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September 2009 Employee Benefits Update

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SELECT COMPLIANCE DEADLINES AND REMINDERS

PPA Amendment Deadline Is End of 2009 for Calendar Year Retirement Plans

The Pension Protection Act of 2006 (PPA) made numerous changes to the laws governing retirement plans including specifying a new interest rate and mortality table for calculating lump sum distributions from defined benefit plans, requiring a "qualified optional survivor annuity" for plans subject to the qualified joint and survivor annuity rules, creating new options for automatic contribution arrangements and accelerating the minimum vesting requirements for employer contributions to a defined contribution plan. Many of the PPA's changes became effective beginning with the 2008 plan year. Plan amendments incorporating the PPA's changes are generally required by the end of the 2009 plan year (*i.e.*, December 31, 2009 for calendar year plans). Plan sponsors should contact their document providers to ensure PPA amendments are timely made and confirm that retroactive amendments accurately reflect the plan's operation.

403(b) Written Plan Document Is Required by December 31, 2009

The Internal Revenue Service (IRS) published final regulations under Internal Revenue Code (the Code) section 403(b) implementing numerous changes for 403(b) plans, generally effective for tax years beginning on or after January 1, 2009. The final regulations require all 403(b) plan sponsors to maintain a written plan document satisfying the final regulations in both form and operation. As summarized in Reinhart's January 2009 Employee Benefits Update, the IRS extended the deadline for certain 403(b) plan sponsors to adopt written plan documents (or amend existing plans) until the end of 2009. Accordingly, sponsors of 403(b) plans utilizing the deadline extension will need to update

Nonspouse Beneficiary Rollovers Are Required Beginning in 2010

Effective for distributions made after December 31, 2006, nonspouse beneficiary rollovers became optional for retirement plans. The Worker, Retiree and Employer Recovery Act of 2008 requires retirement plans to offer the rollover option to nonspouse beneficiaries, effective for plan years beginning after December 31, 2009 (*i.e.*, January 1, 2010 for calendar year plans). In addition, beginning with 2010 plan years, nonspouse beneficiary rollovers will be subject to the same notice and withholding requirements as other eligible rollover

distributions. To prepare for this change, plan sponsors should confirm that distribution notices and summary plan descriptions (SPDs) are updated to discuss nonspouse beneficiary rollovers.

Additional Deadline Extension for Filing FBAR Report

As reported in Reinhart's August 2009 Employee Benefits Update, the IRS only recently indicated that the foreign bank or financial account report (FBAR) may apply to tax-exempt benefit trusts with certain foreign investments. In general, the FBAR requires a "U.S. Person" to disclose a "financial interest in, or signature or other authority over, any foreign financial account(s)" if the aggregate value of the account(s) exceeded $10,000 during the year. The IRS previously extended the FBAR filing deadline from June 30, 2009 until September 23, 2009 for certain persons who only recently learned about the FBAR filing obligation.

The IRS recently issued Notice 2009-62, providing an additional deadline extension until June 30, 2010 for filing the FBAR for 2008 and earlier years for: (1) persons with signature authority over, but no financial interest in, a foreign financial account; and (2) persons with a financial interest in, or signature authority over, a foreign financial account in which the assets are held in a commingled fund. The IRS intends to issue regulations clarifying the FBAR filing requirement for the persons described above and asks for comments by October 6, 2009. In light of this new guidance, plan sponsors should continue to work with their advisors to determine their FBAR filing obligations.

RETIREMENT PLAN DEVELOPMENTS

IRS Modifies Determination Letter Process for Governmental Plans

The IRS issued Revenue Procedure 2009-36, modifying the determination letter process for governmental plans as follows:

- Extension of Remedial Amendment Period. If a plan sponsor files a determination letter application before the end of its remedial amendment period (RAP), the RAP is typically extended until 91 days after the IRS issues its final determination. In Revenue Procedure 2009-36, the IRS provides that if a governmental plan sponsor timely files a determination letter application, the RAP will be extended until 91 days after the close of the first regular legislative session beginning more than 120 days after the IRS issues its final determination.
- Choice of Cycle C or Cycle E. In late 2008, the IRS announced that it was

implementing a one-time modification to the five-year remedial amendment cycle for individually designed plans to permit sponsors of governmental plans to submit determination letters requests during either Cycle C or Cycle E. (Cycle C ended on January 31, 2009, while Cycle E begins on February 1, 2010 and ends on January 31, 2011.) In Revenue Procedure 2009-36, the IRS officially modifies its guidance to reflect this one-time modification.

Reinhart Comment: In April 2008, the IRS began its "Governmental Plans Initiative" to better serve the governmental plan sector by raising awareness of the need to comply with tax qualification requirements and educating the IRS on how governmental plans comply with tax qualification requirements. In connection with this initiative, the IRS created a governmental plans webpage to contain basic resources for governmental plans.

Court Rejects Scrivener's Error Theory to Correct Plan's Terms

The Fourth Circuit Court of Appeals held that plan participants were entitled to have their pension benefits calculated under a revised benefit formula, even though the actuary who drafted the plan admitted that the revised benefit formula was erroneously included in the plan document. Cross v. Bragg, 2009 WL 2196887 (4th Cir. 2009). This case reflects the general unwillingness of courts to allow plan sponsors to correct plan drafting errors under a "scrivener's error" theory and underscores the importance of carefully reviewing plan provisions for accuracy.

In this case, the pension plan and its administrator argued that they should not be required to pay additional benefits to the plaintiffs under the revised benefit formula because the inclusion of the more generous formula was a correctable scrivener's error. On appeal, the Fourth Circuit affirmed the district court and rejected the defendants' attempt to equitably reform the plan document based on a scrivener's error theory. The court noted the importance of a written plan document under ERISA and stated that only in limited circumstances may a court reform an ERISA plan to correct a mutual mistake or to mitigate a fraud scheme. The court concluded that a plan administrator cannot reform a plan to "correct what it unilaterally perceives to be a mistake or error contained in the plan's written terms."

Amendment to Death Benefit Did Not Violate ERISA's Anticutback Rule

The Tenth Circuit Court of Appeals held that an amendment to a pension plan

eliminating a death benefit for participants retiring after a certain date did not violate ERISA's anticutback rule. *Kerber v. Qwest Pension Plan*, 2009 WL 2096221 (10th Cir. 2009). As highlighted by this case, ERISA's anticutback rule limits certain types of amendments to retirement plans, and plan sponsors should keep this 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 alter plan benefits.

In this case, the pension plan (the Plan) included a pensioner death benefit equal to twelve months' wages. The Plan allowed certain retiring employees to elect a lump sum payment of their retirement benefits, including a discounted version of the death benefit. In 2003, the Plan was amended to eliminate the death benefit, including the discounted version of the benefit, effective for employees retiring after January 1, 2004. The Plan contained a "reservation of rights" clause, stating that the Plan sponsor had the authority to amend the Plan. The plaintiffs were Plan participants who argued that the death benefit, specifically the discounted version of the death benefit, was a protected benefit under the Plan that could not be reduced or eliminated.

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. On appeal, the Tenth Circuit affirmed the district court and held that the discounted version of the death benefit was neither a retirement-type subsidy nor an early retirement benefit protected under ERISA's anticutback rule. Based on the plan's "reservation of rights" language, the court also rejected the plaintiffs' arguments that the death benefit was contractually vested.

PBGC Proposes Rule Addressing Guaranteed Benefits of Service Members

The Pension Benefit Guaranty Corporation (PBGC) issued a proposed rule to address the PBGC's guarantee of benefits for participants who are serving in the uniformed service when their pension plans terminate. Under the proposed rule, as long as a service member is reemployed within the time limits of the Uniformed Services Employment and Reemployment Rights Act (USERRA) and even if the reemployment occurs after the pension plan's termination date, the PBGC would treat the participant as having satisfied the reemployment condition as of the plan's termination date. According to the PBGC, this would put service members in the same position as other employees by ensuring that their pension benefits would generally be guaranteed up until the plan's termination date.

IRS Request for Comments on DB(k) Plans

The PPA added Code section 414(x), effective for plan years beginning after December 31, 2009, providing small employers (*i.e.*, 500 employees or less) with a choice for a new type of plan that combines the features of a defined benefit plan and a 401(k) plan (DB(k) plans). The IRS issued Notice 2009-71 to request comments on possible issues to be addressed in IRS guidance under Code section 414(x) including minimum benefits and contributions, vesting and nondiscrimination requirements and notice and reporting obligations. Written comments must be submitted by October 15, 2009.

HEALTH AND WELFARE PLAN DEVELOPMENTS

Interim Final Regulations on New Breach Notification Requirements under HIPAA

The Department of Health and Human Services (HHS) issued interim final regulations and a request for comments regarding the new requirement to notify affected individuals of breaches of unsecured protected health information (PHI). As summarized in Reinhart's March 2009 Employee Benefits Update, President Obama signed the Health Information Technology for Economic and Clinical Health Act (HITECH) into law as part of the American Recovery and Reinvestment Act of 2009 (ARRA). HITECH significantly expands HIPAA's Privacy and Security requirements, for example, by requiring covered entities to notify affected individuals, and requiring business associates to notify covered entities, following the discovery of a breach of unsecured PHI.

HITECH defines "unsecured PHI" as PHI that is not secured though the use of a technology or methodology specified by HHS. In April 2009, HHS issued proposed regulations setting forth the technologies and methodologies necessary to secure PHI by rendering it unusable, unreadable or indecipherable to unauthorized persons. As part of the interim final regulations, HHS issued an update to its guidance on securing PHI.

The interim final regulations are effective 30 days after publication, or September 23, 2009. However, HHS states that it will not impose sanctions for failure to provide the required notifications for breaches that are discovered before February 22, 2010. Comments on the regulations are due by October 23, 2009. Some key points in HHS's guidance are as follows:

- Securing PHI. HHS clarifies that its guidance on "unsecured PHI" does not

modify a covered entity's responsibilities under the HIPAA Security Rule, and it does not impose a new requirement that covered entities encrypt all PHI. HHS also declines to include "access controls" and redaction of paper records as alternate methods of rendering PHI unusable, unreadable or indecipherable to unauthorized individuals. More information on securing PHI to avoid HITECH's notification requirements can be found on the HHS website.

- Determining Whether a Notification Is Required. HHS provides that for an acquisition, access, use or disclosure of PHI to be considered a "breach," it must violate the HIPAA Privacy Rule. To determine if a notification is required, the final regulations provide that covered entities and business associates will need to perform a risk assessment to determine if the violation poses a significant risk of financial, reputational or other harm to the individual. Covered entities and business associates carry the burden of demonstrating that no breach has occurred because the impermissible use or disclosure did not pose a significant risk of harm to the individual.

- Breach Notification. The final regulations contain the requirements for breach notifications including specifications for content, methods of delivery and timing of the notice. In the regulations' preamble, HHS states that it will update its Web site to include information for notifying HHS immediately of breaches involving 500 or more individuals and annually for breaches involving less than 500 individuals.

Reinhart Comment: Health plans and other covered entities should start taking steps to comply with HIPAA's new breach notification requirements. Among other actions, covered entities should: (1) analyze the extent to which PHI can be encrypted or destroyed to satisfy HHS's safe harbor for securing PHI; (2) review and update business associate agreements to reflect the new requirements; (3) develop procedures for identifying and responding to breaches of unsecured PHI; and (4) train employees on the new breach notification requirements.

In addition, HITECH directed the Federal Trade Commission (FTC) to issue regulations requiring certain non-HIPAA entities to notify individuals regarding security breaches involving health information. The FTC recently issued final regulations requiring vendors of personal health records and related entities to notify affected individuals and the FTC upon discovery of a security breach. The FTC's regulations are proposed to be effective September 24, 2009, although the FTC has also announced an enforcement delay until February 22, 2009.

IRS Addresses Whether Over-the-Counter Expenses Qualify as "Medical Care"

The IRS issued an information letter providing some general guidelines for determining whether certain over-the-counter (OTC) items qualify as "medical care" under Code section 213(d) for purposes of tax free reimbursements from health flexible spending accounts (FSAs) and health reimbursement arrangements (HRAs). To highlight some key points, the IRS stated that dual purpose items, such as sunscreen, antibacterial hand sanitizer, fiber supplements and medical grade face masks, may qualify as "medical care" under Code section 213(d) or may be personal items, depending on the taxpayer's use. The IRS also addressed items that have no purpose other than to treat a disease, illness or mental or physical defect, such as treatments for acne, incontinence, arthritis, constipation, colds and indigestion. According to the IRS, these medical-only items most likely qualify as "medical care" under Code section 213(d). Further, the IRS stated that the excess cost of an otherwise personal item that is specially designed to treat or alleviate a medical condition (*e.g.*, diabetic socks), over the cost of the item without the special features may be an allowable medical expense. While such items are used most commonly to treat a medical condition, the IRS cautioned that it is reluctant to conclude that such items would not also have a personal or preventive use.

Reinhart Comment: For ease of administration and other reasons, many health FSAs and HRAs are designed to reimburse participants for "medical care" that is more narrowly defined than the Code section 213(d) definition. Administrators of health FSAs and HRAs that cover OTC expenses should review the IRS's information letter for insights on determining whether an OTC expense qualifies as "medical care" under Code section 213(d).

HHS Delegates HIPAA Security Rule Administration and Enforcement to OCR

HHS delegated the power to administer and enforce the HIPAA Security Rule to the Office for Civil Rights (OCR). This authority was previously with the Centers for Medicare and Medicaid Services (CMS). OCR has been responsible for enforcing the HIPAA Privacy Rule since 2003. HITECH mandates improved enforcement of the HIPAA Privacy and Security Rules. According to HHS, combining the enforcement of the HIPAA Privacy and Security Rules in one agency within HHS "will facilitate improvements by eliminating duplication and increasing efficiency." CMS will continue to have the power to administer and enforce the HIPAA Administrative Simplification Rules.

OTHER DEVELOPMENTS

Application of FTC's Red Flags Rule to 401(k) Plans and Health FSAs

The FTC's Red Flags Rule applies to "financial institutions" and "creditors" with "covered accounts," and requires these entities to implement a written identity theft prevention program to detect the warning signs of identity theft. The FTC recently announced that it will delay enforcing the Red Flags Rule until November 1, 2009. The FTC also posted answers to frequently asked questions (FAQs) on the FTC website, addressing, in part the Red Flags Rule.

Rule's application to certain employee benefit plans. To highlight, the FAQs provide as follows:

- 401(k) Plan Loans. Participants taking loans from individual retirement plans, such as 401(k) plans, are borrowing from their own funds. Thus, a 401(k) plan sponsor is not a "creditor" under the Red Flags Rule solely because the plan allows participant loans.
- 401(k) Plan Accounts. If a 401(k) plan sponsor otherwise meets the Red Flags Rule's definition of "financial institution" or "creditor," it would not need to include the 401(k) plan accounts in its written identity theft prevention program because, according to the FTC, the 401(k) plan's accounts are with the plan and not the sponsor.
- Health FSAs. The uniform coverage rule for health FSAs does not trigger application of the Red Flags Rule. However, an entity that makes debit cards available to access health FSA benefits is considered a "financial institution" covered by the Red Flags Rule.

SEC Proposes Rules to Curtail "Pay to Play" Practices

The Securities and Exchange Commission (SEC) proposed rules intended to curtail "pay to play" practices by investment advisers seeking to manage money for state and local governments. According to the SEC, the proposed restrictions are intended to prevent investment advisers from making political contributions or other payments to influence their selection by government officials. The proposed rule would apply to investment advisers required to register with the SEC and unregistered advisers relying on the Investment Advisers Act's de minimis exception. Comments on the proposed rules are due by October 6, 2009. To briefly summarize some key points, the proposed rules contain the following

restrictions:

- An investment adviser who makes a political contribution to an elected official in a position to influence the selection of the adviser would be barred for two years from providing advisory services for compensation;
- An investment adviser would be prohibited from paying a third party, such as a solicitor or placement agent, to solicit a government client on behalf of the investment adviser;
- An investment adviser would be prohibited from coordinating, or asking another person or political action committee to: (1) make a contribution to an elected official who can influence the selection of the adviser; or (2) make a payment to a political party of the state or locality where the adviser is seeking to provide services; and
- An investment adviser would be prohibited from indirectly engaging in "pay to play" conduct, such as by directing or funding contributions through third parties.