

BENEFITS UPDATE

New Rules for 2005

Fall 2004

Recent changes in law and regulations will affect both welfare plans and qualified plans in early 2005. Two of these changes are summarized in this issue of *Benefits Update*: a change to the definition of the term "dependent" under Internal Revenue Code §152 and a new requirement for automatic rollovers of certain qualified plan distributions.

WARNING: ELDERLY PARENTS WITH PENSION OR OTHER INCOME CANNOT BE COVERED UNDER DEPENDENT CARE ASSISTANCE PLANS IN 2005

As open enrollment periods begin for dependent care assistance plans, employers should warn employees that under the Working Families Tax Relief Act of 2004 (discussed in some detail below), participants may not receive dependent care plan reimbursements for care of their elderly parents if the parents have pension or other income that exceeds the income tax exemption level (\$3200 for 2005). Employees who had planned to cover parents with income over \$3200 should not be permitted to enroll in the plan for 2005.

Because the Act was signed so recently, the Internal Revenue Service has not yet issued regulations. It is possible that participants will be permitted to make a mid-year election change to terminate participation because of the new income limitation. However, in the absence of regulations, such employees should be excluded.

As will be discussed in more detail below, dependent care plans should be reviewed to determine whether an amendment is required.

NEW DEFINITION OF DEPENDENT MAY BRING SURPRISING RESULTS FOR BENEFIT PLANS

Employee benefit plan sponsors may be surprised to learn that effective as of January 1, 2005, their health care plans, dependent care spending accounts, medical reimbursement plans and even 401(k) plans could be impacted by a new definition of "dependent." The Working Families Tax Relief Act amended the definition of dependent in Internal Revenue Code §152 by creating a "uniform definition of child" and a new definition of "qualifying relative." A dependent as defined in Code §152 can be either a "qualifying child" or a "qualifying relative." Chart 1 shows the statutory requirements for a qualifying child and a qualifying relative.

 **GREENSFELDER**
ATTORNEYS AT LAW

Employee Benefits Practice Group

314-241-9090

2000 Equitable Building ♦ 10 S. Broadway ♦ St. Louis, Missouri ♦ 63102
12 Wolf Creek Drive ♦ Belleville (Swansea), Illinois ♦ 62226



Although the statutory definition of dependent has changed, an employer's plans are not required to provide coverage to all individuals who satisfy this new statutory definition. For example, an employee's domestic partner may satisfy the statutory definition of dependent, but may be excluded from coverage under the employer's health care plan. The employer is not required to add additional categories of dependents eligible for coverage as a result of the new law. Thus, if the employer's health plan did not cover grandchildren prior to the new law, it need not cover them afterwards.

Plan Sponsors should review the definition of dependent in their welfare benefit plans and Summary Plan Descriptions to be sure that after the changes to Code §152, the plan is still covering the intended group of dependents. Some examples that follow may be helpful.

Health plan participants may ask about the changes in residency and support requirements applicable to children under age 19 (24 if a student) and — if the health plan covers older children—those over age 19 (24 if a student). Chart 2 provides a brief summary of these requirements.

Is the Plan Sponsor required to make an independent determination of whether a child satisfies these requirements?

No. By enrolling the child as a dependent, the participant is certifying that the child qualifies as a dependent. However, as a safeguard, a self-insured health plan or medical reimbursement plan might ask the participant to verify the child's eligibility by signing a statement to that effect on the enrollment or claim form. Many plans ask the participant to re-certify the child's eligibility annually.

How might this change affect employer health care plans?

Company A's health plan provides coverage for a participant's dependent children up to age 21 even if they are not students. Beginning in 2005,

must the plan be amended to limit coverage to children under age 19? No. In order to enjoy the tax-favored status available to dependents under employer health plans, a child must be either a "qualifying child" or a "qualifying relative." A child over age 19 who isn't a student doesn't satisfy the statutory age restriction for a "qualifying child." However, this child would satisfy the requirements for a "qualifying relative" if the participant provided more than ½ of the child's support for the year.

Company B's health plan provides coverage for a participant's dependents who are under age 18. Beginning in 2005, must the plan be amended to extend coverage to children under age 19? No. The change in Code §152 merely sets forth the requirements for tax-favored status of health plan participants, a taxpayer's income tax exemptions, etc. It does not mandate coverage of any specific group of dependents under employer health plans.

Company C's health plan extends dependent coverage to any person described in Code §152. The employer has determined that it will not provide coverage for grandchildren beginning in 2005. Must the plan be amended if the employer does not wish to extend coverage to grandchildren? Yes. Because a grandchild might satisfy the requirements for a Code §152 dependent, if Company C wants to exclude grandchildren from coverage, it must amend its plan so that the plan no longer defines dependent by reference to the Code §152 definition.

How are 401(k) plan hardship distributions affected?

Surprisingly, this change in Code §152 may have an impact on 401(k) plans that permit hardship distributions. Many 401(k) plans permit a hardship distribution to pay for medical expenses of a participant's dependents as defined under Code §152.

Company D's 401(k) plan permits hardship distributions to pay medical expenses for a

participant's dependents "as defined in Code §152." John's 25-year-old daughter is a graduate student who earns \$5,000 per year from her job as a teaching assistant. John provides over half of his daughter's support during the year. His daughter becomes very ill in 2005 and John needs to take a hardship distribution from his 401(k) account to pay her medical expenses. Can he do so? No, unless the IRS publishes new regulations to the contrary. Because John's daughter is too old to satisfy the definition of "qualifying child" under Code §152, she must satisfy the definition of "qualifying relative." As noted in Chart 1, for purposes of a 401(k) plan, a "qualifying relative" cannot earn more than the exemption limit, which is \$3200 for 2005. John's daughter cannot qualify as a dependent "as defined in Code §152" and therefore John cannot take a hardship distribution to pay for her medical expenses.

The Internal Revenue Service has not yet issued regulations under the Working Families Tax Relief Act, but it is expected to do so soon. Stay tuned!

AUTOMATIC ROLLOVER DISTRIBUTIONS REQUIRED BY EGTRRA

Joe is a participant in his employer's profit-sharing plan. He quits his job at a time when his vested account balance equals \$2,800. The profit-sharing plan provides for immediate cash outs of small benefits, and the employer intends to cash out Joe's account balance as of the end of the plan year, which for this plan is March 31, 2005. Although the employer sends Joe a rollover election form, Joe does not respond.

What action is his employer required to take?

Until March 28, 2005, Joe's employer could simply assume that Joe wanted the benefit paid directly to him, with no rollover, and the employer could direct the plan's trustee to send a check (minus the required income tax withholding) payable to Joe. Now, however, the rules have changed. With the

publication of final rules under ERISA, effective as of March 28, 2005, employers will be required to pay distributions like Joe's in the form of a rollover to an individual retirement plan.

What caused the rules to change?

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) amended Internal Revenue Code Section 401(a)(31) to provide for automatic rollovers of certain small distributions from qualified plans to individual retirement accounts or individual retirement annuities (IRAs). Because the selection of an IRA provider and the investment of the transferred funds are fiduciary decisions under ERISA, EGTRRA delayed the effective date of the new rules until six months after the issuance of final regulations addressing the fiduciary's duties. On September 27, 2004, the Department of Labor issued such final regulations, and qualified plans will be required to comply with the new rules as of March 28, 2005.

Which distributions are affected?

If a qualified plan provides for automatic cash out of small benefits, the new rules will apply to distributions:

- that exceed \$1,000 but do not exceed \$5,000 and
- for which the distributee has not made an election either to receive the distribution as a rollover or to receive the distribution directly.

A plan may provide that the automatic rollover rules also apply to distributions under \$1,000 for which the distributee has made no election as to rollover or direct payment.

What do the new regulations provide?

The new regulations provide a safe harbor for plan fiduciaries. A plan fiduciary who complies with the new regulations will be deemed to have

satisfied his fiduciary duties respecting both the selection of an IRA provider and the investment of the funds in connection with the rollover of the mandatory distributions.

A brief summary of the new rules follows:

The distribution must be transferred to an IRA as described in Section 408(a) or 408(b) of the Internal Revenue Code.

- In connection with the distribution of the rolled-over funds, the fiduciary must enter into a written agreement with the IRA provider that provides:

1. The rolled-over funds will be invested in an investment product designed to preserve principal and provide a reasonable rate of return consistent with liquidity.
2. The investment product must seek to maintain, over the term of the investment, the dollar value equal to the amount invested.
3. The investment product must be offered by:
 - an FDIC-insured bank or savings association;
 - a credit union whose member accounts are insured under the Federal Credit Union Act;
 - an insurance company whose products are protected by state guaranty associations; or
 - an investment company registered under the Investment Company Act of 1940.
4. Fees and expenses related to the IRA must not exceed the fees and expenses charged by the provider for comparable IRAs established for reasons other than an automatic rollover distribution.
5. The participant on whose behalf the automatic rollover was made must have the right to enforce the terms of the contract establishing the IRA.
 - Participants must be furnished with a Summary Plan Description or Summary of Material Modifications that
1. describes the plan's automatic rollover provisions;

2. explains that the mandatory distribution will be invested in an investment product designed to preserve principal and provide a reasonable rate of return and liquidity;
 3. explains how fees and expenses of the IRA will be allocated; and
 4. gives the name, address and phone number of a plan contact for further information about the automatic rollover provisions, the IRA, or the fees and expenses.
- The selection of the IRA and the investment of funds must not result in a prohibited transaction.

What actions should be taken now?

- ⊙ Qualified plans must be reviewed and, if necessary, amended to contain provisions requiring the automatic rollovers described in Internal Revenue Code Section 401(a)(31)(B).
- ⊙ Summary Plan Descriptions or Summaries of Material Modifications giving the information described above must be prepared and distributed to participants.
- ⊙ The Plan Sponsor should make preliminary arrangements with a potential provider whose investment products satisfy the requirements listed above. Before any funds can be transferred, the plan sponsor and the provider must enter into a contract containing the provisions described above.
- ⊙ If the Plan Sponsor does not want to provide for the automatic rollovers described above, it must amend its plan to lower the cash-out limit to \$1,000.

Unless we are otherwise instructed, we will review your qualified plan and provide you with an appropriate amendment, if necessary, and a Summary of Material Modifications. Upon request, we will be happy to assist you with the required contract.

For further information please contact :

**Theresa A. Brennan, Toni S. Landreth
Douglas S. Neville, or Daniel J. Schwartz**



CHART 1

“QUALIFYING CHILD” & “QUALIFYING RELATIVE” UNDER CODE §152

Requirement	Qualifying Child	Qualifying Relative
Relationship to Taxpayer	The taxpayer's child or a descendant of such child or a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative	The taxpayer's child or a descendant of a child; brother, sister, stepbrother, or stepsister; father or mother or ancestor of either; stepfather or stepmother; niece or nephew, uncle or aunt, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or an individual other than the taxpayer's spouse who has the same principal place of abode as the taxpayer and is a member of the taxpayer's household "Qualifying Relative" cannot be a "qualifying child" of the taxpayer or any other taxpayer for the year.
<i>AND</i>	<i>AND</i>	<i>AND</i>
Residence	Must have the same principal place of abode as the taxpayer for more than one-half of the year	None, except for an individual other than the taxpayer's spouse who is a member of the taxpayer's household. In order to be a Qualifying Relative this individual must have the same principal place of abode as the taxpayer.
<i>AND</i>	<i>AND</i>	<i>AND</i>
Age	Under age 19 (24 if a student). There is no age limit in the case of a child who is disabled. The under-age-13 limit still applies to dependent care assistance plans.	None
<i>AND</i>	<i>AND</i>	<i>AND</i>
Support	Qualifying child must not have provided more than one-half of his/her own support for the year.	Taxpayer must have provided over one-half of qualifying relative's support for the year.
<i>AND</i>	<i>AND</i>	<i>AND</i>
Income Restriction on Dependent	None	Qualifying relative's gross income for the year must be less than the exemption amount defined in Code Section 151(d) (\$3,200 for 2005). This income restriction doesn't apply to health plans, but it does apply to dependent care assistance plans and certain other benefit plans, such as the hardship distribution provisions of 401(k) plans.

CHART 2

RESIDENCY AND SUPPORT REQUIREMENTS

REQUIREMENT	CHILD UNDER AGE 19 (24 IF A STUDENT)		CHILD OVER AGE 19 (24 IF A STUDENT)	
	PRE-2005	2005	PRE-2005	2005
Support	Participant must provide over ½ of child's support	Child cannot provide more than ½ of his or her own support	Participant must provide over ½ of child's support	Participant must provide over ½ of child's support
Residence	No requirement	Child must have same principal place of abode as taxpayer.	No requirement	No requirement