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THE BRIEFING

Employee Benefits Practice Group

January 2009

Employee Benefits Developments

RULINGS, OPINIONS, ETC.

IRS Delays the December 31 Written Document Deadline for 403(b) Plans. On December 11 of last year the IRS announced it is generally delaying the 403(b) document deadline until December 31, 2009. This was great news for many 403(b) sponsors who, despite their best efforts, had not yet completed work on their plan documents.

In the Notice announcing the plan document relief, the IRS acknowledged that there essentially is no current program under which a 403(b) plan sponsor can obtain assurance that the written form of its plan satisfies 403(b), and that compliance with the final regulations would be facilitated by the establishment of both pre-approved and individually designed plan 403(b) programs. For those reasons, the IRS announced that it will not treat a 403(b) plan as failing to satisfy the requirements of the 403(b) regulations during the 2009 calendar year, so long as:

1. On or before December 31, 2009, the sponsor of the plan has adopted a written 403(b) plan that is intended to satisfy the requirements of 403(b) (including the final regulations) effective as of January 1, 2009;

2. During 2009, the sponsor operates the plan in accordance with a reasonable interpretation of 403(b), taking into account the final regulations; and

3. Before the end of 2009, the sponsor makes its best efforts to retroactively correct any operational failure during the 2009 calendar year to conform to the terms of the written 403(b) plan.

More guidance to come. The IRS will be establishing a prototype 403(b) plan program that will include procedures for obtaining IRS approval of prototype 403(b) plans. It is expected that the IRS will publish sample 403(b) plan language for drafting prototype plan documents. The IRS also intends to establish a determination letter program for individually designed 403(b) plans once the 403(b) prototype program is established. These programs will allow for the retroactive remedial amendment of 403(b) plans for years after 2009. Finally, the Service is expected to modify its correction programs to allow for correction of additional 403(b) issues.

Employee Benefits Security Administration Publishes New Guidance On Fidelity Bonding. On November 25, the Employee Benefits Security Administration (EBSA) issued Field Assistance Bulletin 2008-04 (the FAB) on the fidelity bonding requirements under section 412 of the Employee Retirement Income Security Act (ERISA). Section 412 generally requires a person, including a fiduciary, who handles plan funds or other property (a "plan official") to be bonded for at least 10% of the amount the plan official handles, but in no event less than $1,000. The maximum bond amount required with regard to any one plan is $500,000 per plan official, or $1 million per plan official in the case of a plan that holds employer securities.

EBSA investigators were confronting fidelity bonding questions during their examinations of ERISA plans. The FAB, which is presented in a question and answer format, addresses 42 of the frequently asked questions faced by EBSA investigators, including what losses an ERISA bond must cover, whether a fidelity bond is the same as fiduciary liability insurance, how to calculate the bond amount when multiple plans are covered under a single bond, whether the $1 million bond maximum applies to plans that hold employer securities solely as a result of investments in pooled investment funds, whether third-party service providers are subject to the bonding requirements if they handle plan funds, and which plans are exempt from the bonding requirements.

This new guidance offers ERISA plan sponsors an excellent opportunity to confirm that proper bonding is place. The FAB is available at http://www.dol.gov/ebsa/regs/fab2008-4.html.

Mandatory Medicare Secondary Payer Reporting Requirements to Begin in 2009. Medicare is a health insurance program for people age 65 or older, people under age 65 with certain disabilities, and people of all ages with End-Stage Renal Disease (i.e., permanent kidney failure requiring dialysis or a kidney transplant). It is not at all uncommon for a person covered by Medicare to also be covered under his or her employer's group health plan (e.g., employees age 65 or older). Generally, in cases where an employee is covered under both Medicare and an employer plan, the employer's group health plan must pay before Medicare does (i.e., Medicare is the so-called "secondary payer"). Insurers, third-party administrators, and plan administrators are responsible for understanding when they are required to pay first (i.e., when coverage is

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"primary" to Medicare), and for paying appropriately. If Medicare pays a claim that should have been paid by an employer's group health plan, the employer, insurer, third-party administrator, plan, or other plan sponsor will be billed the amount improperly paid by Medicare.

Under the Medicare, Medicaid, and SCHIP Extension Act of 2007 (MMSEA), insurance carriers, third-party administrators, and plan administrators of employer-sponsored group health plans that are self-funded and self-administered are required to meet new reporting requirements designed to ensure that Medicare does not pay first when an employer's group health plan is required to do so. The new requirements are designed to enable CMS to identify cases *before* claims are paid. A failure to report can bring a penalty of $1,000 per day per individual. The Centers for Medicare and Medicaid Services (CMS), the responsible government agency, has published extensive guidance available via a dedicated website (http:\\www.cms.hhs.gov/MandatoryInsRep/). Insurers and other reporting entities will need to access the information on the dedicated website for guidance concerning the information required to be reported. Reportable information includes Social Security numbers of individuals whose coverage begins on or after January 1, 2009. For individuals initially enrolled before 2009, Social Security numbers are not required until the first quarter of 2010. The website also provides detailed guidance about how and when required information is to be reported to CMS.

The new CMS reporting requirements take effect January 1, 2009.

Employers should confirm that the insurers and third-party administrators with whom they have contracted have the knowledge and capacity to ensure compliance with the new data collection and reporting process. Service agreements should clearly assign these responsibilities to the insurer or third-party administrator, and appropriate indemnification provisions should be in place.

NYS Insurance Department Issues Guidance Requiring Same-Sex Coverage. The New York State Insurance Department issued Circular Letter No. 27 (2008), advising New York State insurance companies that they must recognize marriages of same-sex couples legally married in jurisdictions that sanction such marriages. This means that insurance policies written in New York must recognize terms such as “spouse” and “marriage” to encompass same-sex couples legally married in other jurisdictions, such as Canada and Massachusetts. Although the Circular Letter interprets New York State Insurance Law (directly affecting only insurance companies), it also indirectly affects employers with insured benefits. Employers who sponsor insured plans may be obligated, under the terms of their insurance contracts, to provide same-sex benefits to spouses legally married in other jurisdictions.

While this guidance does not have a direct impact on cafeteria plans and HRAs, any link between these types of programs and an employer’s health insurance plan (e.g., a premium payment component of a cafeteria plan that permits pre-tax payment of medical insurance premiums) could cause adverse tax consequences. Employers are encouraged to discuss the matter with their insurance carriers and tax and benefits advisors.

Selection of Annuity Providers - Final Regulations. The Department of Labor (DOL) has issued final regulations dealing with the purchase of annuity contracts by ERISA plans. Fourteen years ago, a DOL interpretive bulletin was issued (IB 95-1) that has been generally described as requiring a plan fiduciary to choose the “safest annuity available” when purchasing an insurance company annuity contract with plan assets. As retirement benefits have become more concentrated in defined contribution plans such as 401(k) plans, and participants have generally been uninterested in applying their account balances to the purchase of annuity contracts in the minority of plans where an annuity option is available, most defined contribution plans have not purchased or distributed annuity contracts or annuity benefits. Furthermore, the “safest annuity available” standard seemed inappropriate to most defined contribution plan fiduciaries who may have considered annuities as an option, especially in the context of a plan that offered participant-directed investments in mutual funds or other similar investments. The Pension Protection Act of 2006 directed the DOL to issue regulations to establish that an annuity option in a defined contribution plan will not be subject to the “safest annuity available” standard but would be subject to the general ERISA fiduciary standards. The regulations issued pursuant to this directive establish standards for the prudent selection of annuity providers in defined contribution plans. Under these rules, a fiduciary will be deemed to have acted prudently by: (1) conducting an objective, thorough, and analytical search to identify and select annuity providers, (2) considering information to assess the insurer’s ability to make future payments, (3) considering the fees, commissions, and other costs of the contracts in relation to the benefits, and (4) concluding that any selected provider is financially sound, able to make future payments, and has reasonable expenses. Fiduciaries may consult with appropriate advisors to assure compliance with these standards. While it remains to be seen whether participants will become more interested in annuity distributions from 401(k) or other individual account plans, these regulations will provide fiduciaries with a reasonable basis for offering annuity choices. The regulations do not require that 401(k) plans, for example, offer annuity choices on distribution, but the regulations may open the door for these insurance products in some plans. (*Selection of Annuity Providers - Safe Harbor for Individual Account Plans*, 29 CFR Part 2550, Federal Register, Oct. 7, 2008)

IRS Regulations Issued on Notice and Consent Periods for Pension Distributions. Section 1102 of the Pension Protection Act of 2006 amended the statutory provisions and directed the IRS to modify regulations on pension plan distributions to expand the period that a plan can provide notice to participants on distribution options, including the right, if any, under the plan, to defer a distribution and the effect of a deferral. Under the new rules, a plan's notice may be provided up to 180 days before benefit commencement rather than the 90 days permitted under prior rules. Distribution notices must include descriptions of federal tax rules, including rollover rules, early distribution penalties and other differences in taxation based on the form of payment or of deferral. For defined contribution plans the required notice must address investment options available inside and outside the plan and the impact of fees and expenses. For example, if a participant defers a 401(k) distribution, the notice must describe the investment options that will be available under the plan and the expenses related to the account. If distribution options impact the availability of retiree medical benefits, social security supplements or have other material impacts, these must be explained. The regulations are designed to require a comprehensive explanation of retirement-related benefit arrangements while permitting cross-references to other sources of information. These are proposed regulations that are designed to be effective in 2010. Prior to the effective date, plans may rely on the proposed regulations or on the guidance in IRS Notice 2007-7 in complying with the statutory rules. A public hearing on the proposed regulations is scheduled for February 20, 2009. (*Notice to Participants of Consequences of Failing to Defer Receipt of Qualified Retirement Plan Distributions*, 26 CFR Part 1, Federal Register, Oct. 9, 2008)

CASES

University Required to Withhold FICA on 403(b) Contributions. The University of Chicago lost an appeal from a lower court decision that it should have withheld Federal Insurance Contributions Act (FICA) tax on salary reduction contributions made by its employees to their Internal Revenue Code (Code) Section 403(b) tax-deferred annuity plans. The University maintains two Code Section 403(b) retirement plans and requires all eligible employees to participate in one of the plans. The plans require employees to "contribute" a fixed percentage of their salaries to their retirement plan. The employee contributions are combined with additional amounts contributed by the University to fund the purchase of annuity contracts for participants. Between 2000 and 2003 the University did not pay, report, or withhold FICA tax on amounts employees contributed to the plans. In 2005, the Internal Revenue Service (IRS) assessed the University with additional FICA taxes, interest and failure-to-deposit penalties for each quarter during the years in question. The University paid a portion of the assessed amounts and filed for refunds from the IRS. When the refunds were denied the University filed suit, claiming the employee contributions fall under an exception to the general rule on FICA taxation of salary reduction contributions. Under Code Section 3121(a), FICA tax is generally imposed on all "wages," which is defined as all remuneration for employment unless it meets an exception. An exception is provided for payments made to, or on behalf of, an employee or his beneficiary under or to a Code Section 403(b) annuity contract, unless the payment is made "by reason of a salary reduction agreement (whether evidenced by a written instrument or otherwise)." The University argued that its arrangement met the exclusion from FICA taxation because the phrase "made by reason of a salary reduction agreement" applies only to individually negotiated salary reduction agreements and not to mandatory salary reduction agreements under a retirement plan. Finding that both plans fell "squarely within" the definition of wages, the district court sided with the IRS and upheld the imposition of both back taxes and penalties for failure to withhold the FICA tax. On appeal, the U.S. Court of Appeals for the Seventh Circuit upheld the lower court decision, determining that the statutory language, IRS guidance, and legislative history all support the IRS's contention that Congress did not intend that a "salary reduction agreement" should apply solely to a situation in which an employee voluntarily chooses to receive a lower stated salary plus payments to purchase annuity contracts. According to the Court, the word "agreement" does not preclude mutual assent through something other than individual negotiation or "voluntary" election. As a result, the IRS was found to have properly assessed the University for FICA taxes on contributions made under the salary reduction agreements and to have properly imposed failure-to-pay penalties on the underwithheld amounts. (*University of Chicago v. United States of America*. (2008, CA 7th Circuit)

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