EMPLOYEE BENEFITS DEVELOPMENTS NOVEMBER 2008

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Practices & Industries

Employee Benefits

2009 Benefit Limits Announced

The Internal Revenue Service and Social Security Administration have announced the cost-of-living adjusted dollar limits applicable to benefit plans for 2009. A listing of key limits is set out below: **2009 Limit** 401(k)/403(b)/457 plan maximum elective deferral $16,500 401(k)/403(b)/457 catch-up $5,500 Defined contribution maximum annual addition $49,000 Defined benefit maximum annual pension $195,000 Qualified plans maximum compensation limit $245,000 Highly compensated employee $110,000 IRA limit $5,000 IRA catch-up $1,000 SIMPLE limit $11,500 SIMPLE catch-up $2,500 Social Security taxable wage base $106,800

Mental Health Parity Provisions Made Permanent

As part of the Emergency Economic Stabilization Act of 2008, the mental health parity provisions, which were scheduled to expire December 31, 2008, were made permanent. Under revised provisions, effective January 1, 2009, the mental health parity requirements would also apply to services for substance use disorder. Additionally, changes were made in the qualification rule for exemption from the requirements if applying the mental health parity requirements results in increasing the plans costs.

Changes to Executive Compensation Rules under Economic Rescue Act

The Emergency Economic Stabilization Act of 2008 (EESA) made certain changes affecting employee benefits and executive compensation. Some highlights are:

- Section 457A was added to the Internal Revenue Code (IRC) which provides for taxation of amounts deferred under nonqualified deferred compensation plans at the time there is no further substantial risk of forfeiture of so-called "tax indifferent" partnerships and foreign corporations. Generally "tax indifferent" partnerships and foreign corporations are off-shore entities which are not subject to US tax or to foreign tax rules. New IRC Section 457A generally applies to amounts attributable to services performed after December 31, 2008. Additionally, amounts attributable to services prior to 2009 would be brought into income in 2017 or, if later, upon expiration of substantial risk of forfeiture.

- For financial institutions that receive assistance under EESA two levels of restrictions on compensation payments are applicable. For institutions in which the government maintains a meaningful debt or equity position through debt purchase the following restrictions may apply:

  - Limitations on compensation which provide for incentives for taking "excessive risks"

  - Clawback of incentive compensation paid pursuant to financial results that are proven to be materially inaccurate

  - Prohibition of making payments that would constitute golden parachute payments

For companies that receive more than $300 million in assistance and if at least some funds come through auction purchases of assets, additional restrictions apply:

- IRC Section 162(m) provides a limit on deductible compensation of $500,0000 with no exception for commission, performance-based compensation or grandfathering rules. The $500,000 limitation applies for periods after the officer is no longer a named executive officers. The limitation would apply to privately held companies.

- The golden parachute rules would be applicable to all involuntary terminations and terminations connected with bankruptcy or other insolvency proceedings and not just limited to change-in-control transactions.

- Entering into a parachute-type arrangement is prohibited

- Exceptions for small business corporations and shareholder approvals exemptions are limited Institutions that are receiving financial assistance under these programs should carefully review the interim guidance issued by the IRS in form of Notice 2008-94 and interim final regulations published at Fed. Reg. 2008-24781.

2008 Legislation Extends IRA Charity Distributions

The Pension Protection Act of 2006 amended IRA distribution rules to allow an IRA holder to direct up to $100,000 of a distribution from the IRA to a charity. A charitable donation from the IRA is excluded from gross income. This tax-free qualified charitable distribution rule only applied to distributions made in 2006 and 2007. Under new legislation adopted in October, 2008, the IRA charitable distribution rule has been extended to the 2008 and 2009 tax years. (H.R. 1424, signed

into law October 3, 2008).

IRS Issues Guidance on Qualified Reservist Distributions from Health FSAs

The Internal Revenue Service (IRS) recently issued Notice 2008-82 which provides guidance relating to the cafeteria plan provisions of the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART). HEART, passed in June 2008, contains provisions impacting health care flexible spending accounts (Health FSAs). HEART added section 125(h) to the Internal Revenue Code which permits cafeteria plans to provide qualified reservist distributions (QRDs) to eligible employees of all or a portion of the unused balances in their Health FSAs. QRDs are an exception to the general rule that a Health FSA may not make distributions other than for reimbursements of substantiated medical expenses.

An individual who participates in a cafeteria plan that provides for QRDs, may receive a distribution if:

- The individual is a member of a reserve component ordered or called to active duty for a period of 180 days or more or for an indefinite period, and

- The request for distribution is made during the period beginning with the order or call to active duty and ending on the last day of the plan year that includes the date of the order or call to active duty.

A QRD may only be made with respect to an employee's Health FSA balance in existence on or after June 18, 2008. An employer must pay the QRD to the employee within a reasonable period of time but not more than 60 days after the request for a QRD has been made.

Employers wishing to allow for QRDs must amend their cafeteria plans to provide for these types of distributions. Generally, a QRD may not be made before the cafeteria plan is amended to provide for a QRD from a Health FSA. However, the Notice includes a transition rule allowing plans to be retroactively amended to permit QRDs requested on or before December 31, 2009. The retroactive amendment must be made by December 31, 2009, and be effective retroactively to the date of the first QRD paid under the plan, but not prior to June 18, 2008. The transition rule does not allow an employee to request a QRD with respect to a plan year after the last day of the plan year during which the order or call to active duty occurred.

A QRD is included in the gross income and wages of the employee and is subject to employment taxes. The employer must report the QRD as wages on the employee's W-2 for the year in which the QRD is paid to the employee.

Michelle's Law Offers Extended Coverage for Critically Ill or Injured Students

Michelle's Law, signed by President Bush on October 9, 2008, will require most self-insured and many fully-insured group health plans to extend a student's medical coverage for up to one year if the student loses dependent status as a result of a medically necessary leave of absence or other change in enrollment (e.g., a change from a full-time to a part-time academic schedule).

Covered group health plans become subject to Michelle's Law on the first day of the plan year following October 9, 2009 (January 1, 2010 for calendar year plans). The law will apply to medically necessary leaves of absence or other changes in enrollment beginning on or after that date.

Michelle's Law is named after a New Hampshire college student who was diagnosed with colon cancer. Because she could not afford COBRA coverage, she was compelled to continue her studies on a full-time basis so that she could remain covered as a dependent under her family's health insurance plan. Unfortunately, Michelle lost her battle with cancer in 2005.

Covered Group Health Plans

Michelle's Law applies to self-insured and fully-insured group health plans if, under the terms of the plan, a child can qualify for coverage as a dependent based on student status at a post-secondary educational institution. This means, for example, that Michelle's Law will not apply to fully-insured plans funded by insurance policies issued in states which mandate coverage for "over-age" dependents regardless of student status. Self-insured state and local governmental plans may opt out of the requirements of Michelle's Law.

When Continuation is Required

A covered group health plan is required to offer continuation coverage in compliance with Michelle's Law with respect to a dependent child in the following circumstances:

- The child is enrolled in the plan as a dependent by reason of his or her status as a student at a post-secondary educational institution, and becomes seriously ill, or is seriously injured (as determined by the child's treating physician), while dependent coverage is in effect

- The child takes a leave of absence (or changes enrollment status) while suffering from the illness or injury

- The change in student status causes a loss of coverage

- The child's treating physician provides a written certification which states that the child is suffering from a serious illness or injury and that the leave (or other change in enrollment) is medically necessary given the nature of the illness or injury.

Length of Coverage

The one-year period of coverage begins when the change in student status begins. The continuation period may end before the expiration of the one-year period if the child's coverage would terminate for a reason other than loss of student status (e. g., the dependent "ages- out" of the student status provision).

Disclosure Requirements

A group health plan must include, with any notice regarding a requirement for certification of student status for coverage under the plan, a description of the terms of the plan with respect to Michelle's Law. Of course, a complete and accurate summary of this continuation right should be included in the plan's summary plan description.

Interplay with COBRA

Michelle's Law does not explain the interplay between Michelle's Law and COBRA. May a plan credit coverage under Michelle's Law against the dependent child's COBRA period? What impact, if any, does Michelle's Law have on COBRA notices?

Action Steps

Employers who sponsor group health plans will need to review the governing plan documents to determine whether Michelle's Law applies. If so, amendments will need to be in place by the required compliance date. As noted, calendar year plans must be in compliance by January 1, 2010. As with any new law, Michelle's Law does not address all important matters. The prospective effective date will afford the responsible government agencies the time to generate needed guidance. We will keep you apprised of these developments as they occur.

Eighth Wife Vests in QJSA Benefits Despite Husband's Remarriage

Overturning a lower court, the U.S. Court of Appeals for the Ninth Circuit ruled that a pension plan participant's ninth wife is not entitled to her husband's qualified joint and survivor annuity (QJSA) benefit, because the benefits had irrevocably vested in a former wife. The dispute arose between the eight and ninth wives of a participant who, at the time of his death, was receiving benefits in two qualified retirement plans, both of which provided QJSA benefits to a surviving spouse. At the time of his retirement in 1992, the participant was married to his eighth wife, who was designated as his survivor beneficiary under both plans. Two years later, they began divorce proceedings, and, as part of the divorce settlement, the participant was awarded both pensions as his sole and separate property. In 1997, the participant remarried and petitioned the Nevada family court for an order formally substituting his new wife as his surviving spouse for purposes of the QJSA benefits. Following the participant's death in 1999, the family court ordered the plan administrators to award the QJSA benefits to his ninth wife, concluding that the former wife had waived her right to the pension benefits under the property settlement agreement. The decision was upheld by the Nevada Supreme Court, and the eighth wife appealed. On appeal, the Ninth Circuit ruled that the surviving spouse at the time of the participant's retirement was entitled to his QJSA benefits after his death, because she had neither waived her interest in the benefits, nor consented to a different beneficiary. The family court orders were determined not to be valid qualified domestic relations orders (QDROs, because the orders were issued after the participant's retirement). As the participant's spouse at the time of his retirement, the eighth wife was held to have irrevocably vested in the QJSA benefit at that time. No QDRO could later reassign the benefits to a subsequent spouse. The appeals court also rejected the argument that the former wife had waived her right to surviving spouse benefits under the settlement agreement, ruling that the only way under the Employee Retirement Income Security Act for a surviving spouse to effectively waive his or her right to benefits is for both the participant and his spouse to waive the benefits in writing during the applicable election period. *Carmona v. Carmona*, 9th Cir. 2008.

Retirees Efforts to Preserve Unvested Post-Retirement Welfare Benefits Unsuccessful in Two Cases

Generally, welfare benefit plans, unlike pension plans, are not subject to the vesting requirements under the Employee Retirement Income Security Act (ERISA), and an employer is able to amend a welfare benefit plan to eliminate a welfare benefit as long as there is no contrary contractual provision expressly vesting the benefit. In two recent noteworthy cases, retirees were unsuccessful in litigation commenced to preserve their welfare benefits. First, the court, in *Poore v. Simpson Paper Co. (9th Cir. 2008)*, held that retirees' health benefits were not vested under ERISA and the retirees therefore lacked the necessary standing to sue their employer when those health benefits were eliminated. The court found the health

benefits were not vested because the relevant collective bargaining agreement incorporated by reference a benefits booklet that reserved to the employer the right to negotiate a cancellation of the benefits. The court also concluded that the company retained the exclusive authority to change retirement health benefits irrespective of the outcome of the negotiations.

Second, in *In re Lucent Death Benefits ERISA Litigation (3rd Cir. 2008)*, the court held that a death benefit payable under a pension plan (i.e., a lump-sum payment made in the event of a pensioner's death) was an unvested welfare benefit that could be terminated without violating ERISA's anti-cutback rule or unilateral contract principles. The court opined that the evidence showed the death benefit does not meet ERISA's definition of a pension benefit because the death benefit neither provides retirement income to employees nor results in a deferral of income by employees, and that there was nothing in the plan documents to suggest the death benefit vests during the life of the pensioner. The court indicated that the plan documents did not state such vesting in clear and express language. Accordingly, the federal appeals court affirmed the decision of the district court dismissing the retirees' complaint.

90-Day Election Period Satisfies Tax Rules

One requirement found in the Treasury Regulations for pension plans is a rule that a "significant detriment" cannot be imposed on a plan participant who defers early receipt of a pension benefit. For example, a 401(k) plan cannot impose unreasonable charges on the account of a terminated vested participant who has not consented to a plan distribution following separation from service. In a case arising in the Seventh Circuit, a participant complained about the 90-day election period imposed by a pension plan to choose between a lump sum distribution or a periodic pension at retirement age. The participant chose the lump-sum but later regretted that decision. The participant then sued the plan alleging that the 90-day election period following separation unreasonably pressured the participant into making a benefit decision and that the election period constituted an impermissible "significant detriment" on the plan benefit. Declaring that the establishment of a limited period to choose a cash lump sum does not diminish the value of a pension, the court denied the participant's claim. *McCarter v. Retirement Plan for the District Managers of the American Family Insurance Group (7th Circuit, 2008)*.

Former Employees Have Standing to Sue Plan For Fiduciary Breach

The Ninth Circuit joined the First, Third, Fourth, Sixth, Seventh, and Eleventh Circuits in holding that a former employee who received a full distribution of his account under a defined contribution plan has standing to file suit under the Employee Retirement Income Security Act (ERISA). In this case, the plaintiff sued his former employer alleging a fiduciary breach for imprudently investing the non-participant-directed plan assets. Specifically, the plaintiff alleged that plan assets should have been invested in money market accounts in light of a set of circumstances that suggested that the plan would soon be terminated and therefore had a short investment horizon. The Ninth Circuit vacated a lower district court decision that the former employee did not have standing. The district court ruled that the plaintiff was no longer a "participant" because he received a full distribution from his account. The district court reasoned that, as a non-participant, any relief from the plan would be characterized as damages, relief unavailable under ERISA. In contrast, the Ninth Circuit's holding theorized that the plaintiff did not receive the "full" benefit he was entitled to under the plan because the amount of his lump sum distribution was reduced by the alleged fiduciary breach. This case, and cases like it, are important to employers because they potentially expand the population to whom employers owe a fiduciary duty. Following from this decision, and others like it, it is possible that employers would be held responsible for fulfilling other fiduciary responsibilities to former

employees, such as the provision of requested plan information or documentation. *Vaughn v. Bay Environmental Management Inc.*, (9th Cir., 2008).

San Francisco Health Care Ordinance Upheld

In another attempt at the state and local level to address the population of individuals with no health insurance, the city of San Francisco enacted an ordinance to establish a health care program for uninsured citizens and to require employers to make a specified level of health care expenditures on behalf of their employees. The Golden Gate Restaurant Association challenged the law on the basis that it is preempted by the Employee Retirement Income Security Act (ERISA) and its preemptive rule that precludes state or local regulation of employee benefit plans. ERISA's preemption clause has been involved in a fair amount of litigation in this area as states have made different attempts to expand health insurance coverage. The San Francisco ordinance does not require employers to establish health care plans, it does not require any specific benefit provisions in existing plans, and it is not concerned with the nature of health care benefits provided to employees. It is focused on the dollar amount of the payments an employer makes toward employee health benefits. If the required expenditures are not made in some way, the employer is then required to pay the mandated amount to the city. In general, the required expenditure levels are $1.17 per hour for non-profit employers and $1.76 per hour for taxable employers. The restaurant association argued that the required payments to the city and its associated health care program created an impermissible ERISA benefit plan. Alternatively, the association asserted that the mandated employer expenditures was a state law that "related to" an ERISA employee benefit plan and was therefore preempted. A district court decision ruled in favor of the association and enjoined the implementation of the employer spending requirements. The 9th Circuit Court of Appeals has reversed this decision and has upheld the San Francisco ordinance. The Court distinguished this case from other "pay or play" statutes on the basis that the San Francisco law has no criteria for the health care expenditures or any prescribed coverages. As states and the U.S. Congress continue to debate health care policy, we may see the enactment of more state and local laws dealing with the issue as well as continued litigation over the scope of those laws. For the time being, the San Francisco law may be copied in other places if this preemption decision holds up. *Golden Gate Restaurant Association v. City and County of San Francisco* (9th Circuit 2008).