EMPLOYEE BENEFITS DEVELOPMENTS JUNE 2012

Hodgson Russ Newsletter
June 27, 2012

Practices & Industries

Employee Benefits

RULINGS, OPINIONS, ETC.

IRS Proposes Rule Permitting Deduction for Local Lodging Expenses

The Internal Revenue Service (IRS) has issued proposed regulations relating to the deductibility of lodging expenses incurred when not traveling away from home (i.e., local lodging expenses). Existing regulations from the U.S. Department of the Treasury generally provide that local lodging expenses constitute nondeductible personal expenses. With the proposed regulations, the IRS has retreated somewhat from this position.

Whether local lodging expenses may be deducted as a business expense is determined based on all the facts and circumstances. One factor is whether an employee incurs the expense because of a condition of employment imposed by the employer. By now a familiar concept in determining the deductibility of business expenses, expenses paid for lavish lodging or lodging that primarily provides a personal benefit are not deductible. Local lodging expenses deductible as a business expense, of course, would also qualify as a working condition fringe, thereby allowing an employee to exclude from income any amounts paid or reimbursed by the employer for such expenses.

The proposed regulation includes a safe harbor for deducting local lodging expenses. To qualify:

- The lodging must be necessary for the individual to participate fully or be available for a bona fide business meeting, conference, training activity, or other business function.
- The lodging must be for a period that does not exceed five calendar days and does not recur more frequently than once per calendar quarter.
- In the case of an employee, the employer must require the employee to remain at the activity or function overnight.
- The lodging must not be lavish under the circumstances and must not provide any significant element of personal pleasure, recreation, or benefit.

Six examples are included in the proposed regulation. These examples demonstrate that local lodging expenses are likely to be deductible when the employee is required to stay overnight. On the other hand, where local lodging expenses are incurred primarily for an employee's convenience, those expenses are not deductible, even when the expense arguably advances a business purpose.

None of the examples relate to taxpayers considered to be self-employed—remember, partners are considered employees for purposes of working condition fringe benefits. Even so, when an employer pays or reimburses local lodging expenses, the touchstone is whether a noncompensatory business purpose for the expense exists.

Note that the proposed rules apply to lodging only, not meals. Also, although the rules apply to expenses incurred on or after the date the proposed regulations become finalized, the proposed regulations provide that taxpayers may apply the rules to local lodging expenses incurred in taxable years for which the period of limitation on credit or refund has not expired. Finally, the proposed rules do not alter the requirement that any reimbursements must be made under an accountable plan in order to be excluded by the employee.

CASES

COBRA Election Notice Failure Results in Statutory Damages

The U.S. District Court for the District of New Jersey awarded a plaintiff statutory damages for a health plan administrator's failure to provide her with a timely COBRA election notice. In this case, the plaintiff's employment terminated September 30, 2008, yet coverage under her former employer's health plan was mistakenly continued until the error was discovered in March 2009. Upon discovery of the error, the plan administrator terminated the plaintiff's coverage retroactively to January 1, 2009. However, the plaintiff was not provided a COBRA election notice until September 3, 2009.

The COBRA regulations provide that, where the plan administrator is the employer, a participant is entitled to a COBRA election notice within 44 days from the date of his or her qualifying event. A qualifying event is an event, such as the termination of employment, which results in a loss of coverage under a group health plan. Based on the date of her termination of employment, the plaintiff was entitled to receive her COBRA election notice by November 13, 2008.

In its decision, the district court awarded the plaintiff statutory damages of $2,930. Although technically a victory for the plaintiff, this case could have been much more costly to the defendant. The statutory damages awarded to the plaintiff equates to only $10 a day for each day the COBRA election notice was late, even though regulations permit a court to award penalties of up to $110 a day. The district court also declined to assess the plan administrator with attorneys' fees or the cost of medical expenses the plaintiff incurred during the lapse in coverage.

Although the plan administrator was not assessed significant damages, this case should serve as a reminder for plan administrators to provide timely COBRA election notices to terminating employees, including in situations where their coverage is mistakenly continued for a period of time. (*Fama v. Design Assistance Corp.*, D.N.J. 2012)

Transgender Spouse Reinstated as an Eligible Plan Participant

The U.S. District Court for the District of Minnesota recently held that a union welfare benefit trust fund breached the terms of its health plan when it terminated the plaintiff's coverage based on its erroneous and unreasonable interpretation of Minnesota law. The plaintiff in this case was born a male but later changed gender through sex-reassignment surgery. The plaintiff legally changed her name and gender on her birth certificate and later married. Following the marriage, the plaintiff's husband enrolled her as his spouse and provided the plan with a copy of the marriage certificate. However, once the fund became aware of the plaintiff's history, the fund denied her eligibility in the health plan, claiming that in Minnesota, a lawful marriage may be contracted only between persons of the opposite sex and that, despite the amended birth certificate, the plaintiff's marriage was not recognized under Minnesota law.

The district court held that the fund's decision to deny plan benefits "was not only wrong … it was a flagrant violation of its duty." The district court ruled that the fund erred when it terminated the plaintiff's participation as an eligible family dependent and ordered that the plaintiff be reinstated as a participant. (*Radtke v. Miscellaneous Drivers & Helpers Union Local #638 Health, Welfare, Eye & Dental Fund*, D. Minn. 2012)

Keogh Plan With Qualification Defects Found to be Exempt From Bankruptcy Estate

Generally, retirement plan benefits are excluded from a bankruptcy estate. However, if the retirement plan is not covered by Title I of the Employee Retirement Income Security Act of 1974 (ERISA), a separate exemption from the bankruptcy estate must be found. Some retirement plans are not covered by Title I of ERISA because they do not cover employees, which, for this purpose, excludes the sole owner of a business and the owner's spouse. These types of plans are commonly referred to as "Keogh" plans.

A recent case in the U.S. Court of Appeals for the Tenth Circuit provides some additional guidance in this area. The doctor in this case had a medical practice in Utah and adopted a plan intended to be a qualified plan under Internal Revenue Code §401(a) (IRC).

It is important to note that the State of Utah has elected not to adopt the federal bankruptcy rules defining which property is exempt from a bankruptcy estate, and has instead adopted its own set of rules. Under Utah's exemption provisions, any money or other assets held or payable to a debtor where the debtor is a participant and beneficiary in a retirement plan or arrangement that is described in IRC § 401(a) is exempt from execution by creditors and would therefore be exempt from the bankruptcy estate.

During the period in which the doctor operated the Keogh plan, numerous operational errors occurred. An expert witness testified that many of the errors were significant, and that the Keogh plan was defective and therefore disqualified from receiving special tax treatment awarded to qualified plans under IRC § 401(a). Based on this information, the bankruptcy trustee objected to the claimed exemption of the funds held in the Keogh plan. Both the bankruptcy court and the district court disagreed, determining that most of the funds were exempted from the bankruptcy estate. The Tenth Circuit affirmed the lower court opinions, finding that the Utah statute applied to retirement plans if they "substantially complied" with

IRC § 401(a). The expert witness had also testified that the errors in the operation of the Keogh plan fell within the scope of the Employee Plan Compliance Resolution System of the Internal Revenue Service and could, therefore, be corrected. Because the operational errors could be corrected, the Tenth Circuit found that the plan substantially complied with the requirements of Section 401(a) and fell within Utah's exemption provision. (*Gladwell v. Reinhart [In re Reinhart]*, 10th Cir. 2012)

Court Upholds Plan Administrator's Valuation Decision for Plan Distribution

With the technology to facilitate daily valuations of defined contribution plans readily available, we see fewer and fewer plans that operate with annual valuations and balance forward plan accounting, but balance forward plans do still exist. As illustrated by a recent case, distributions from balance forward plans can present difficult fiduciary decisions when there is a significant swing in the market value of plan assets.

In December 2008, a participant in a 401(k) profit-sharing plan requested distribution of her benefits based on an account valuation date of December 31, 2007, which was the most recent valuation preceding the date of her distribution request. Under the plan terms, valuation of the assets must be conducted at least annually, but the plan administrator may request interim valuations. Plan terms state that assets are distributed based on the valuation date that "immediately precedes the date the participant receives his/her distribution from the plan."

Because the plan's value dropped dramatically over the course of the 2008 plan year, the plan sponsor determined that processing the participant's claim using the December 31, 2007 valuation would be a breach of fiduciary duty owed to the remaining plan participants. Accordingly, the participant's distribution was processed using an upcoming valuation date of December 31, 2008, which would have resulted in the participant receiving approximately $60,000 less than she anticipated.

The participant refused to take receipt of the distribution based on the 2008 valuation, but later accepted a distribution based on a valuation date of December 31, 2009. The 2009 valuation was still nearly $36,000 less than the original 2007 valuation. After making a claim under the plan's claims procedures, which the plan denied, the participant sued and sought to recover the difference between what she eventually received and her expected payout based on the December 31, 2007 valuation.

The court ruled the plan sponsor reasonably decided to use the 2008 valuation to distribute the participant's benefits because that valuation more accurately represented the true value of her account. The court concluded the plan sponsor acted reasonably when it determined that, due to unforeseen market conditions, paying benefits to the participant based on the 2007 valuation would prejudice the other participants in the plan, and that the plan sponsor reasonably concluded that making a distribution based on the 2007 valuation would have allowed the participant to escape her share of the losses occurring in 2008 and forced the other participants to bear those losses.

Given that the participant's request for disbursement came a mere two weeks before the scheduled end-of-the-year valuation for the 2008 plan year, the court also concluded the plan sponsor did not act unreasonably by waiting to apply that 2008 valuation. Conducting an interim valuation would have required additional expenditure, and the already-scheduled 2008 valuation provided an accurate valuation of the participant's account for disbursement. (*Wakamatsu v.*

Oliver, N.D. Cal. 2012)

Severance Denied to Employee Who Retired Following Expiration of Medical Leave

A recent decision upholding the denial of severance benefits to an employee who retired after exhausting medical leave demonstrates the importance of a well-drafted severance plan.

The employee in this case was granted six months of paid medical leave because of a health condition that made it difficult for her to meet the demands of her job. Still unable to work when the leave expired, the employee elected to take early retirement. Claiming she had been told she would be eligible for severance, the employee then requested severance benefits, only to be informed that the circumstances of her retirement did not satisfy the eligibility requirements of the company severance plan.

On appeal, the plan administrator's denial of severance was upheld by the plan's review committee, resulting in the employee's lawsuit against the company. Granting summary judgment to the employer, the U.S. District Court for the Southern District of Indiana found that the employee was not eligible for benefits under the terms of the company severance plan.

To receive benefits under the plan, the separation from employment must be for one of two qualifying reasons. The dispute centered on whether the employee's inability to perform her duties satisfied the "workplace efficiency enhancement" definition for severance eligibility. In finding for the employer, the court focused on the "clear language" of the definition in the plan. Finding that "it is not enough" that the employee was not meeting job performance expectations, the court quoted from the plan in holding that the employee must also have been "involuntarily [s]eparat[ed] from [s]ervice because of" that failure to meet expectations. The court pointed to the employee's admission that she had voluntarily accepted early retirement, and noted there is no evidence that the company made her working conditions "so intolerable that [she was] forced into an involuntary resignation." The court also rejected her claim that she should still receive severance "based on purported representations from [her supervisor] that if she retired, she would be eligible for severance," because the alleged misrepresentation of her rights was not made in writing, as required for such a claim under the Employee Retirement Income Security Act of 1974. (*Karr v. Dow Agrosciences LLC*, S.D. Ind. 2012)

Presumption of Prudence Defeats Stock Drop Case

Litigation continues to proceed in so-called "stock drop" cases, which are typically class action lawsuits brought by plan participants when plan assets that are invested in employer stock have declined significantly in value. In a recent case before the U.S. District Court for the Eastern District of Pennsylvania, the court dismissed most claims brought by plan participants in the action.

The case in question involved shares of company stock held in a plan with both a 401(k) feature and an ESOP component. From 2007 to 2008, the value of the employer's stock declined by approximately 90 percent, prompting participants to bring numerous claims alleging breach of fiduciary duty under the Employee Retirement Income Security Act of 1974 (ERISA).

The court examined the plan documents and found that, while the plan did not require that employer stock must be offered within the plan, the plan document did more than simply permit the plan's fiduciaries to offer it as an option. Under the "more than simply permitting" standard, the court found that the presumption of prudence standard announced in the *Moench* case was applicable. Applying this standard, the court found that the participants had to show that the ERISA fiduciaries could not have reasonably believed that continued offering of employer stock in light of the plan's terms was in keeping with the expectation of how a prudent fiduciary would operate. Rather, participants would have to allege facts depicting a "dire situation," which would then require the fiduciaries to remove company stock as an investment.

Based on this standard, the court found that the participants merely alleged mismanagement of the company and made sweeping allegations of wrongdoing only with respect to information contained in certain securities laws filings. The court held that these allegations did not rise to the standard necessary to defeat the standard of presumption of prudence set forth in the *Moench* case. (*Schmalz v. Sovereign Bancorp Inc*., E.D. Pa. 2012)

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