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October 2008 Employee Benefits Update

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SELECT COMPLIANCE DEADLINES AND REMINDERS

DOL Letters on Late Deposits of Elective Deferrals

The Department of Labor (DOL) has been automatically contacting plan sponsors who list late deposits of elective deferrals on the Form 5500, regardless of whether the plan sponsor indicated that the failure has been corrected. The DOL letters encourage plan sponsors to correct the failure under the Voluntary Fiduciary Correction Program (VFCP). Although plan sponsors are not required to use VFCP, plan sponsors that correct under this program receive a "no-action" letter from the DOL, are not subject to civil penalties and may be eligible for excise tax relief. Plan sponsors who receive a letter from the DOL and would like more information on VFCP should contact their Reinhart attorney or visit the DOL's website.

403(b) Written Plan Document Required by December 31, 2008

The final regulations under Internal Revenue Code (Code) section 403(b) issued last year represent the first comprehensive guidance in this area in almost 40 years. In these regulations, the IRS implemented numerous changes for 403(b) arrangements, which are now subject to many requirements similar to 401(k) plans. One of the most significant changes is that 403(b) arrangements must now have a written plan document. Employers will need to update their existing documents or adopt a new plan document by December 31, 2008. IRS is expected to issue a prototype this fall and implement a determination letter program next year. Reinhart also has prepared a model 403(b) plan document that can be tailored to the individual needs of our clients. To learn more about the new requirements for 403(b) plans or our model document, please contact your Reinhart attorney or any member of our employee benefits team.

RETIREMENT PLAN DEVELOPMENTS

IRS Updates EPCRS

On August 14, 2008, the IRS released an update to its voluntary correction program, the Employee Plans Compliance Resolution System (EPCRS). See Rev. Proc. 200850. The update contains many additions and clarifications, including streamlined procedures and standard application forms for certain corrections

with IRS approval. The EPCRS changes are effective January 1, 2009, but plan sponsors may apply the new provisions on or after September 2, 2008. Reinhart will publish a separate *Employee Benefits E-Alert* on this subject.

EBSA Issues Proposed Regulations on Investment Advice Exemption

On August 22, 2008, the DOL's Employee Benefits Security Administration (EBSA) proposed regulations and a prohibited transaction class exemption (PTE) implementing the provisions added by the PPA for "eligible investment advice arrangements." 73 Fed. Reg. 49895; 73 Fed. Reg. 49924. Under the PPA, investment advice provided to participants or beneficiaries in individual account plans, such as 401(k) plans, will not be a prohibited transaction if the investment advice is provided on a flat-fee basis (fee leveling) or based on a computer model audited by a third party. The proposed rules include the following requirements for these arrangements:

Fee Leveling: The investment advice must be provided under a fee-leveling arrangement that meets these requirements:

- The investment advice is based on generally accepted investment theories that take into account the historic returns of different asset classes
- The investment advice takes into account information furnished by a participant or beneficiary relating to age, life expectancy, retirement age, risk tolerance, other assets or income and investment preference
- The fees or compensation received by the individual employee or agent providing the advice and the fiduciary adviser does not vary depending on the investment option selected by the participant or beneficiary

Computer Modeling: The investment advice must be generated by a computer model that:

- Is designed and operated to apply generally accepted investment theories that take into account the historic returns of different asset classes
- Utilizes information furnished by a participant or beneficiary relating to age, life expectancy, retirement age, risk tolerance, other assets or income and investment preference
- Utilizes appropriate objective criteria to provide asset allocation portfolios
- Avoids investment recommendations that inappropriately favor investment options offered by the fiduciary adviser or that may generate greater income for the fiduciary adviser over other investment options available under the plan
- Takes into account all investment options under the plan

- Has been certified by an eligible investment expert

In addition, the proposed regulations require that both types of investment advice arrangements satisfy the following requirements:

Authorization: The arrangement is authorized by a plan fiduciary.

Audit: The arrangement is audited annually by an independent auditor for compliance with the regulations.

Disclosure: The fiduciary adviser discloses certain information to participants and beneficiaries, including information on fees and compensation for the arrangement and the role of affiliated parties in the arrangement. The proposed rule includes a model form for this fiduciary adviser disclosure.

Record Retention: The fiduciary adviser maintains records of advice provided pursuant to the arrangement for at least six years.

Other Conditions: The fiduciary adviser provides disclosures required under securities law, the fiduciary adviser receives only reasonable compensation for any investments, the investment is made solely at the direction of the participant or beneficiary, and the terms of an investment are at least as favorable as an arms-length transaction.

In connection with the proposed regulations, the DOL issued a proposed PTE. In addition to prohibited transaction relief for investment advice arrangements described in the proposed regulations, the PTE would provide relief for individualized investment advice following the furnishing of a recommendation generated by a computer model. In addition, the PTE applies the fee-leveling limit solely to compensation received by the employee or agent providing the investment advice (i.e., not to total compensation received by the fiduciary adviser).

The proposed rules and PTE are expected to be effective 60 and 90 days, respectively, after publication of final regulations. Comments on the proposed regulations must be received by October 6, 2008.

IRS Issues Guidance on Recurring Part-Year Compensation

In Notice 2008-62, the IRS provided interim guidance on arrangements involving recurring part-year compensation, such as public school employees who provide services during a 10-month school year and elect to be paid ratably over 12

months. The Notice provides that an employee or independent contractor who receives recurring part-year compensation does not have deferred compensation for purposes of Code section 457(f) or 409A if the following requirements are met:

1. Payment is not deferred beyond the last day of the 13th month following the beginning of the service period; and
2. The amount deferred to the next taxable year does not exceed the limit under Code section 402(g)(1)(B) in effect for the calendar year in which the service period begins ($15,500 for 2008).

The IRS anticipates that these changes will be incorporated in regulations to be proposed under Code sections 457(f) and 409A. Taxpayers may rely on the Notice until further guidance is issued beginning with taxable years that include July 1, 2008.

IRS Rules Pension Plan Transfers Violate Exclusive Benefit Rule

The IRS ruled that current law prohibits an employer from transferring a tax-qualified pension plan to an unrelated taxpayer when the transaction is not in connection with a transfer of significant business assets, operations or employees. Rev. Rul. 2008-45. The Revenue Ruling addressed a scenario in which a corporation transferred its underfunded pension plan, along with cash and securities equal to the underfunding, to a subsidiary that had no employees and only nominal assets. The corporation then sold the stock of the subsidiary to an unrelated corporation. The transaction was not in connection with a transfer of other business assets, operations or employees. Instead, the only business risk or opportunity in the transaction was to profit from the acquisition and operation of the pension plan.

The IRS ruled that after the transaction, the corporation that acquired the plan would not be part of the former control group and would not have any employees. Therefore, for purposes of the exclusive benefit rule, the plan would no longer be maintained by an employer to provide retirement benefits for its employees and beneficiaries. The IRS noted that this conclusion would be the same even if the acquiring corporation had some employees covered by the plan or some business assets or operations were transferred when substantially all the business risks and opportunities under the transaction were associated with the pension plan.

In conjunction with this Revenue Ruling, the Treasury Department released a set of principles to guide Congress in developing legislation to permit pension plan

transfers under certain circumstances. The legislative framework was developed by the Treasury Department, Labor Department, Commerce Department, and the Pension Benefit Guaranty Corporation. It provides that transfers must satisfy certain conditions, including the following:

- The plan sponsor provides participants with advance notice of the transfer and provides regulators with information necessary to review the transaction
- The transfer may only be made to financially strong entities in well-regulated industries
- The transfer would be in the best interest of participants and beneficiaries and the plan would be exposed to less risk as a result of the transfer
- The controlled group acquiring the plan would assume full responsibility for the liabilities of the plan and would comply with post-transaction reporting and fiduciary requirements

Ninth Circuit Holds Cash Balance Plans Are Not Age Discriminatory

The Ninth Circuit Court of Appeals joined four other federal appellate courts in holding that cash balance plans do not discriminate against older employees. *Hurlic v. Southern California Gas Co.*, 9th Cir. No. 0655599 (Aug. 20, 2008). The Ninth Circuit agreed with the Seventh Circuit that younger workers' total accrued benefit under the cash balance plan at retirement age may be greater than an older worker's benefit, but the difference is due to the time value of money, not age discrimination. The Ninth Circuit also ruled that the "greater of" formulas do not violate the antibackloading rules in the Employee Retirement Income Security Act of 1974 (ERISA). Finally, the Ninth Circuit sent the case back to the district court to review whether the company provided workers with adequate notice of the conversion and its diminishing effect on future benefit accruals.

HEALTH AND WELFARE PLAN DEVELOPMENTS

IRS Provides Guidance on Dependent Status for Children of Divorced Parents

The IRS has released guidance providing that children whose parents are divorced, separated, or living apart will be treated as dependents of both parents for purposes of health coverage and fringe benefits under certain circumstances, regardless of whether the custodial parent releases the claim to the exemption. Rev. Proc. 2008-48. This guidance provides some relief from the changes made to Code section 125(e) by the Working Families' Tax Relief Act of 2004 (WFTRA). Under pre-WFTRA law, children of divorced or separated parents were treated as dependents of both parents under certain Code sections. Under WFTRA, a child

may be treated as a dependent of a noncustodial parent only if the custodial parent releases the claim to the exemption, or the child is a qualifying child or relative under Code sections 152(c) or (d).

The Revenue Procedure provides that if certain requirements are met, a child will be treated as a dependent of both parents for purposes of medical expense reimbursements, accident or health plan coverage, no-additional-cost services, qualified employee discounts, medical expenses and health savings accounts. A child qualifies for dependent status if the following requirements are met:

- The child receives over one-half of the child's support during the year from the child's parents
- The child is in the custody of one or both parents for one-half of the year
- The child is a qualifying child or qualifying relative of one of the child's parents
- The parents are divorced, legally separated, or live apart at all times for the last six months of the calendar year

This guidance is effective August 18, 2008, but may be applied to taxable years beginning after December 31, 2004.

HHS Proposes New Electronic Transaction Standards and Code Sets for HIPAA Compliance

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) includes administrative simplification provisions that mandate nationwide standards for electronic data interchange to reduce inefficiencies and operating costs in the health care industry. The Department of Health and Human Services (HHS) published code sets and standards for electronic transactions in 2000 and modified those rules in 2003. HHS has now proposed updated versions of the code sets and standards as well as a new standard for Medicaid pharmacy subrogation. 73 Fed. Reg. 49742 (Aug. 22, 2008); 73 Fed. Reg. 49796 (Aug. 22, 2008).

The proposed regulations would replace the code sets in the Ninth Revision of the International Classification of Diseases (ICD-9), which are now used to report health care diagnoses and inpatient hospital procedures, with the expanded ICD-10 code sets. The ICD-10 code sets contain more than 155,000 codes compared to the 17,000 codes in ICD-9, which was developed almost 30 years ago and is widely viewed as outdated. The proposed updates to the electronic transaction standards are required to support the new code sets and contain structural and technical improvements.

These proposed rules affect health plans, other covered entities and their business associates and are proposed to be effective in 2010 and 2011. Comments on the proposed rules must be received by October 21, 2008.

CMS Publishes Guidance on Medicare Secondary Payer Reporting Requirements

The Medicare, Medicaid and SCHIP Extension Act of 2007 (MMSEA) added new mandatory reporting requirements for group health plans effective January 1, 2009. MMSEA requires insurers and third-party administrators of group health plans, as well as fiduciaries and administrators of self-insured plans, to gather information to help the Centers for Medicare and Medicaid Services (CMS) determine when the group health plan should pay primary to Medicare.

CMS has posted summary guidance on its web site to implement these statutory reporting requirements. The new guidance provides that submissions must be made electronically and will likely be required no more than quarterly for group health plans. The web site also includes a link to the Supporting Statement for the reporting requirements, which contains background information and a description regarding the justification for the requirements, as well as definitions and a list of required and optional data elements for the reporting. All instructions for implementation of the Medicare secondary payer mandatory reporting requirements will be posted on the CMS website. The CMS website also allows users to sign up to receive alerts when the web site is updated. Plan sponsors will want to become familiar with these new requirements as information becomes available, especially in light of the substantial fines authorized by the MMSEA ($1,000 per day for each day of noncompliance for each individual for whom information should have been submitted).

Seventh Circuit Holds State Law Claims of Negligent Representation and Estoppel Are Not Preempted

The Seventh Circuit Court of Appeals held that a health care provider can assert state law claims of negligent representation and estoppel against a plan for failure to disclose that a patient was covered under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA). *Franciscan Skemp Healthcare, Inc. v. Central States Joint Board Health and Welfare Trust Fund*, 2008 WL 2927347 (7th Cir. 2008). The health care provider called to verify coverage under an employee benefit health plan. The plan's representative said the individual was covered for the relevant services, but the provider later learned that the individual's coverage

was terminated for failure to pay COBRA premiums. The provider sued the plan in state court alleging claims of negligent misrepresentation and estoppel under Wisconsin law for the plan's failure to disclose that the individual coverage was subject to COBRA and could be retroactively terminated.

The plan removed the case to federal court and moved to have the case dismissed for failure to state a claim under ERISA. Although the provider recharacterized its claims as ones arising under ERISA, the district court dismissed the claims. The Seventh Circuit reviewed the question of federal jurisdiction de novo and found that the provider was not asserting a claim for benefits under ERISA as an assignee of the former participant. Instead, the provider was seeking damages arising from alleged misrepresentations the plan made to the provider in response to its inquiry. Therefore, the Seventh Circuit held that the provider's claims were not preempted by ERISA and directed the district court to remand the case to state court.

OTHER DEVELOPMENTS

EBSA Updates Enforcement Manual on Gifts to Fiduciaries

EBSA added a new section to its enforcement manual to address fiduciary violations involving gifts and gratuities. The enforcement manual contemplates that a plan fiduciary's acceptance of consideration (such as meals, gifts, entertainment or expenses for educational conferences) from a party dealing with the plan may be a violation of ERISA section 406(b)(3). The enforcement manual directs the DOL investigator to determine whether the facts support such an allegation and whether a policy exists regarding gifts and gratuities.

The manual also provides, for enforcement purposes only, the investigator should generally conclude that the following are not fiduciary violations:

1. $250—De Minimis Amounts. The total value of the amount the fiduciary (including his or her relatives) receives from any one individual or entity (including any employee, affiliate or other related party) has an annual aggregate value of $250 or less. In addition, the receipt of these amounts cannot violate any plan policy or provision and the items must be in the form of gifts, gratuities, meals, entertainment, other non-cash consideration or reimbursements of expenses for educational conferences.
2. Educational Expenses. Reimbursement to a plan of expenses for a plan representative's attendance at an educational conference, if the plan fiduciary reasonably determines in advance (and documents in writing)

that: (a) the plan's payment of the expenses is prudent; (b) the expenses are consistent with a written policy designed to prevent abuse; (c) the conference has a reasonable relationship to the duties of the attending plan representative; and (d) the expenses are reasonable and unlikely to compromise the representative's ability to faithfully perform his or her duties.

IRS Highlights De Minimis Fringe Benefits

The IRS recently released an information letter highlighting the liberal tax treatment of de minimis fringe benefits. IRS information letter 2008-0023 (June 13, 2008). In this letter, the IRS responded to a taxpayer who questioned his employer's $50 limit on noncash gifts (gifts in excess of $50 were processed through payroll to withhold taxes). The IRS advised that the $50 limit was not imposed by the Code and the employer may have used the limit merely for administrative convenience.

The IRS noted that a *de minimis* fringe benefit is any property or service with so small a value as to make accounting for it unreasonable or administratively impractical. Code section 132(e)(1). Treasury regulations include the following examples of de minimis fringe benefits that are excludable from an employee's gross income:

- occasional typing of personal letters by a company's secretary
- occasional personal use of an employer's copy machine provided certain restrictions are imposed on personal use
- occasional cocktail parties, group meals or picnics for employees and their guests;
- traditional birthday or holiday gifts of property (noncash) with low fair market value;
- occasional theater or sporting event tickets
- coffee, donuts and soft drinks
- local telephone calls
- flowers, fruit, books or similar property provided to employees under special circumstances (*e.g.*, on account of illness, outstanding performance or family crisis)

The IRS concluded its letter by pointing out that the regulations do not place a dollar limit on any of these fringe benefits.

IRS Provides Guidance on Withholding from Severance Pay

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In Revenue Ruling 200829, the IRS provided guidance on withholding income taxes from supplemental wages, including commissions, severance pay, vacation and sick leave allowances, and signing bonuses. Generally, employers may calculate the income tax withholding from supplemental wages using a 25% flat rate or the aggregate method. Under the aggregate method, the employer determines the taxes as if the entire amount was regular wages and backs out the taxes that have already been withheld to determine the withholding on the supplemental pay. The IRS ruled that severance payments made on a weekly basis for 51 weeks after termination, which stretch into the next calendar year, are supplemental wages and the employer may use either the aggregate or flatrate withholding method.

San Francisco Mandates Transit Benefits

A new ordinance requires employers with 20 or more employees in San Francisco to offer commuter benefits to their workers. Under the ordinance, employers have the option of:

1. Setting up a qualified transportation fringe benefit program under Code Section 132(f) so employees can make pretax contributions for mass transit;
2. Directly paying for employees' transportation expenses, for example, by purchasing transit passes; or
3. Furnishing transportation for workers by setting up a van pool for employees.

The ordinance is intended to reduce San Francisco's greenhouse gas emissions and will take effect in late December 2008.