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Client Alert

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Welfare Benefits

Extension of "Use it or Lose it" Grace Period Under Flex Plans

The IRS issued welcome relief for participants in health and dependent care flex spending arrangements (FSAs) by granting a 2½ month grace period following the end of the taxable year during which covered expenses may be incurred. Under this new rule, described in Notice 2005-42, a participant with funds remaining in his FSA account at the end of a plan year may continue to use these funds to pay for covered expenses incurred up to 2½ months following the end of the plan year (e.g., March 15 for calendar-year plans). Previously, the

participant would have been forced by the "use it or lose it" rule to forfeit any amounts remaining in the FSA at the end of the plan year.

In order to take immediate advantage of this new rule, plan documents must be amended by the last day of the current plan year. Participant communications should also be prepared in advance to ensure that participants are informed of the change with enough time remaining in the plan year to allow them to adjust their spending habits accordingly.

HIPAA Security Standards

Regulations issued under HIPAA concerning the security of protected health information stored in electronic form ("e-PHI") are now effective for most group health plans. Compliance with these regulations requires, at a minimum, preparation of a policies and procedures manual identifying employees with access to e-PHI and setting forth rules concerning security issues, such as electronic access rights to e-PHI and encryption of e mail messages containing e-PHI. If your firm sponsors a group health plan but has not yet formulated a compliance strategy, our benefits team can help you assess how these regulations apply to your plan.

Qualified Plans

Outsourcing Leads to Potential ERISA Liability

Many employers have found it advantageous to "outsource" certain employees by reclassifying them as independent contractors or by reassigning them to different divisions. Doing so often results in cost savings to the employer due to reduced benefits. But, employers should beware. These cost savings could also lead to litigation under section 510 of ERISA, which prohibits employers from discharging an employee with the intent of interfering with the attainment of ERISA rights.

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A recent case from the 8th Circuit — *Register v. Honeywell Federal Manufacturing & Technologies, LLC*, 2005 WL 367319 (8th Cir. 2005) — highlights the importance of one key factor in outsourcing cases: proof of the employer's intent. In this case, a number of employees who alleged they received reduced pension benefits as a result of outsourcing thought they had uncovered a "smoking gun" in a statement from the employer's annual report indicating that the outsourcing had resulted in benefits-related cost savings for the employer of \$5.7 million. Despite this evidence, the court ultimately sided with the employer, holding that the employer had adequately demonstrated other, non-benefits-motivated reasons for the outsourcing. The employer in this case helped its cause tremendously by offering to amend its pension plans to enable many of the outsourced employees to reach retirement milestones.

If your company is considering outsourcing employees, consult with benefits counsel to ensure that non-benefits-motivated reasons for the move are adequately documented.

Proposed Regulations on Code Section 415 Benefit Limitations

Proposed regulations under Code section 415 — which limits the amount of the annual benefit payable under defined benefit plans and the amount of annual contributions to defined contribution plans — were published on May 31, 2005. These regulations are largely a codification of previous guidance from various sources, but include several important clarifications. Highlights of the proposed regulations include the following:

- *Post-severance compensation.* The proposed regulations indicate, as a general rule, that participants may make elective deferrals on compensation paid within 2½ months following severance, and that such severance payments are included in the participant's compensation for Code section 415(c) purposes.
- *Multiple annuity starting dates.* The proposed regulations clarify a previously confusing set of rules about how to calculate the effect of prior distributions from previous years in calculating the 415 limit in the current year.

These regulations, once finalized, will be effective for limitation years starting on or after January 1, 2007.

Non-qualified Deferred Compensation

409A Regulations Expected Soon

Drafts of proposed regulations under new Code section 409A are near completion and are expected to be published soon. Inside sources at the Treasury Department indicate that these regulations are quite lengthy and will clarify many outstanding issues that have not yet been addressed by official guidance. Sponsors of nonqualified deferred compensation arrangements should be aware that once these regulations are published, existing plans may have only a short period of time to make any necessary plan amendments.

IRS Issues Audit Guide on Executive Benefits

The IRS has published a guide for its auditors focusing on the tax treatment of payments and perks given to departing or retiring executives. Under these guidelines, IRS auditors will focus heavily on fringe benefits such as club membership dues (which are deductible to the corporation only if included in the executive's income as compensation), home improvements (including furnishings purchased by the employer for the executive's home office), non-commercial air travel, and qualified retirement planning services.

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Employers who have executive fringe benefits such as these should review the IRS Audit Guide to determine which of these practices are likely to attract IRS scrutiny.

Federal Credit Union Eligibility to Sponsor 457(b) Arrangements

The IRS has postponed issuance of definitive guidance concerning the status of federally chartered credit unions as eligible employers for purposes of the nonqualified deferred compensation provisions of Code section 457(b). In Notice 2005-58, the IRS indicated that federally chartered credit unions that already sponsor such arrangements may continue to maintain them until further notice, provided that the credit union has consistently treated itself as a tax-exempt governmental entity. In the event that future guidance establishes that credit unions are not eligible employers for purposes of section 457, the IRS has promised to provide a reasonable transition period to enable credit unions to amend any existing plans accordingly.

Employment Law Seminar: *Rules of the Game*

On November 3rd, the K&C Employment Law Team will host the premiere showing of the 22nd Annual Employment Law Update at the Chesapeake Conference Center. This year's program is designed to provide employers with the rules to reduce risk in the ever-changing legal environment.



This program has been approved for 5 credit hours toward PHR and SPHR recertification through the Human Resource Certification Institute (HRCI). For more information about certification or recertification, please visit the HRCI homepage at www.hrci.org.

Reserve your seat now! For more information or to register, please contact Nicole Naidyhorski at (757) 624-3232 or visit www.kaufmanandcanoles.com.

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- HIPAA Security Standards
- 409A Regulations Expected Soon
- IRS Issues Audit Guide on Executive Fringe Benefits
- IRS Notice on 457(b) for Federal Credit Unions

Employee Benefits & Executive Compensation Group

The attorneys who practice in the firm's Employee Benefits Practice Group have established a full-time commitment to this practice. They offer clients the highest level of experience and sophistication in the area of employee benefits.

The benefits arena has become exceedingly complex with each new layer of state and federal regulation. Due to the continuing stream of complex and technical employee benefits litigation since ERISA, the federal government plays an active role in how you plan and administer your employee benefits programs. Every employee benefit program demands frequent evaluation in light of fast changing federal laws and regulations.

The Employee Benefits Practice Group works with the legal, financial, and human resource professionals of our clients to implement and maintain the most effective and cost efficient benefits programs.

If you would like to be added to the Kaufman & Canoles mailing list
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