The Internal Revenue Service (IRS) has issued proposed regulations that consolidate and expand prior guidance regarding the permissible uses of electronic media in connection with employee benefit plans. When finalized, the regulations will apply to any notice, election, or similar communication provided to, or made by, a participant in a variety of retirement and welfare plans, including qualified plans, 403(b) tax sheltered annuities, eligible governmental plans, health plans, cafeteria plans, and health savings accounts. The proposed rules do not apply to notices regarding suspension of benefits or to COBRA notices, nor do they apply to any notices or elections regulated by the Department of Labor or the Pension Benefit Guaranty Corporation.

Under the proposed regulations, if a notice is required, under the Internal Revenue Code, to be in writing, electronic media may be used to provide the notice, provided either:

- The recipient affirmatively consents to electronic delivery of the notice after receiving information regarding (i) his right to receive a paper document, (ii) his right to withdraw consent, (iii) the scope of the consent, (iv) procedures to provide updated contact information to the sender, and (v) any software or hardware requirements needed to access the notice electronically, and is advised of any changes in the needed software or hardware; or
- The electronic medium that is used is one that the recipient has the effective ability to access and, at the time the notice is provided, the recipient is told that he may request a paper copy of the notice free of charge upon request; and
- At the time the notice is provided, the recipient is informed of its importance and provided with instructions on how to access the notice.

Additionally, a participant election that is required to be in writing can be transmitted electronically, provided:

- The electronic medium that is used is one that the participant has the effective ability to access (otherwise, the election will not be treated as available to the participant);
- The system is reasonably designed to preclude someone other than the participant from making the election (e.g., through use of a PIN);
- The system provides the participant a reasonable opportunity to review, confirm, modify or revoke the election;
- The participant receives confirmation of the effect of the election (either electronically or in paper form) within a reasonable period of time after making the election (electronic confirmations must satisfy the rules described above that apply to providing notices electronically); and
- Any elections that are required to be witnessed by a plan representative or a notary public are physically witnessed (although electronic acknowledgement of the witnessing of the signature is acceptable).

For more information on use of electronic media in employee benefit transactions, please contact Margaret Bernardin at mbernardin@fordharrison.com or 407-418-4365 or any member of the Ford & Harrison Employee Benefits Group. ■

This is an advertisement.