EMPLOYEE BENEFITS DEVELOPMENTS

RULINGS, OPINIONS, ETC.

SMALL BUSINESS TAX CREDIT FOR EMPLOYER HEALTH INSURANCE CONTRIBUTIONS

The Internal Revenue Service (IRS) recently issued guidance on a tax credit made available through the Patient Protection and Affordable Care Act that benefits certain small employers who help defray the cost of their employees' health insurance premiums.

In general, in order to qualify for the credit:

- The employer must have fewer than 25 full-time-equivalent employees for the tax year,
- The average annual wages of its employees must be less than $50,000, and
- The employer must pay at least half of the cost of insurance premiums for their employees at the single coverage rate.

Calculating Full-Time-Equivalent Employees

To calculate the number of full-time-equivalent employees, an employer must add the number of full-time employees (employees working at least 40 hours per week) plus the number of full-time-equivalent part-time employees. With certain exceptions, full-time-equivalent part-time employees are calculated by dividing the total annual hours of part-time employees by 2080. To be eligible for the credit, the total number of full-time employees and full-time-equivalent part-time employees must be fewer than 25.

Calculating Average Annual Wages

To calculate the employees' average annual wages, an employer must determine the total annual wages paid to employees and divide that number by the total number of full-time-equivalent employees (see above). To be eligible for the tax credit, employees' average annual wages must be less than $50,000.

Assuming the above requirements are met, and the employer contributes at least 50 percent of the single coverage premium and at least that dollar amount toward more expensive coverage, the employer will be eligible for the tax credit in 2010. For periods after 2010, the amount of the employer contributions must comply with certain uniformity provisions as described in the notice from the IRS.

Maximum Tax Credit

From 2010 through 2013, the maximum credit will be 35 percent of the employer's contribution toward premiums (25 percent for tax-exempt employers). Beginning in 2014, the maximum credit will be 50 percent of the employer's contribution (35 percent for tax-exempt employers). Also, the tax credit will only be available for two consecutive years following 2013.

Although the criteria to be eligible for *any* tax credit is described above, to be eligible for the *maximum* tax credit, an employer must have fewer than 11 full-time-equivalent employees (see calculation above) and the average wage must be no more than $25,000. The available tax credit is reduced as the number of full-time employees increases from 10 to 25 and the average employee wage increases from $25,000 to $50,000. (IRS Notice 2010-44)

EBSA PUBLISHES PROPOSED REGULATIONS ON INVESTMENT ADVICE

The Employee Benefits Security Administration (EBSA) recently published new proposed regulations intended to implement provisions of the Pension Protection Act of 2006 (PPA) that create a new statutory exemption from the prohibited transaction rules for the purpose of expanding the availability of investment advice to participants in certain plans like 401(k) plans and individual retirement accounts (IRAs). An earlier final regulation, and a related class exemption, pertaining to these PPA provisions were published in January 2009 and then withdrawn in November 2009.

The new proposed regulation allows investment advice to be given under the statutory exemption in two ways — through the use of a computer model certified as unbiased, or through an adviser compensated on a "level-fee" basis (i.e., fees do not vary based on investments selected by the participant). The new proposed regulation contains key safeguards and conditions, including:

- A requirement that a plan fiduciary (independent of the investment adviser or its affiliates) select the computer model or fee leveling investment advice arrangement

- Mandatory recordkeeping requirements for investment advisers relying on the exemption for computer model or fee-leveling advice arrangements
- A requirement that computer models must be certified in advance as unbiased and meeting the exemption's requirements by an independent expert
- The establishment of qualifications and a selection process for the investment expert who must perform the above certification
- A clarification that the fee-leveling requirements do not permit investment advisers (including its employees) to receive compensation from affiliates on the basis of their recommendations
- Mandatory annual audits of investment advice arrangements, including the requirement that the auditor be independent from the investment advice provider
- Required disclosures by advisers to plan participants

The new proposed regulation in many respects is very similar to the withdrawn regulation. The new regulation, however, does not include the class exemption available under the withdrawn regulation that would have allowed advisers to provide follow-up investment advice to plan participants who received advice based on computer modeling — concerns were raised about the potential for adviser self-dealing, which resulted in the withdrawal of the first set of regulations.

The regulations will be effective 60 days after they are published as final regulations in the Federal Register.

EBSA ISSUES FINAL REGULATIONS GOVERNING PENALTIES RELATING TO MULTIEMPLOYER PLANS

The Department of Labor's Employee Benefits Security Administration (EBSA) has issued two final regulations relating to multiemployer plan operations. The first set of regulations implements Section 101(k) of the Employee Retirement Income Security Act of 1974 (ERISA), which imposes penalties if an the administrator of a multiemployer pension plan fails, on the written request of any plan participant, beneficiary, employee representative, or any employer that has an obligation to contribute to the plan, to furnish copies of requested financial and actuarial reports of the plan. (75 Fed Reg. 9334, March 2, 2010)

The second set of regulations finalizes procedures for imposing civil penalties under Section 502(c)(8) of ERISA when a multiemployer plan that is in endangered-funding status fails to timely adopt a funding improvement plan or meet certain applicable benchmarks required under Section 305 (c) of ERISA or when a multiemployer plan that is in critical-funding status fails to timely adopt a rehabilitation plan. (75 Fed. Reg. 8796, Feb. 26, 2010)

NEW GUIDANCE REGARDING THE AGE-26 DEPENDENT COVERAGE MANDATE

Under the Patient Protection and Affordable Care Act as amended by the Health Care and Education Reconciliation Act of 2010, group health plans that extend coverage to dependent children must continue to make such coverage available until age 26. On May 10, 2010, the IRS, Department of Labor (DOL), and Department of Health and Human Services (HHS) jointly issued interim final regulations implementing the age-26 coverage mandate.

The act also amended the Internal Revenue Code to provide that medical benefits provided on behalf of an employee's adult child are not taxable through the end of the year in which the child attains age 26. In Notice 2010-38, issued on April 27, 2010, the IRS provides guidance on the tax treatment of health coverage for young adults under age 27.

This article provides a brief description of the new guidance. In an Employee Benefits Alert expected to be published in the near future, we will provide a detailed analysis of the new guidance and its impact on the design and operation of employer-sponsored group health plans.

Interim Final Regulations

The age-26 dependent coverage mandate and the interim final regulations generally apply to group health plans for plan years beginning on or after September 23, 2010. Thus, for example, a group health plan with a plan year that begins October 1, 2010, will need to be in compliance by October 1, 2010. Calendar year plans are required to be in compliance by January 1, 2011. A special effective date applies to collectively bargained plans.

The new regulations confirm that a group health plan may not define dependent child coverage (including coverage of minor children) for purposes of eligibility for coverage "*other than in terms of the relationship between the child and the participant*." Thus, for example, a group health plan's dependent child eligibility criteria may not require that a child be a tax dependent of the participant, be financially dependent on the participant, reside with the participant, be enrolled full-time in college, or be unmarried.

For plan years beginning before January 1, 2014, *grandfathered* group health plans are not required to make coverage available to an adult child who is eligible to enroll in another employer's group health plan. The interim final rules note that regulations relating to grandfathered group health plans are expected to be published in the very near future.

The interim final regulations confirm that a plan is not required to extend coverage to a spouse or dependent child of the young adult.

Importantly, the new regulations do not define the term "child." It seems reasonable to conclude that the term "child" is a reference to natural children, stepchildren, adopted children (including children placed for adoption), and foster children placed with a family. We understand additional guidance in this area is forthcoming.

Notice 2010-38

Before March 30, 2010, employer-provided group health plan coverage for an employee's dependent child was exempt from income tax only if the child was the employee's dependent under federal tax law. Effective March 30, 2010, Notice 2010-38 confirms that an employee will not be taxed on the value of employer-sponsored group health plan coverage for a child, a stepchild, legally adopted child (or child legally placed for adoption) or eligible foster child for any year before the year in which the child attains age 27 *even if, for example, the child does not reside with the employee, and provides more than 50 percent of his or her own support*. In other words, for health care tax purposes, marital status and financial and residency requirements are no longer relevant in determining the tax consequences of coverage provided to young adults under age 27; the relevant requirements are the age of the child and his or her relationship to the employee.

Hodgson Russ Employee Benefits Alert

As noted, in an Employee Benefits Alert we expect to publish in the near future, we will provide a detailed analysis of the new guidance and its impact on the design and operation of employer-sponsored health and cafeteria plans. In the alert we will address (among other things) the types of group health plans to which the new requirements apply, early adoption of the age-26 mandate, how the young-adult coverage mandate applies to COBRA enrollees, and the new notice and enrollment requirements associated with young-adult coverage.

CASES

ESOP PERMITTED TO END COMPANY STOCK INVESTMENT AT SEPARATION

An employee stock ownership plan (ESOP) was operated and ultimately amended to eliminate company stock from a participant's account once the participant separated from service with the company. At one point, the plan permitted the continuing investment in company stock after a participant had left employment, but the plan was amended to change this. Under the amended plan, a participant who separated from service was entitled to receive a cash-lump-sum distribution based on the current value of company stock or, alternatively, the participant could defer a distribution, in which case the account balance would be invested in a stable value fund maintained in the plan. As a result, participants who terminated employment with the company were no longer allowed to retain an investment in company stock.

A group of terminated participants challenged this policy on several grounds in a federal court lawsuit. One claim was that by amending the plan document to explicitly prohibit an account investment in company stock, the plan had illegally eliminated a protected benefit right. The participants further claimed that the process to enact the policy was a breach of fiduciary responsibility. A federal court denied these claims and dismissed the lawsuit. The court held that the availability of the cash-lump-sum benefit satisfied the requirements of the "anti-cutback" rule, which is designed to protect against the erosion of accrued benefits as opposed to the expectations of future growth of an investment. The court observed that the nature of an ESOP motivates employees to maximize their efforts to promote company profitability, and that the efforts of current employees should not be expected to increase the value of an account held for the benefit of departed employees.

This decision supports a common ESOP plan provision on which the IRS is currently declining to issue favorable determination letters. The IRS has taken the position that it will not rule favorably on ESOP documents that take company stock out of the accounts of terminated participants until it develops a policy position on this point. Perhaps this court decision will persuade the IRS to rule favorably on this plan design in other cases. (*Hoffman v. Tharldson Motels Inc. Employee Stock Ownership Plan*, DND 2010)

REDUCED LUMP SUM DOESN'T VIOLATE ANTI-CUTBACK RULE

A small law firm maintained a defined-benefit, cash-balance pension plan. A cash-balance plan normally describes its accrued benefit in the form of a cash lump sum even though the normal form of payment is an annuity benefit. In a case tested in federal court, a participant in a terminated cash-balance plan had the option of taking a monthly benefit in the normal form or a cash lump sum. The cash-lump-sum payment, however, was substantially reduced from the actuarial value of the annuity payment because the plan was underfunded. The plan offered to pay a much smaller lump-sum benefit, and the participant accepted this but preserved her right to contest the payment. In a court action, the participant claimed that the reduction of the lump sum violated the regulatory "anti-cutback" rule that a pension plan cannot reduce accrued benefits except as permitted by regulation. The plan took the position that while the normal form of benefit remained the choice, the lump-sum alternative was sufficiently preserved even though it is reduced based on plan funding status.

The court rejected the participant's claim and described the IRS regulation that purports to protect the value of benefit options as being in conflict with the statutory provision and therefore inapplicable to the plan. The court ruled that the preservation

of the lump-sum option, as opposed to the amount of the lump sum, was sufficient to satisfy the law. The court also rejected a claim that plan funding was impermissibly based on poor actuarial assumptions that violated the fiduciary standards. It remains to be seen whether this decision will hold up on appeal. The ruling undermines the authority of the Treasury Regulation, at least in this individual case, and some response from the IRS may be forthcoming. (*Clark v. Feder Semo & Bard*, DDC, 2010)

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