EMPLOYEE BENEFITS DEVELOPMENTS JUNE 2013

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Practices & Industries

Employee Benefits

Supreme Court Declares DOMA Unconstitutional

On June 26, the U.S. Supreme Court in *United States vs. Windsor* ruled that Section 3 of the Federal Defense of Marriage Act (DOMA) is unconstitutional in that it denies equal protection to persons of the same sex who are legally married under state law. The Court's decision has a wide-ranging and immediate impact on employers that sponsor qualified retirement plans, group health plans, fringe benefit programs, and executive compensation arrangements.

The benefit plan implications may differ depending on whether a benefit program is subject to ERISA (the case for most retirement and health plans maintained by private employers). Benefit plans that are not subject to ERISA, such as church plans and plans maintained by governmental employers, will have separate but related concerns.

The implications of the Supreme Court's decision in *Windsor* may also depend on the laws of the state in which an employee works, resides, or is married. Importantly, the Supreme Court did not rule that there is a constitutionally protected right to same-sex marriage; therefore, it appears that state laws that ban same-sex marriages remain for now. This complicates matters for employers with employees who work, reside, or were married in states on both sides of this issue.

Group Health Plans

Here are some implications of the Supreme Court's decision for employers that sponsor major medical and other group health plans (e.g., dental and vision plans):

• Employees are no longer required to pay federal tax on the value of employer-sponsored health coverage provided to a same-sex spouse. This means employers will no longer be required to impute to the employee additional W-2 compensation equal to the value of the coverage provided to a same-sex spouse. There are state tax implications as well.

• An employee may now pay for the cost of qualified benefits (e.g., medical, dental, or vision benefits) provided to a same-sex spouse with pre-tax dollars through a cafeteria plan. Similarly, HRAs, health FSAs and HSAs may now pay (or reimburse) the eligible expenses incurred by same-sex spouses with pre-tax dollars.

• Same-sex spouses who are covered as dependents under a group health plan that is subject to COBRA would now qualify for COBRA coverage (i.e., may now achieve the status of "qualified beneficiary") when a qualifying event occurs, such as termination of an employee's employment or divorce.

• Same-sex spouses now enjoy special enrollment rights under HIPAA; new same-sex spouses and spouses who lose coverage may now be added to a group health plan mid-year. Before DOMA, these rights were afforded only to opposite-sex spouses.

As noted above, it may be that these rights can only be enjoyed by employees and same-sex spouses who are covered by the laws of a state, like New York, that recognizes same-sex marriages.

Can a self-insured ERISA health plan continue to define "spouse" in a manner that excludes same-sex spouses? We think the answer may well be "yes," but the issue has yet to be settled. One thing seems fairly clear: such plans may now be at greater risk of discrimination claims.

Retirement Plans

The Supreme Court's decision also has a number of implications for employers that sponsor qualified retirement plans. Retirement plan operations impacting spouses that may be impacted, particularly in states like New York that permit or recognize same-sex marriages, include:

• Survivor Benefits. Survivor benefit rights must be granted to same-sex spouses under plans that are subject to the qualified joint and survivor annuity (QJSA) rules. Under the QJSA rules, the normal form of benefit is an annuity that pays a benefit for the participant's lifetime and pays a 50 percen survivor benefit to the surviving spouse of his or her lifetime. In the event a participant predeceases his or her spouse prior to retirement, the surviving spouse will be entitled to receive a qualified preretirement survivor annuity (QPSA) that pays a survivor annuity in an amount generally equal to 50 percent of the annuity benefit the participant would have received on retirement.

• Consent Rights. The right granted to spouses under plans to consent to participant elections, such as the designation of a non-spouse beneficiary, the waiver of a QPSA, the selection of a form of distribution other than a QJSA, or the application for a plan loan, will now extend to same-sex spouses.

• QDROs. A qualified domestic relations order (QDRO) may now be used to award a portion of the benefits accrued by a retirement plan participant in the event the participant is divorced from his or her same-sex spouse.

• Eligible Rollover Distributions. A same-sex spouse who is entitled to an eligible rollover distribution from a qualified retirement plan will be able to elect a direct or traditional 60-day rollover of that distribution to an IRA or other eligible retirement plan.

• Hardship Withdrawals. Certain retirement plans allow for hardship withdrawals on account of a spouse's medical, tuition, or funeral expenses. For those retirement plans, the right to apply for spouse-related expenses will extend to withdrawals by participants in same-sex marriages.

• Minimum Required Distributions. Certain rules under the age 70 1/2 minimum distribution rules that are specifically applicable to spouses will now extend to same-sex spouses. For example, a same-sex spouse will now be able to defer payment of minimum required distributions until April 1 of the year immediately following the year in which the participant would have reached age 70 1/2.

Open Issues and Action Steps

The full scope of the employee benefit plan implications coming out of the Supreme Court's decision in *Windsor* are not yet known. For example, might a qualified retirement plan need to retroactively grant a survivor benefit to a same-sex spouse? Whether and how the Supreme Court's decision might need to be retroactively applied by plan sponsors is unclear. May a health plan participant or a health plan sponsor seek a refund for past payroll and income taxes paid on imputed income resulting from the coverage of a same-sex spouse? If so, how?

And there almost certainly are many other similar issues that will require guidance from regulatory agencies at the state and federal levels as employers work to modify their plans in response to *Windsor*. In the meantime, we suggest plan sponsors undertake the following action steps:

• Employers and other plan sponsors will need to undertake an immediate review of plan documents and summary plan descriptions (SPDs) to determine the rights and obligations of same-sex spouses who are or may become entitled to plan benefits.

• Identify any such provisions in the plan documents and SPDs that are inconsistent with the Supreme Court's decision, and prepare to modify the plan's terms and the plan's operational procedures.

• Review payroll practices and procedures, and modify income and payroll tax procedures to the extent they tax same-sex spousal benefits in a manner inconsistent with the Supreme Court's decision.

• Monitor future guidance.

The attorneys in the Hodgson Russ Employee Benefits Practice Group are well-positioned to assist employers and other plan sponsors in evaluating *Windsor*'s impact and will communicate new developments as they occur.

RULINGS, OPINIONS, ETC.

Exchange Notice Due October 1, 2013

Beginning January 1, 2014, individuals will be able to purchase coverage through a new private health insurance market, referred to as the Exchange. The Patient Protection and Affordable Care Act (ACA) requires employers to notify their employees of the new coverage options available through the Exchange through an Exchange Notice. The U.S. Department of Labor (DOL) issued Technical Release No. 2013-02, providing temporary guidance regarding this notice requirement. The Technical Release also provides a link to the DOL's revised model Consolidated Omnibus Budget Reconciliation Act (COBRA) election notice that includes information regarding health coverage alternatives offered through the Exchange.

Which Employers Must Send the Notice?

All employers subject to the Fair Labor Standards Act (FLSA) are required to provide the Exchange Notice. In general, the FLSA applies to employers that employ one or more employees who are engaged in, or produce goods for, interstate commerce. The FLSA also covers the following entities: hospitals; institutions primarily engaged in the care of sick, aged, mentally ill, or disabled people who reside on the premises; schools for children who are mentally or physically disabled or gifted; preschools, elementary and secondary schools, and institutions of higher education; and federal, state, and local government agencies. The DOL's Wage and Hour Division provides guidance relating to the applicability of the FLSA in general, including an internet compliance assistance tool to determine applicability of the FLSA.

Which Employees Must Receive a Notice?

Employers must provide an Exchange Notice to each employee, regardless of whether the employee is enrolled in the employer's plan or whether the employee is part-time or full-time. Employers are not required to provide a separate Notice to dependents or other individuals who are not employees.

What Must Be in the Notice?

The Exchange Notice must advise employees of the existence of the Exchange and available coverage options, as well as contact information and a description of the services provided by the Exchange. The Notice must also inform employees that they may be eligible for a premium tax credit if they purchase coverage through the Exchange. In addition, the Notice must include a statement informing employees that if they purchase coverage through the Exchange, they may lose employer contributions (if any) to any health benefits plan offered by the employer and that all or a portion of such contribution may be excludable from income for federal income tax purposes. To satisfy the content requirements, model language is available here.

When and How Must the Notice Be Delivered?

Beginning October 1, 2013, employers are required to provide the Notice to each new employee at the time of hiring. For 2014, the department will consider a Notice to be provided at the time of hiring if the Notice is provided within 14 days of an employee's start date.

With respect to employees who are current employees before October 1, 2013, employers are required to provide the Notice not later than October 1, 2013. The Notice is required to be provided automatically, free of charge. The Notice may be provided by first-class mail. Alternatively, it may be provided electronically if it meets the requirements of the DOL's electronic disclosure safe harbor.

Changes to DOL's Model COBRA Election Forms

In addition to providing a model Exchange Notice, the DOL has modified its model COBRA Election Notice to provide information regarding coverage options available through the Exchange. The updated DOL COBRA Election Form may be found here.

Anti-Cutback Relief for ESOPs

Internal Revenue Code Section 401(a)(28) requires an Employee Stock Ownership Plan (ESOP) to allow certain 55-year-old participants the opportunity to elect to direct the plan as to the investment of at least 25 percent of the participant's account. This ESOP diversification requirement can be satisfied by distributing a portion of the participant's account, even if the plan might otherwise be restricted from distributing plan benefits before the termination of employment or the occurrence of certain other events.

Code Section 401(a)(35), which was added to the Code by the Pension Protection Act of 2006, also prescribes investment diversification requirements for qualified retirement plans that allow investments in employer securities. Section 401(a)(35), however, applies to an ESOP only if the ESOP holds employer securities that are readily tradable on an established securities market and the ESOP either is a portion of a larger plan or holds contributions that are or were subject to Section 401(k) or 401(m). The section 401(a)(35) diversification requirements cannot be satisfied by distributing a portion of the participant's account.

The diversification requirements of Section 401(a)(28) do not apply to an ESOP that becomes subject to the diversification requirements of Section 401(a)(35). So, what happens when an ESOP later becomes subject to 401(a)(35) and no longer is subject to the 401(a)(28) diversification requirements? In that case, the ESOP must comply with applicable rules restricting the distribution of plan benefits before the termination of employment or the occurrence of certain other events. Does an amendment eliminating the 401(a)(28) distribution option violate the anti-cutback rules of 411(d)(6)?

Recently published Internal Revenue Service Notice 2013-17 provides an answer. An amendment eliminating the 401(a)(28) distribution option will not violate the anti-cutback rule as long as the amendment is both adopted and put into effect by the last day of the first plan year beginning on or after January 1, 2013, or by the time the ESOP must be amended to satisfy Section 401(a)(35), if later. In cases where ESOPs have been timely amended to satisfy Section 401(a)(35) and the remedial amendment period with respect to that amendment expires before the ending date of Section 411(d)(6) relief, Notice 2013-17 also extends the remedial amendment period to the last day of the first plan year beginning on or after January 1, 2013, to permit the adoption of an amendment to the ESOPs eliminating a 401(a)(28) distribution option.

CASES

Administrator's Decision to Calculate Benefit Under Method Elected by Participant Upheld by Sixth Circuit

The Court of Appeals for the Sixth Circuit recently upheld a district court's ruling that a plan administrator did not act arbitrarily and capriciously in determining that an employee elected to have his benefit calculated under the account balance method offered by the plan. In 1999, the employer in this case amended its defined benefit pension plan to allow employees to make an irrevocable election to have their future pension accruals determined according to an account balance method. Before the amendment, all benefits were calculated using the final average pay method. Any employees who failed to make the election to switch to the account balance method by April 30, 2000, would continue to have their benefits calculated under the prior method.

In early 2000, the employee in question attended an informational meeting covering the election and the process for making the change. Employees were informed that they could make an irrevocable election to have their benefits calculated under the account balance method by calling the plan's third-party administrator. The employee was moved to the account balance method on April 27, 2000, after making several phone calls to the third-party administrator.

In 2010, in connection with his retirement planning, the employee questioned the calculation of his retirement benefits under the account balance method and requested that the benefits committee recalculate his benefits under the final average pay method. The benefits committee denied the request, based on evidence of his 2000 election to switch to the account balance option. Following the employee's formal appeal of the decision, the committee investigated further, eventually affirming its determination that the employee had properly made an election to change methods. After exhausting his administrative remedies, the employee sued under ERISA to have his benefit calculated under the original final average pay method. The district court granted summary judgment to the plan, finding that the committee's decision was reasonable.

Pointing to plan language giving the administrator discretionary authority to determine eligibility for benefits or to construe the terms of the plan, the appeals court applied the deferential "arbitrary and capricious" standard in upholding the district court's decision. In evaluating the committee's review process, the court found that the committee's process was reasoned and took into account all available evidence in reaching its decision. The court pointed to phone logs, a letter from the third-party administrator confirming the employee's election, annual statements referencing his "Account Balance Option," and other documentation in support of the plan's contention that the employee properly and timely elected the account balance method. Further finding that the committee's reliance on electronic records, account statements, and beneficiary designation forms in making its determination was neither unprincipled nor unreasonable, the appeals court upheld the committee's determination that the employee elected to participate in the account balance program and is not entitled to have his pension benefits calculated under the alternative program. *Durbin v. Columbia Energy Group Pension Plan* (6th Cir. 2013)

Contingent Event Benefit Constitutes Early Retirement Subsidy for Purposes of QDRO

As part of a divorce settlement, a participant in a defined benefit retirement plan and his spouse entered into a qualified domestic relations order (QDRO) with respect to the participant's benefit in the plan. The QDRO assigned to the spouse 53 percent of the present value of the participant's accrued benefit in the plan as of December 20, 2004. In addition, the QDRO provided that if payments to the spouse commenced while the participant was still employed and the participant subsequently retired prior to attaining age 65, then the amount payable to the spouse would be recalculated to include 53 percent of any employer subsidy for early retirement.

The spouse elected to commence benefits in August 2006, after the participant had attained early retirement age under the plan. The participant continued to work until he was discharged as part of a company-wide reduction in force in 2009.

A participant who elected to receive early retirement benefits under the plan would ordinarily have his or her accrued benefit actuarially reduced to reflect payments being made prior to attainment of age 65; however, enhanced retirement benefits were provided under the plan to employees who were eligible for early retirement and who executed a release following their discharge in connection with certain organizational changes, including a reduction in force. The enhanced retirement benefits provided a qualifying participant with an unreduced retirement benefit – that is, a participant's monthly pension benefit would be the same as if he or she had retired at age 65.

As a result of his discharge in 2009, the participant was eligible for the plan's enhanced retirement benefit, and he executed the required release. Pursuant to the QDRO's terms, the participant's spouse contended that she was entitled to 53 percent of the enhanced retirement benefit's value as an employer subsidy for early retirement. The plan administrator rejected the spouse's claim, reasoning that the enhanced retirement benefit was payable due to a reduction-in-force, not on account of early retirement.

In reviewing the plan administrator's determination, the court viewed the word "for" as taking on a different meaning than that ascribed to it by the administrator. Starting with the proposition that the QDRO was intended to provide the spouse with 53 percent of her former husband's retirement benefit, rather than treating "for" as meaning "because of" or "on account of," the court treated "for" as meaning "to indicate purpose," such as a "grant for studying medicine." Because the enhanced retirement benefit applied only to participants who were eligible for early retirement under the plan, the court held that the enhanced retirement benefit was an employer subsidy for early retirement. Accordingly, the spouse was entitled to share in the enhanced retirement benefit pursuant to the QDRO's terms.

Although ERISA does not require plan administrators to maintain model QDRO forms, many plan administrators frequently do so in the interest of streamlining the QDRO approval process. Plan administrators of defined benefit pension plans that provide for enhanced retirement benefits upon the occurrence of a contingent event may wish to examine the terms of the plan's model QDRO with an eye toward how any enhanced benefit would be treated under the model QDRO. *Gruber v. PPL Retirement Plan* (3d Cir. 2013)

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