Hodgson Russ LLP ATTORNEYS

EMPLOYEE BENEFITS DEVELOPMENTS SEPTEMBER 2008

Hodgson Russ Newsletter
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Practices & Industries

Employee Benefits

IRS/DOL Rulings, Opinions, Etc.

Proposed Rules for Reporting Statutory Stock Transfers.
The Internal Revenue Service (IRS) recently proposed new rules for information reporting related to the exercise and disposition of statutory stock options. Reflecting changes to Section 6039 of the Internal Revenue Code (IRC) made under the Tax Relief and Health Care Act of 2006, the proposed regulations require corporations to furnish employees with sufficient information to enable them to calculate their tax obligations upon disposition of the shares acquired by the exercise of an incentive stock option (ISO) or the transfer of stock acquired under an IRC Section 423 employee stock purchase plan (ESPP). With respect to ISOs, the information required to be furnished to employees under existing regulations was determined to be generally sufficient to enable them to calculate their tax obligations. Where the existing regulations require only that the corporation report the total cost of all shares acquired, the new rules would require instead the reporting of the exercise price per share. This information is considered more readily usable by employees in calculating their taxes on disposition of some or all of the shares. In addition to information already required, the proposed regulations also would require a corporation that transfers a share of stock under an ESPP to provide the following information on its returns: (1) the date of grant of an option; (2) the fair market value of a share of stock on the grant date; (3) the exercise price per share; (4) the date of exercise; and (5) the fair market value of the stock on the date of exercise. The information returns must be filed by January 31 of the year following the calendar year for which the returns are required. The IRS expects to release the required information returns later this year. (IRS Prop. Reg. §1.6039; 73 Fed. Reg. 40999; corrections issued 73 Fed. Reg. 47563)

IRS Proposes Updated Regulations for Employee Stock Purchase Plans.
In 2004 the Internal Revenue Service (IRS) requested comments as to whether and how the existing regulations governing Internal Revenue Code (IRC) Section 423 employee stock purchase plans (ESPPs) should be changed. In response to the comments it received, the IRS has now issued comprehensive new proposed regulations governing ESPPs. Designed in part to make the ESPP rules more consistent with the regulations governing incentive stock options, the proposed rules

also update the ESPP regulations for statutory changes, provide additional guidance in a number of areas, and remove obsolete rules. For example, the proposed regulations clarify existing rules and provide additional guidance regarding the following issues:

- circumstances that trigger the need for new shareholder approval of the plan;
- changes in the maximum aggregate number of shares available for grants;
- the exclusion of certain categories of employees;
- exceptions to the requirement that all participating employees have the same rights and privileges;
- determination of the option price and the date of grant;
- operation of the annual $25,000 purchase limitation for individual employees; and
- the individual or plan-wide consequences of certain failures to comply with plan terms or ESPP requirements.

The new rules are effective for any ESPP option issued on or after January 1, 2010. In the interim, taxpayers may rely on the proposed regulations for any ESPP option that is granted after July 29, 2008. (IRS Prop. Reg; §1.423, 73 Fed. Reg. 43875)

DOL Proposed Fee Disclosure Regulation.
Recently, the Department of Labor (DOL) issued proposed regulations that would require the disclosure of plan investment related information, including fees and expenses, to participants in plans with participant-directed investment accounts. The DOL points out that plans that elect to comply with Employee Retirement Income Security Act (ERISA) section 404 (c) already disclose information to participants about their plans and designated investment options. However, compliance with section 404(c) is voluntary and, because not all plans elect to comply, the 404(c) disclosure requirements do not extend to all participant-directed plans. The goal of these proposed regulations is to empower all participants by providing them with information needed to make sound investment decisions. A major focus of the proposed regulations is not only providing participants information, but also providing the information in a format that is easy to use and understand. To that end, the DOL created a model comparative chart that will enable participants to evaluate investment choices by comparing information. Information that must be disclosed includes:

- Investment options available under the plan and how to provide investment direction;
- Fee and expense information, past performance data, comparable benchmark returns, and a web site address;
- A description of fees and expenses related to plan administrative services, and how these charges will be allocated to individual accounts; and
- A description of fees and expenses charged to a specific participant's account based on actions taken by that participant, such as charges for processing loans, QDROs, or investment advice.

While the DOL is not requiring use of the model chart, fiduciaries that use the DOL model chart will be deemed to have satisfied their disclosure obligations under these proposed regulations.

The timing of the disclosure of this investment information is also addressed by the proposed regulations. Information must be disclosed when a participant first becomes eligible to participate in the plan, and on an annual basis thereafter. In addition, on a quarterly basis, plan fiduciaries must disclose to participants the actual amount charged to their account during the preceding quarter for administrative expenses.

The proposed effective date for these regulations is for plan years beginning on and after January 1, 2009. (DOL Prop. Reg. §2550.404a–5; 73 Fed. Reg. 43014)

IRS Publishes New Rules Under 409A for Annualized School-Year Compensation Elections.
There is new guidance on Internal Revenue Code Section 409A ("409A") and its application to annualized school-year compensation elections (i.e., elections to pay salary over 12 months for employees who work 10 months). Under 409A guidance in effect prior to July 1, 2008, school districts that offer teachers or other employees who work 10 months a choice between payments over a 10-month or 12-month period were required to take the following steps prior to commencement of the 2008-2009 school year:

- the district must establish a written procedure (but not necessarily a separate plan document) for the election of the payment period; and
- the employee must provide a written election to the district that identifies how the employee wishes to be paid.

On July 1, 2008, however, the IRS published new guidance in the form of Notice 2008-62 that significantly modifies how 409A is applied to annualized school-year compensation elections by 10-month school employees. Now, under the new guidance, a school employee who defers a portion of his or her compensation from one calendar year to the next as part of an annualized school-year compensation election would neither be subject to the potential extra taxes (under 409A), nor be required to sign the irrevocable election form as required under earlier guidance if the arrangement: (1) does not defer payment of any of the recurring part-year compensation beyond the last day of the 13th month following the beginning of the service period, and (2) does not defer from one calendar year to the next the payment of more than the applicable dollar amount under Internal Revenue Code Section 402(g)(1)(B) in effect for the calendar year in which the service period begins ($15,500 for 2008). A school district also would not be obligated to establish written procedures for an arrangement satisfying these conditions.

In practical terms, the new guidance should be applicable to virtually all school employees in districts where the school year begins September 1 because a 10-month school employee would have to have annual compensation exceeding $232,500 (for 2008) to not to be covered by the new IRS guidance. If the school year begins August 1, annual compensation would have to exceed $186,000 (for 2008) in order for the 10-month school employee not to be covered by the new IRS guidance. The new guidance is effective beginning with the 2008-2009 school year. (Notice 2008-62; www.irs.gov/pub/irs-drop/n-08-62.pdf)

Cases

Second and Ninth Circuits Holds Cash Balance Plans Not Age Discriminatory.
Resolving a dispute among district court cases in the Second Circuit (see Employee Benefit Developments March 2008), the Second Circuit (*Hirt v. Equitable Retirement Plan for Employees, Managers and Agents*, 2d Cir., 2008) has ruled that cash

balance pension plans are not age discriminatory in violation of ERISA. The Ninth Circuit also reached a similar conclusion. (*Hurlic v. Southern California Gas Co.*, 9th Cir., 2008) Thus, the Second and Ninth Circuits have joined with three other Circuits (Third, Sixth, and Seventh) holding that cash balance plan design is not per se discriminatory. Similarly, the U.S. District Court for the District of Colorado has held that a pension equity formula is not discriminatory. (*Wells v. Gannett Retirement Plan*, D. Colo., 2008)

Fiduciary Representatives Beware.
When responding to inquiries by participants or beneficiaries, ERISA fiduciaries have an obligation to provide complete and accurate information. In fact, at least one court has held that it isn't enough to respond only to the question posed if the fiduciary knows (or should know) that information not specifically requested is important to the participant or beneficiary. Under these circumstances, the fiduciary is obliged to provide the additional information.

A recent case reminds us that a fiduciary can be sued when a participant or beneficiary believes he or she has lost a benefit entitlement because the fiduciary failed to provide all of the information the fiduciary (or beneficiary) needed to make an informed decision. In this case, the trustees of a multiemployer pension fund were sued by the heirs of a deceased participant who was eligible for retirement but died of cancer before the effective date of his retirement election. As a result of his death before retirement, his retirement benefit (for all practical purposes) was forfeited. The heirs claimed that the plan representative was, at all relevant times, aware of the participant's terminal condition, yet failed to advise him that if he elected to retire under a "10-Year Certain Annuity" (an annuity option that continues payments to a retiree's beneficiaries if the retiree dies before the 10-year period) his heirs could collect benefits following his death. This breach of duty, they claimed, was the cause of the loss of benefits. As a general rule, fiduciaries are not required to provide information or advice tailored to the individual circumstances of participants and beneficiaries. However, once this obligation is undertaken, it must be done in accordance with ERISA's prudence standards (i.e., with the care, skill, and diligence a prudent person would exercise under the circumstances). In this case, the court held that the fiduciaries failed to meet this standard. The court sided with the heirs, ruling that the heirs were entitled to the benefits they would have received if the participant had retired under the 10-Year Certain Annuity. If this decision is appealed, it is possible the fiduciaries will prevail. However, that victory, if it comes, will be achieved at considerable expense. (*Anderson v. Board of Trustees of the Northwest Ohio United Food and Commercial Workers Union and Employers' Joint Pension Fund*; N.D. Ohio, 2008).

Careful Plan Drafting Prevails.
A group of managerial employees was covered under a non-qualified plan under which stock of the employer could be purchased at a discount. The plan was voluntary. Under the arrangement a covered employee could elect to divert a portion of current compensation to be applied to the purchase of the discounted stock. Stock purchases occurred each six months. At the end of each six-month period, the compensation that had been foregone during the period was applied to a stock purchase. Once the stock was purchased, a vesting schedule applied. If the employee left employment before vesting (over two or three years), the shares would be forfeited, including the value of the compensation diverted to purchase the shares. A description of the forfeiture rule was included in the documentation of the program. Although some elements of the program did not refer to a forfeiture of the compensation applied to purchase the shares as a consequence of a forfeiture of the shares, this point was made clear in several of the plan's documents and disclosures. The propriety of the forfeiture of compensation used to purchase stock under the plan was challenged by a group of participants who left employment before vesting. The challenge alleged various causes of action, including breach of contract, fiduciary breaches and an illegal

conversion of the employee's compensation used to purchase forfeited stock. The claims were dismissed by a Federal district court and affirmed on appeal. While every reference in every document relating to a forfeiture did not explicitly refer to a forfeiture of the compensation used to purchase the stock, the plan's overall documentation was consistent and made adequate reference to a plan prospectus and other disclosures that described the scope of plan forfeitures. In upholding the employer's application of the plan's forfeiture rules, the court did not allow the participants to isolate portions of the documentation in their attempt to characterize the program as inconsistent or ambiguous. The plan did not violate any standard of law, and the well-drafted plan withstood the challenge. (*In re Citigroup Inc. Capital Accumulation Plan Litigation*, 1st Cir. 2008).

Top-Hat Plan Does Not Result in ERISA Violation.
A federal appeals court ruled that an employer that terminated a top-hat plan did not violate ERISA. The plan was a contributory, defined benefit top-hat plan with a split-dollar life insurance benefit. Under the terms of the plan, the executive who brought the lawsuit chose an option that would have provided him with a $15,000 per year annuity for 10 years starting at age 65, a life insurance policy with a $95,000 cash value, and a paid-up death benefit of $375,000. As part of an early retirement package, the executive received 65% vesting in the deferred compensation plan which effectively gave him a 10-year payment at age 65 of $9,750, a life insurance policy having a post-age 65 cash value of $61,750, and a death benefit of $243,750.

The plan included a provision that allowed a plan termination if proposed or pending tax law changes or other events cause the plan to have an adverse financial effect on the employer. In 2000, the employer decided to terminate the plans on the grounds of unfavorable interest rates and declining participation. The terms of the plan, however, stated that if the plan is terminated before benefits have commenced, the executive is to receive a lump sum distribution of his deferrals to the date of termination, plus 6% interest. The plan was terminated six months before the executive's benefits would have commenced, and he was refunded his contributions plus interest in a lump sum amount of $75,419.

The federal trial court ruled that the plan's termination provisions gave the employer the right to terminate the plan. In his appeal to the Second Circuit, the executive argued that the employer breached its fiduciary duties under ERISA by terminating the plan. The appeals court found that the termination of the plan was permitted under the plan and, in doing so, rejected the executive's claim that the employer should be equitably estopped from terminating the plan because the early retirement package he received allegedly guaranteed he would receive benefits when he reached age 65. The court found that the plan's provisions giving the employer the right to terminate the plan superseded the terms of the early retirement package, in part due to a disclaimer in the early retirement brochure which indicated that the brochure provided only summaries of the early retirement package, and that the plan documents and insurance contracts would govern in any conflict between the brochure and the underlying benefit plans. The court's reliance on the disclaimer is noteworthy, particularly because there have been other cases where courts have disregarded similar disclaimers. (*Paneccasio v. Unisource Worldwide Inc.*, 2nd Cir. 2008)