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March 2008 Employee Benefits Update

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SELECT COMPLIANCE DEADLINES

• **Required Minimum Distribution Deadline is April 1, 2008**. Generally, minimum distributions from qualified retirement, 403(b) and 457(b) plans are required to begin no later than April 1 following the calendar year in which a participant attains age 70-1/2 or terminates employment, if later. Plan sponsors should confirm compliance with this distribution requirement for participants who attained age 70-1/2 in 2007. The required beginning date for 5% owners and plans that retained pre-Small Business Job Protection Act (SBJPA) provisions is not extended by continued employment past age 70-1/2.

• **Deadline for Distributing Excess Deferrals is April 15, 2008**. Any elective deferrals exceeding the Internal Revenue Code (the Code) section 402(g) limit for 2007 ($15,500), plus allocable earnings, must be distributed to affected participants by April 15, 2008 to avoid double taxation. For taxable years beginning on or after January 1, 2007, Internal Revenue Service (IRS) regulations require the distribution of gap period income (gains and losses from January 1, 2008 to the actual date of distribution) related to excess deferrals. Please refer to Reinhart's August 2007 Employee Benefits Update for more information on gap period income.

• **HSA Contribution Deadline for 2007 is April 15, 2008**. The deadline for making contributions for 2007 to a health savings account (HSA) is April 15, 2008. IRS guidance provides that, although the dollar limit on HSA contributions is determined monthly, HSA contributions for a taxable year can be made in one or more payments as long as the payments are not made before the beginning of the applicable tax year and not later than the original filing deadline (without extensions) for the individual's federal income tax return for that year (i.e., April 15th for calendar year taxpayers).

• **401(k) Plans Compliance Reminder - Changes to the Definition of "Compensation**." Effective for plan years beginning on or after July 1, 2007, final IRS regulations under Code section 415 provide that 401(k) deferral elections can only be made from "compensation" as defined under Code section 415(c)(3). As a general rule, Code section 415(c)(3) compensation does not include amounts paid after employment ends. As an important exception to the general rule, IRS regulations provide that Code section 415(c)(3) compensation includes certain

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types of regular post-severance compensation if paid within a certain timeframe and if the payments would have been made had employment continued. The final 415 regulations also permit plans to recognize other specific types of post-severance payments. Depending on current plan terms, a plan amendment may be necessary to reflect the new compensation rules and the new rules may require changes in plan administration.

RETIREMENT PLAN DEVELOPMENTS

Expansion of Plan Participants' Right of Recovery Under ERISA

The United States Supreme Court unanimously held that an individual participant in a 401(k) plan can sue under ERISA for losses to his own plan account resulting from an alleged fiduciary breach. *LaRue v. DeWolff, Boberg & Associates, Inc.*, 2008 WL 440748. The Supreme Court's holding in LaRue expands the right of recovery under ERISA for participants in 401(k) and other individual account plans. 2

IRS Guidance and Retroactive Relief on Applying the Code's Backloading Rules to "Greater-of" Benefit Formulas

The IRS issued Revenue Ruling 2008-7 (the Ruling) providing long-awaited guidance on how the Code's backloading rules apply to defined benefit plans with "greater-of" benefit formulas. The Ruling analyzes a traditional defined benefit plan that was converted to a cash balance plan prior to the effective date of the PPA's conversion requirements. The Ruling also provides certain plans with retroactive relief from the Code's backloading requirements for plan years beginning before January 1, 2009.

To prevent the practice of providing a faster rate of accrual at the end of participants' careers, the Code's backloading rules provide that a defined benefit plan must satisfy one of the following three accrual rules: (1) the 3% method; (2) the 133-1/3% rule; or (3) the fractional rule. Many traditional defined benefit plans that convert to cash balance plans provide a benefit based on the traditional formula or a benefit based on the cash balance formula, whichever is greater (*i.e.*, a greater-of benefit formula). IRS guidance provides that when "greater-of" benefit formulas are tested for compliance with the Code's backloading rules, the accrual rules must be applied to the benefit resulting from the combined formulas and cannot be applied separately to each benefit formula. It is often difficult for defined benefit plans with "greater-of" benefit formulas to satisfy the Code's backloading rules when the formulas are tested together.

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To highlight some key provisions, the Ruling provides the following guidance for applying the Code's backloading rules to a "greater-of" benefit formula:

- A defined benefit plan satisfies the Code's backloading rules if, for all participants, the accrued benefit of each participant satisfies one of the three accrual rules. As a general rule, IRS regulations require all formulas applicable to a participant to be aggregated when applying the backloading rules.
- If the benefits of all participants do not satisfy the same accrual rule, a defined benefit plan can use different accrual rules with respect to different employee classifications, provided the classifications are not structured to evade the Code's backloading requirements. For example, the IRS concludes in the Ruling that the converted cash balance plan satisfies the 133-1/3% rule for all participants except certain grandfathered participants. The IRS notes that if the grandfathered participants' accrued benefits satisfy the fractional rule, then the plan will satisfy the Code's backloading rules. The IRS also provides insight on what employee classifications are permissible.

The IRS also announced in a separate press release that it expects to issue proposed regulations effective for plan years beginning after December 31, 2008 that will allow separate testing of backloading for "greater-of" benefit formulas.

Proposed PBGC Regulations on Reporting Requirements for Underfunded Plans and Reporting Deadline Extension

Proposed Regulations. The Pension Benefit Guaranty Corporation (PBGC) issued proposed regulations implementing changes made by the PPA to the annual reporting requirements of ERISA section 4010. ERISA section 4010 requires reporting of actuarial and financial information by controlled groups with pension plans that have significant funding problems. Among other changes, the PPA amended ERISA section 4010 to revise the triggers for the annual reporting requirement, effective for plan years beginning on or after January 1, 2008.

To highlight some key provisions, the PBGC's proposed regulations (1) reflect the changes to the annual reporting triggers under ERISA section 4010, including how to determine whether reporting is required based on the plan's funding target attainment percentage; (2) waive reporting in certain cases for controlled groups with aggregate underfunding of $15 million or less; (3) modify the standards for determining which plans are exempt from reporting actuarial information; and (4) make other clarifications on the reporting requirements. The regulations are

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generally proposed to be applicable for information years beginning after December 31, 2007. Comments on the regulations must be submitted on or before April 21, 2008.

Reporting Deadline Extension. The PBGC released Technical Update 08-1 providing an automatic one-day extension for the ERISA section 4010 reporting deadline due to the leap year. ERISA section 4010 reports are due 105 days after the end of the information year, which is generally the calendar year. For a calendar year filer, Technical Update 08-1 extends the filing deadline from April 14, 2008 to April 15, 2008.

Amendment to Pension Plan's Disability Benefit Did Not Violate ERISA

The Second Circuit Court of Appeals ruled that an amendment to a pension plan's eligibility rules for its disability benefit did not violate ERISA's anticutback rule or constitute a breach of contract. *Robinson v. Sheet Metal Workers' National Pension Fund*, 2008 WL 302610. As highlighted by this case, ERISA's anticutback rule limits certain types of amendments to retirement plans, and plan sponsors should keep this important restriction in mind when considering plan amendments. This case also demonstrates the importance of careful plan drafting, in particular the significance of plan language reserving the right to terminate or alter plan benefits.

The Sheet Metal Workers' National Pension Fund (the Plan) provided for an industry-related disability pension (the IRD pension) in addition to its normal retirement pension, early retirement pension and disability pension. The IRD pension allowed employees to receive Plan benefits when they were totally and permanently unable to work in the sheet metal industry, but capable of employment in another industry. Effective January 1, 2005, the Plan was amended to provide that the IRD pension would be unavailable to any participant who earned more than $35,000 per year in any employment. The plaintiffs, two Plan participants affected by the amendment, brought a class action lawsuit on behalf of all Plan participants who received the IRD pension prior to the Plan's amendment. The plaintiffs argued that the amendment violated ERISA's anticutback rule and was a breach of contract.

As background, ERISA section 204(g) provides that, as a general rule, a participant's accrued benefit under a retirement plan may not be reduced or eliminated by a plan amendment. This is commonly referred to as the "anticutback rule." Certain benefits do not fall under the purview of the

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anticutback rule, such as ancillary benefits and accident or health insurance benefits. In this case, the Second Circuit affirmed the lower court and held that the IRD pension was a welfare benefit, not a pension benefit, and that the benefit was also an ancillary benefit. Thus, the court held that the IRD pension was exempt from ERISA's anticutback rule. The Second Circuit also dismissed the plaintiffs' breach of contract claim holding that the Plan's and summary plan description's language clearly provided the Plan's trustees with authority to terminate or alter the IRD pension.

HEALTH AND WELFARE PLAN DEVELOPMENTS

DOL Checklist for Wellness Programs

The Department of Labor (DOL) issued Field Assistance Bulletin No. 2008-02 providing a checklist that an employer or other plan sponsor can use to help it determine whether it maintains a wellness program and, if so, whether the program complies with HIPAA's final nondiscrimination regulations. HIPAA generally prohibits a group health plan or health insurance issuer from denying an individual eligibility for benefits based on a health factor and from charging an individual a higher premium than a similarly situated individual based on a health factor. As an exception, plans may vary benefits (including cost-sharing mechanisms) and premiums or contributions based on whether an individual has met the standards of a wellness program that complies with HIPAA's final nondiscrimination regulations. The final nondiscrimination regulations are discussed in Reinhart's January 2007 Employee Benefits Update. The final regulations are effective for plan years beginning on or after July 1, 2007. Thus, for calendar year plans, the new regulations became effective as of January 1, 2008.

DOL Advisory Opinion on ERISA Preemption of State Withholding Law

The DOL issued Advisory Opinion 2008-02A (the Opinion) stating that, in its view, ERISA section 514(a) preempts a Kentucky law requiring an employer to obtain written consent before withholding amounts from an employee's wages for contribution to an ERISA welfare benefit plan. The Opinion was requested on behalf of the Sprint Nextel Welfare Benefit Plan (the Plan). The Sprint Plan provides that if an employee fails to make a medical coverage election, or certify that he or she has medical coverage from another source, the employee will receive default coverage under the Sprint Plan. Plan contributions are collected through payroll deductions, regardless of whether Plan coverage is default or affirmatively elected.

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ERISA section 514(a) provides that ERISA supersedes any and all state laws insofar as they relate to an ERISA employee benefit plan. In the Opinion, the DOL reviews Supreme Court guidance on ERISA preemption and notes that a state law relates to an ERISA employee benefit plan if it makes reference to or has a connection with the plan. The DOL then states its view that the Kentucky withholding law has a prohibited connection with ERISA plans because it prohibits automatic enrollment arrangements in such plans and regulates Sprint Nextel's decisions on how it provides employee medical coverage and plan funding. Thus, the DOL states that the Kentucky law is preempted by ERISA.

In a footnote, the DOL addresses the PPA's recent amendments to ERISA's preemption provisions. As amended, ERISA section 514(e) expressly preempts any state law which directly or indirectly prohibits or restricts an automatic contribution arrangement in any plan. The DOL provides that the PPA amendment to ERISA section 514(e) only applies to individual account pension plans, and indicates that welfare plans' automatic enrollment arrangements remain subject to ERISA's general preemption rules.

IRS Guidance on Supplemental Health Insurance Coverage Exception to HIPAA

The IRS issued Notice 2008-23 setting forth a safe harbor for excepting supplemental group health insurance coverage from HIPAA's health reform provisions, such as HIPAA's portability and nondiscrimination requirements. HIPAA's health reform provisions generally apply to group health plans, but not to certain excepted benefits, including supplemental excepted benefits. The IRS, DOL and Department of Health and Human Services (HHS) are collectively responsible for enforcing HIPAA. The IRS's guidance contains the same rules previously announced by the DOL and HHS in December 2007. Reinhart's January 2008 Employee Benefits Update discusses the DOL's guidance on excepting supplemental coverage from HIPAA's health reform provisions.

OTHER DEVELOPMENTS

DOL Proposed FMLA Regulations

The DOL issued new proposed regulations under the Family and Medical Leave Act (FMLA). The proposed regulations are long awaited and would constitute the first change to the FMLA's rules since 1995. According to the DOL, the primary purpose of the proposed regulations is to reduce workplace friction by helping workers and employers better understand their respective rights and

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responsibilities under the FMLA. Among numerous other provisions, the proposed regulations would increase employers' notice obligations, clarify when and how employees should provide notice of their leaves, provide guidance on how "light duty" should be considered in the context of an FMLA leave, change the process for "fitness for duty" certifications and provide clarification on defining "serious health condition." The regulations also propose to streamline the medical certification process and clarify how the HIPAA privacy rules affect the process. An appendix to the regulations contains proposed revised forms and notices. Comments on the proposed regulations are due by April 11, 2008.

As summarized in Reinhart's February 2008 Employee Benefits Update, President George W. Bush signed the National Defense Authorization Act of 2008 (the Act) into law in late January 2008 expanding the FMLA to provide broader leave protections for military families. Some of the changes for military families became effective immediately, while others become effective upon the DOL's release of guidance. To speed up implementation of the Act, the DOL is also seeking comment on the new military family leave protections.

Although the DOL's regulations are only proposed at this point, employers subject to the FMLA should review the suggested changes and clarifications. The DOL's website contains valuable resources for employers, including a fact sheet describing the proposed regulations, answers to frequently asked questions (or FAQs) and some additional FMLA information.

DOL Guidance on Plan Contributions

The DOL issued Field Assistance Bulletin 2008-1 (the FAB) providing guidance to ERISA plan fiduciaries on their responsibilities to monitor and collect delinquent employee and employer plan contributions. The DOL also issued proposed regulations that would establish a safe harbor period applicable to small employee benefit plans for depositing employee contributions.

Guidance on Delinquent Plan Contributions. The DOL issued the FAB in response to a number of pension plan investigations where the DOL found agreements purporting to relieve plan trustees of any responsibility to monitor and collect delinquent contributions. The FAB notes that the duty to collect delinquent plan contributions is a trustee responsibility and provides the following guidance for ERISA plan fiduciaries:

- The steps necessary to discharge a duty to collect delinquent contributions will depend on the facts of each situation. Relevant considerations include: (1) the

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value of the plan assets involved; (2) the likelihood of a successful recovery, including consideration of the employer's solvency; and (3) the expenses involved.

- If a plan is not making systematic, reasonable and diligent efforts to collect delinquent employer contributions, or if the failure to collect delinquent contributions is the result of an arrangement, agreement or understanding between the plan and the employer, such failure to collect contributions may be deemed to be a prohibited transaction under ERISA section 406.
- The fiduciary of a plan must assign authority over a plan's assets, including a plan's legal claim for delinquent contributions, to: (1) a plan trustee with discretionary authority; (2) a directed trustee subject to the proper and lawful directions of a named fiduciary; or (3) an investment manager.
- If a plan has two or more trustees, the duty to collect delinquent contributions may be allocated to a single trustee. Although a fiduciary may enter into a trust agreement under which a particular trustee is not responsible for monitoring and collecting contributions, if no trustee or investment manager has this responsibility, the fiduciary with authority to hire the trustees may be liable for plan losses due to a failure to collect contributions.
- If a particular trustee is not responsible for monitoring and collecting contributions under the terms of the trust agreement, that trustee (including a directed trustee) still has a fiduciary responsibility to take appropriate steps to remedy a situation where the trustee knows that no party has assumed responsibility for the collection and monitoring of contributions and that delinquent contributions are not being collected.

Based on this guidance, ERISA plan fiduciaries should review trust documents and, if applicable, investment manager agreements to confirm that authority to monitor and collect delinquent plan contributions has been assigned. ERISA plan fiduciaries should also confirm that the assigned trustee or investment manager is properly performing its duties.

Proposed Regulations Establishing a Safe Harbor. Current DOL regulations contain a general rule that participant contributions to an employee benefit plan become "plan assets" and must be deposited with the plan as soon as such amounts can reasonably be segregated from the employer's general assets. Current DOL regulations also provide an outside limit for depositing participant contributions

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(e.g., for most retirement plans, no later than the 15th business day of the month following the month in which the amounts are received or withheld by the employer). This outside limit is not a safe harbor, and according to the DOL, participant contributions may become plan assets well in advance of the outside limit. Late deposits of participant contributions may violate ERISA's fiduciary duty and trust requirements and may create a prohibited transaction. According to the DOL, it devotes significant enforcement resources to cases involving delinquent participant contributions and the vast majority of cases under its Voluntary Fiduciary Correction Program (VFCP) involve late deposits of participant contributions.

To provide a higher degree of compliance certainty regarding the timeframe for depositing participant contributions, the DOL issued proposed regulations providing a safe harbor for small pension and welfare benefits plans (i.e., plans with fewer than 100 participants). Under the safe harbor, participant contributions to a small pension or welfare benefit plan would be considered to have been timely deposited with the plan when such contributions are deposited no later than the seventh business day following the day on which such amount is received by the employer (for amounts that a participant pays to an employer) or would otherwise have been payable to the participant in cash (for amounts withheld from a participant's wages). The proposed regulations would also extend the current regulations' general rule to participant loan repayments and would provide that the safe harbor also applies to loan repayments to plans with fewer than 100 participants.

The DOL notes that small plans typically need more time than large plans (i.e., plans with 100 or more participants) to segregate participant contributions from their general assets. The DOL states that it is unclear at this point whether large plans have the same need for a safe harbor period for depositing participant contributions, and the DOL specifically requests comments on this issue. The regulations are proposed to be effective when published in final form, although the DOL states that it will not assert an ERISA violation for small plans that satisfy the proposed safe harbor. Comments on the proposed regulations are due by April 29, 2008.

New IRS Position on the Deductibility of Performance-Based Executive Compensation

The IRS issued Revenue Ruling 2008-13 setting forth its new position on the federal tax deductibility of performance-based executive compensation by a

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publicly held corporation. As a general rule, Code section 162(m) disallows any tax deduction for compensation paid by a publicly held corporation to certain key executives to the extent the compensation exceeds $1 million for the taxable year. Code section 162(m)(4) provides an exception to the general rule for performance-based compensation that is payable only upon satisfying one or more pre-established, objective performance goals. Departing from its previous guidance, the IRS maintains in Revenue Ruling 2008-13 that performance-based compensation under Code section 162(m) does not include a plan or agreement that provides the compensation will be paid upon attainment of a performance goal and also provides that the compensation will be paid (regardless of the performance goal) upon the executive's termination of employment by the company without cause or by the executive for good reason or due to retirement. According to the IRS, all payments under this type of plan or agreement would fail to qualify under Code section 162(m), even if the applicable performance goals are satisfied.

The IRS provides that its new interpretation will not be applied if either (1) the performance period for such compensation begins on or before January 1, 2009; or (2) the compensation is paid pursuant to an employment contract in effect (without respect to future renewals or extensions, including automatic extensions) on February 21, 2008.

Requirements for Top-Hat Plan Status

The First Circuit Court of Appeals ruled on when an arrangement qualifies for top-hat plan status under ERISA. *Alexander v. Brigham and Women's Physicians Organization, Inc.*, 2008 WL 186385. ERISA defines a "top-hat" plan as an unfunded arrangement maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. If a deferred compensation arrangement satisfies the requirements for top-hat plan status, it is exempt from many of ERISA requirements (*i.e.*, vesting, funding and fiduciary duty). The rationale behind the top-hat plan exemption is that high-echelon employees, unlike their rank-and-file counterparts, are capable of protecting their own retirement interests. The First Circuit's decision is significant because, as explained below, it addresses two key elements for top- hat plan status.

The plaintiff was a surgeon employed by a hospital-based physician's organization (the Organization). The Organization maintained two unfunded deferred compensation arrangements (the Plans). All surgeons were potentially eligible to

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participate in the Plans, but a surgeon could only actually participate if his or her net practice income (NPI) exceeded a certain amount. The plaintiff sued after his employment was terminated, arguing that the Plans did not fall under ERISA's top-hat plan exemption.

The First Circuit rejected the plaintiff's arguments and held that the Plans qualified as top- hat plans under ERISA. In its analysis, the court first addressed whether the Plans were maintained for a select group of management or highly compensated employees. The court held that the surgeons actually eligible to participate in the Plans based on their NPI, as opposed to the entire surgeon population, was the group to be examined in determining whether the select group requirement was satisfied. The court concluded that the group of surgeons actually participating in the Plans was both qualitatively select (these surgeons earned more than five times the average employee income) and quantitatively select (the group comprised no more than 8.7% of the workforce). Second, the court addressed whether individual bargaining power is a requisite for top-hat plan status. The court noted that ERISA's top-hat plan definition does not mention bargaining power. Although a DOL opinion letter mentions bargaining power, the court held that the DOL guidance was not meant as an interpretation of ERISA's definition. Thus, the court refused to read an individual bargaining power requirement into the top-hat plan rules.

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